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### ***TRYING TO GRASP THE INTANGIBLE***

#### ***THE ASSETS THAT REALLY COUNT ARE THE ONES ACCOUNTANTS CAN'T COUNT--YET. HERE'S ONE WAY TO PUT A DOLLAR VALUE ON CORPORATE KNOWLEDGE.***

Your boss is an idiot. You've got this great idea, a strong staff, a half-finished project that all evidence suggests is worth tens of millions, and the idiot kills it.

You quit. Like the little red hen, you'll do it yourself. You take a second mortgage, borrow from your uncle the entrepreneur, persuade a couple of your old staffers to join you, get to where all you need is serious money--and not that much, really, a couple of mil--and make an appointment with Harry at the bank. The bank where your uncle the entrepreneur banks, where you yourself have never missed a mortgage payment. You show Harry the business plan. The prototype. The letters from potential customers. The market research. And Harry, bless his banker's tiny heart, asks just one question before turning you down: "What do you have as collateral?" It occurs to you then that in all these years you've never seen Harry with his jacket off.

I mean, you have assets, lots of assets, but they're intangible--between your ears, on this little diskette, in that patent filing. The whole point is to build a virtual corporation; you'll contract out the manufacturing, warehousing, distribution. You don't have brick and mortar, and you don't want it. But banks don't know the difference between assets and a hole in the ground.

A memory stirs--a smirking, familiar voice: Welcome to that corner of the Information Age that is known as...The Twilight Zone.

Some real-life version of this fable occurs every day: Managers, owners, and investors struggle to make sense of a business whose true assets aren't on the books. A report prepared by Arthur Andersen for 11 large British companies states: "In successful companies, the value of such assets is growing as a proportion of total shareholder value." Indeed: Margaret Blair, a Brookings Institution economist, has calculated the relationship between tangible assets (property, plant, and equipment) and total market

value for U.S. manufacturing and mining companies in the Compustat database. In 1982, she found, hard assets accounted for 62% of the companies' market value; ten years later they made up only 38%. And these were industrials.

Some enormously successful enterprises have almost no tangible assets. A corporate metaphysician can argue, for example, that Visa International, though it processes financial transactions worth two-thirds of a trillion dollars a year, doesn't exist: Each member financial institution exclusively owns that portion of the Visa business it has created. Founder Dee Hock calls it "an inside-out holding company, in that it does not hold but is held by its functioning parts." Similarly, shareholders of EDS (worth \$22 billion) don't own it, at least not until General Motors spins it off; they own GM's revocable assurance that they will receive part of EDS's earnings.

In every business, not just "knowledge intensive" ones, intangibles present real challenges to people who allocate resources internally--that is, managers--and their external counterparts--investors. In both cases, says Harvard business school professor Michael Porter, capital "is more likely to be dedicated to physical assets than to intangible assets whose returns are more difficult to measure."

It follows that there's value for managers and investors in measuring intellectual assets. Lots of people are trying to do so. Over the next few months, we'll look at some of this work. Much of it is new and untested, and none of it--or none I've seen so far--is The Answer. The Answer might not exist-but then, neither does Visa, and isn't it nice to have in your wallet?

One place to start: Try to estimate the total value of a company's intangible assets. An Evanston, Illinois, outfit called NCI Research has developed an elegant way for some companies to do this. NCI, which is affiliated with the Kellogg business school at Northwestern, got into the question of measuring intangibles the same way this columnist did: by fretting over how hard it is for knowledge-intensive companies to deal with banks. For NCI president James Peterson, the problem has socioeconomic as well as business implications: Years of working with local-government economic development agencies convinced him that the usual ways of encouraging new industry (subsidies for rent or land, tax breaks) don't work. Like the University of Chicago MBA he is, Peterson says, "Market forces can address the issues of urban development better than governments and regulations; what's lacking is the information needed for markets to form." In particular, Peterson argues, companies that have outgrown their first funding need a way to demonstrate the value of their knowledge assets to investors.

Leading the NCI project was Thomas Parkinson, who runs the Evanston Business Investment Corp., a seed-money fund that has invested in a score of high-tech companies, mostly startups. He worked with an advisory committee that included bankers (among them John Perkins, retired president of Continental Illinois Bank and a former president of the American Bankers Association), academics, and the head of a small-business-incubator/research park.

