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GETTING A GRIP ON INTANGIBLES

As M&A activity builds, better methods of evaluating a company's goodwill—often a huge chunk of its value—can make the difference between success and failure.

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By **Russ Banham**

For the past two years. companies have hunkered down and hoarded equity capital and cash on their balance sheets, bringing mergers and acquisitions to a virtual halt. With dealmaking reviving, bidders would be wise to stop, catch their collective breath and ask, "Am I buying what I think I'm buying?" That's the message from Mary Adams, co-author, with Michael Oleksak, of a new book, *Intangible Capital*. In it, they argue that many mergers and acquisitions come unglued because the customary methods of valuing a target company's intangible assets fail to tell the full story. While no finance executive would disagree that putting a number on an intangible asset like goodwill is more art than science, in a transaction where shareholders are scrutinizing every dollar spent, a better way is surely needed.

If intangible assets were only a small fraction of a company's value, they might not make much of a difference in whether a deal succeeds. But according to an Ernst & Young survey of 709 M&A transactions in 2007, intangibles essentially are the company. The survey indicates that a mere 30% of the average purchase price of a company could be allocated to tangible assets, while 23% could be allocated to identifiable intangible assets like customer lists, contracts and intellectual property. That leaves a whopping 47% in goodwill—the extra value ascribed to a company by virtue of its brand and reputation.

"Goodwill is basically a fudge factor," Adams asserts. "This means that the acquirers were unable to identify the source of roughly half of the value of the acquired company. This is not something that management teams or investors should continue to tolerate. It's a failure of the accounting system to provide helpful information on intangibles."

No wonder so many mergers fail to deliver on expectations. "They don't meet the projections used to price the deal and the intangibles on the balance sheet, which means the goodwill has to be written down," says Adams. "If you can't identify what you're buying going into the deal, how can you do a good job managing it after the deal closes?"

It's a conundrum that many companies are likely to encounter now that M&A is back on track. The first half of 2010 saw 5,026 global M&A deal announcements totaling $881 billion in value, a 13.3% increase from the first half of 2009, according to Mergermarket. The second half of the year continues the trend, given such big-ticket announcements as Intel's $7.68 billion bid for security company McAfee, and mining company BHP Billiton's $40 per share hostile tender offer for Potash Corp. of Saskatchewan, which has since ignited a bidding war with China's Sinochem.

Other deals include Hewlett-Packard's purchase of data storage company 3Par for $2.4 billion, and Intel's plans to consume the wireless unit of Germany's Infineon Technologies for $1.4 billion. "Mergers come in clusters," says Mark Sirower, leader of the commercial due diligence practice at Deloitte Consulting. "Companies have lots of cash on the books, and private equity has lots of funds they need to invest. The amount of M&A activity was strong in the first half of the year and it has only gotten stronger."

Others agree. "Private equity has more than $400 billion in capital sitting in these funds that has to be spent over the next 18 months," says Dan Tiemann, partner in charge of the transactions and restructuring practice at KPMG. "It's a situation of 'use it or lose it.' They seem to be using it.

"Last year, private equity represented only 5% of deals, but they've accounted for 20% through June," Tiemann adds. The big deals we're seeing send a message of confidence, which then encourages other companies to make bets."

"We're facing the foothills of the next boom in M&A activity," agrees Robert Bruner, dean of the Darden Graduate School of Business at the University of Virginia and author of the book *Deals from Hell*.

"Waves of M&A activity are created by capital market conditions like low interest rates and attractive cash financing conditions, regulatory upheaval creating winners and losers in an industry, and economic activity like the rebounding of Germany and the buoyancy of countries like Brazil, China, India and other emerging countries, which opens the door to more cross-border transactions," Bruner says. "All three factors are now in place."

The pickup in mergers and acquisitions promises more failed combinations down the line, Bruner notes, citing such bust-ups as AOL-Time Warner, Daimler-Benz-Chrysler, Mattel-Learning Co. and Quaker Oats-Snapple. Private equity hasn't been immune, as Cerberus Capital Management's brief ownership of the foundering Chrysler demonstrated.

Adams believes a better grasp of targets' intangible assets will reduce the carnage. "I don't want to give the impression that intangibles do not get valued in today's business world; they get valued all the time, through discounted cash flow, fair value and other valuation approaches," she says. "The problem is that these approaches don't give the full picture of the target company."

Stephan Thollot, a partner in the transaction advisory services division of Ernst & Young in New York, which produced the report on intangible capital, has a similar view of valuation methodologies. "The techniques usually rely on forward-looking information, which makes their forecasting subject to uncertainty," he says.

While acquirers spend much time on detailed due diligence and assessing synergies, they devote far less to "determining what intangible assets target companies have, and how valuable these are in the marketplace," Thollot adds.

Adams, co-founder of consultancy I-Capital Advisors in Winchester, Mass., groups intangible assets into three categories—human capital (the competencies, experience and depth of employees and management); relationship capital (shared knowledge with customers, suppliers, banks, vendors or other close business relationships); and structural capital (systems, processes, databases and intellectual property like patents, trademarks and trade secrets). "These assets are a company's knowledge factory and infrastructure for growth," she says.

To continue to operate this factory, Adams says, the acquirer must know how much investment is needed to preserve and build capacity, the kind of growth it can expect from these investments, and, most importantly, the return they will yield.

