The Hidden Value Of Intangibles
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What can explain the runaway success of an initial public offering from a company with no earnings history? On the other hand, why can a bit of bad news or an earnings report that just misses market expectations send a healthy company's share price into a nosedive?

When the market ignores a company's historical financial performance, the market is often responding to "information asymmetry". The asymmetry occurs because traditional financial reporting methods - audited financial reports, analyst reports, press releases and the like - disclose only a fraction of the information that is relevant to investors. The value of intangible assets - research and development (R&D), patents, copyrights, customer lists and brand equity - represents a large part of that information gap.

Any business professor will tell you that the value of companies has been shifting markedly from tangible assets, "bricks and mortar", to intangible assets like intellectual capital. These invisible assets are the key drivers of shareholder value in the knowledge economy, but accounting rules do not acknowledge this shift in the valuation of companies. Statements prepared under generally accepted accounting principles do not record these assets. Left in the dark, investors must rely largely on guesswork to judge the accuracy of a company's value.

A study comparing market value to the book value of 3,500 U.S. companies over a period of two decades shows the dramatic upward rise in intangible value. In 1978, market value and book value were pretty much matched: book value was 95% of market value. Twenty years on, book value was just 28% of market value. Lev Baruch, an accounting professor at New York University's Stern School of Business, reckons that in the late 1990s businesses invested a staggering $1 trillion per year in intangible assets.

Accounting rules have not kept pace. For instance, if the R&D efforts of a pharmaceuticals company create a new drug that passes clinical trials, the value of that development is not found in the financial statements. It doesn't show up until sales are actually made, which could be several years down the road. Or consider the value of an e-commerce retailer. Arguably, almost all of its value comes from software development and copyrights and its user base. While the market reacts immediately to clinical trial results or online retailers' customer churn, these assets slip through financial statements.

There is a serious disconnection between what happens in capital markets and what accounting systems reflect. Accounting value is based on the historical costs of equipment and inventory, whereas market value comes from expectations about a company's future cash flow, which comes in large part from intangibles such as R&D efforts, patents and good ol' workforce "know-how".

Investors' jumpiness about valuation hardly comes as a surprise. Imagine investing in a company with $2 billion market capitalization but with revenues to date of only $100 million. You would probably
suspect that there is a big grey area in the valuation picture. Perhaps you would turn to analysts to supply missing information. But analysts' metrics help only so much. Rumor and innuendo, PR and the press, speculation and hype tend to fill the information space.

In order to better milk their patents and brands, many companies do measure their worth. But these numbers are rarely available for public consumption. Even when used internally, they can be troublesome. Miscalculating the future cash flows generated from a patent, say, could prompt a management team to build a factory that it cannot afford.

To be sure, investors could benefit from financial reporting that includes improved disclosure. Already a dozen or so countries, including the U.K. and France, allow recognition of brand as a balance sheet asset. The Financial Accounting Standards Board is currently involved in a study to determine whether or not it should require intangibles on the balance sheet. However, because of the enormous difficulty of actually valuing intangibles and the big risk of inaccurate measurements or surprise write-downs, investors should not expect that decision to come any time soon.

It nevertheless pays for investors to try to get a grip on intangibles. Much accounting research is devoted to coming up with ways of valuing them, and, fortunately, techniques are improving. While opinions on suitable approaches still vary sharply, it is worthwhile for investors to take a look.

Here is a place to start: try calculating the total value of a company's intangible assets. One method is calculated intangible value (CIV). This method overcomes drawbacks of the market-to-book method of valuing intangibles, which simply subtracts a company's book value from its market value and labels the difference. Because it rises and falls with market sentiment, the market-to-book figure cannot give a fixed value of intellectual capital. CIV, on the other hand, examines earnings performance and identifies the assets that produced those earnings. In many cases, CIV also points to the enormity of the unrecorded value.

Using microprocessor giant Intel as an example, CIV goes something like this:

**Step 1:** Calculate average pre-tax earnings for the past three years. For Intel, that's $9.5 billion.

**Step 2:** Go to the balance sheet and get the average year-end tangible assets for the same three years, which, in this case, is $37.6 billion.

**Step 3:** Calculate Intel's return on assets (ROA), by dividing earnings by assets: 25% (nice business to be making chips).

**Step 4:** For the same three years, find the industry's average ROA. The average for the semiconductor industry is around 11%.

**Step 5:** Calculate the excess ROA by multiplying the industry average ROA (11%) by the company's tangible assets ($37.6 billion). Subtract that from the pre-tax earnings in step one ($9.5 billion). For Intel, the excess is $5.36 billion. This tells you how much more than the average chip maker Intel earns from its assets.
**Step 6:** Pay the taxman. Calculate the three-year average income tax rate and multiply this by the excess return. Subtract the result from the excess return to come up with an after-tax number, the premium attributable to intangible assets. For Intel (average tax rate 34%), that figure is $3.53 billion.

**Step 7:** Calculate the net present value of the premium. Do this by dividing the premium by an appropriate discount rate, such as the company's cost of capital. Using an arbitrary discount rate of 10% yields $35.3 billion.

That's it. The calculated intangible value of Intel's intellectual capital - what doesn't appear on the balance sheet - amounts to a whopping $35.3 billion! Assets that big deserve to see the light of day.

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