Parkinson's group made two assumptions: First they posited that "the market value of a company reflects not only its tangible physical assets but a component attributable to the company's intangible assets." To find those value-creating intangibles, the group borrowed a method used to evaluate brand equity. Brands, the thinking goes, confer economic benefits (pricing power, distribution reach, improved ability to launch new products such as line extensions) that give their owners a higher return on assets than unbranded competitors. Calculate the premium, and you can infer the asset value of the brand.

Parkinson, Peterson, and crew applied that thinking to whole corporations. They focused on small companies--their chief interest, and that of the Commerce Department's Economic Development Administration, which gave a small grant-but Parkinson ran numbers for some big ones, to show you, dear reader, how the method works for a company you know.

Here's Merck. (Even I can do this math, so fear not and read on.)

- + **Step one:** Calculate average pretax earnings for the past three years. For Merck that's \$3.694 billion.
- + **Step two:** Go to the balance sheet and get the average year-end tangible assets for the same three years: \$12.953 billion.
- + **Step three:** Divide earnings by assets to get the return on assets: 29%. (A nice business, pills.)
- + **Step four:** For the same three years, find the industry's average ROA. NCI used figures from Robert Morris Associates' Annual Statement Studies for companies with the same Standard

Industrial Classification code. For pharmaceuticals, the number is 9.9%. (If a company's ROA is below average, stop: NCI's method won't work. Enjoy the rest of the magazine.)

- + **Step five:** Calculate the "excess return." Multiply the industry-average ROA (9.9%) by the company's average tangible assets (\$12.953 billion). Subtract that from the pretax earnings in step one (\$3.694 billion). For Merck, the excess is \$2.41 billion. That's how much more Merck earns from its assets than the average drugmaker would.
- + **Step six:** Pay Uncle Sam. Calculate the three-year-average income tax rate and multiply this by the excess return. Subtract the result from the excess return to get an after-tax number--the premium attributable to intangible assets. For Merck (average tax rate: 31%), that's \$1.66 billion.
- + **Step seven:** Calculate the net present value of the premium. You do this by dividing the premium by an appropriate discount rate, such as the company's cost of capital. Using an arbitrarily chosen 15% discount rate, that yields, for Merck, \$11.1 billion.

And there you have it: The calculated intangible value (CIV) of Merck's intangible assets, the ones that don't appear on the balance sheet. This is not, Parkinson emphasizes, their market value. That is higher (Merck's market cap minus tangible assets is \$45.6 billion), because it reflects what it would cost a buyer to create those assets from scratch. What it is, NCI says, is a measure of Merck's "ability to use its intangible assets to out-perform other companies in its industry." That makes it a number managers should want.

For investors, a relevant sidelight: Over time, the market's valuation of intangibles (the difference between market cap and book value) ought to parallel the CIV. It's possible to plot the two numbers on the same graph. NCI did this for 23 newly public companies and also, at Fortune's request, for Merck, Intel, and International Flavors & Fragrances. A pattern--not unvarying, but noticeable--appears. First, whenever the CIV declined, the market intangible value (MIV)--and the stock price--usually did too, often dramatically. But if the MIV fell while the CIV rose, that in most cases signaled a buying opportunity. This is another way of saying that it's worth looking at stocks trading near book value, but with this twist: Knowing a company's CIV can help you judge whether a low price-to-book ratio indicates a fading business or one that's rich with hidden value not reflected in the stock.

A nice feature of CIV is that private companies can use it, comparing themselves with their publicly held brethren; so can divisions or business units. Weaknesses: You gotta have earnings and above-average ROA--though a below-average company could calculate a negative number.

Like the Oracle at Delphi, CIV is as good as the questions you ask it. NCI Research ran numbers for several privately held companies and took them to four Chicago-area banks and a commercial finance company, asking if the figures would influence them to grant more credit to a company than they would otherwise. The answer: It ain't collateral--though they might pony up based on an equally intangible asset, the borrower's character. The anomaly might be a matter of familiarity, says quondam Continental Illinois chief Perkins: "I'd think bank managements would be more receptive to this if they got a chance to get used to it." NCI says the calculation might be most useful as an "order-of-magnitude indicator" of a company's ability to create cash flow--no small thing.

And CIV is a useful tool for a manager's kit, certainly for benchmarking. A weak or falling CIV might be a tipoff that your investments in intangibles aren't paying off or that you spend too much on bricks and mortar. A rising CIV can help show that a business is generating the capacity to produce future wealth. Even if the market-or the budget committee-hasn't recognized it yet, isn't it nice to have in your wallet?

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ILLUSTRATION

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