Her message resonates with Roger Shannon, CFO and treasurer of Steel Technologies, a Louisville, Ky.-based steel processor with more than $1 billion in 2009 revenues. "Both the tangible and intangible assets have the same value, that is, the value of the cash flows resulting from them," he says. "If you buy a company with machinery, this fixed asset is expected to create cash flow. The same applies to the intangibles. While valuation firms and Big Four accounting firms have developed models for this stuff, putting a value on the intangibles is extremely difficult."

Darden's Bruner concurs: "Valuing intangibles is extremely difficult, and subject to wild variations in findings from one expert to the next. Consequently, accounting firms take a very conservative approach to valuing intangibles, awarding very little value to them."

In an M&A context, this lack of certainty gives pause. Adams advises buyers to make up the shortfall—to sift the wheat from the chaff in a target's intangibles. Some are doing just that.

"We've learned that pricing a deal has more to it than just confirming the [target's] financials," says Paul Reilly, CFO and executive vice president at Arrow Electronics, a Melville, N.Y.-based global distributor of electronic components and enterprise computing solutions with $18 billion in 2009 revenues. "It's the intangibles—the stuff you can't see for the most part—that tell a truer picture of a company's value."

Arrow closed four acquisitions in the last year. As part of the financial due diligence for these deals, the company's M&A team, of which Reilly is the senior member, invested time evaluating the targets' bench strength. "I don't necessarily mean just the senior officers, but the people who truly make a difference at an organization," Reilly says. "It could be someone in sales or in customer service. If they leave after the deal closes, you haven't bought what you thought you bought."

He adds that it’s not uncommon for Arrow to identify key salespeople and make it a condition of the closing that they stay on for two or three years. A similar process applies to other employees. “If the target has the same customer we have, and their customer service rep has a better relationship with this customer than our person does, we don’t insist that our guy take the reins,” Reilly adds. “We select the better person to serve the customer.”

The PMI Group takes a different tack. “We like to pair up our key people with the target’s key people—treasurer with treasurer, controller with controller, for instance—to get a firmer grasp of their human capital,” says Don Lofe, executive vice president and CFO of the Walnut Creek, Calif.-based mortgage insurer with 2009 revenues of $1 billion. “It’s up to our people, who know our culture, systems and process, to dig deeply into their people to reduce the potential of a mismatch.”

To reduce the risk of losing human capital once a deal closes, Corning Inc. often inks a joint development agreement with a target before executing the acquisition. “It helps us assess the people and culture more intimately and fully,” says Larry McRae, senior vice president of strategy and corporate development at the Corning, N.Y.-based maker of specialty glass and ceramics with $5.8 billion in 2009 revenues. “Once we feel secure in this assessment, we make sure we have an agreement that key people will continue in their current capacity before we sign the deal to acquire.” Corning announced two acquisitions in the past year—Axygen BioScience and Plaslab.

While Adams sees such practices as useful, she believes buyers can augment them by analyzing how much the target has invested in intangibles, and the yield this has produced. “Track the expenditures the target has made in its human capital—how much it has spent on talent acquisition, training and staff development,” she says. “Apply the same rigor to structural capital—the target’s internal costs on process development, its external costs on process development consulting, and the expenses in developing software for internal systems, and on research and development. Also look at the spend on relationship capital, things like customer acquisition costs or the expenses on brand building. How much has it spent on outsourcing partners and product or quality certifications?”

The next step is to look at this data against company yield metrics. For example, Adams suggests comparing the target’s investments in a particular intangible asset to its revenue growth over a three-year period. “The resulting ratios provide a rich source of information about a target’s value creation, making the connection between intangibles and financials clearer,” she says. “It’s a really powerful way to quickly get to know how a company actually works—the human, relationship and structural assets like processes and intellectual property that help them create value for customers and drive revenues.”

Failure to track these investments, on the other hand, is akin to tossing a dart in the dark. “Balance sheets explain only 20% of the value of the average corporation,” says Adams. “No one can explain the other 80%, except to point you to the expected cash flow generation of the company. It’s a dangerous misinformation loop. If you fail to track the investments in intangibles, you can’t see the value that has been built.”

While all this sounds doable and smart, getting to the data underlying the valuation isn’t always a walk in the park. “The problem is getting access to the target’s customers and counterpartie—like suppliers and outsourcing partners,” says Doug Leary, a partner in the Washington office of Sutherland Asbill & Brennan, a law firm with a significant M&A practice. “The target will fight this tooth and nail. They get very nervous that word will get out they’re selling the company. For example, a counterparty might think its relationship with the company will end once the partner is acquired. Or a key employee might jump ship, thinking his or her employment will soon be terminated.”

Adams counters that stakeholder interviews can be conducted a couple of weeks before closing “without telegraphing that a deal is under way,” she says. “You’re not asking about a deal, you’re measuring the strategic strength of a company’s intangible capital. In my experience, deals always take much longer than everyone wants or expects, and there is time to pull this off.

“I know of one case where the seller finally assented to this kind of review when they weren’t getting any bids,” she adds. “The transparency of the information that resulted from the review helped the company get multiple strong bids in the end.”

Invisible assets were made visible, Adams notes. And that’s always better than buying a pig in a poke.

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