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Intellectual capital focus can increase value to VCs

By Mike Oleksak

Venture capitalists are key agents in the development of today's knowledge economy. Their investing has put venture capitalists and private equity investors in the vanguard of analyzing and valuing the potential of knowledge-based businesses. But are venture capitalists taking advantage of new tools available today to improve investment decisions and returns?

The practices of venture and private equity investing will always require sound experience and instinct. However, there is room for more discipline and objectivity in the analysis and decision-making process. Many VCs are learning this discipline from the field of intellectual capital.

What is intellectual capital?

Intellectual capital is a phrase that gets used often and its meaning tends to be different for each of us. However, there is a new field of study around this topic that uses a specific definition that can be helpful in thinking about this aspect of a business. The early thought leaders in creating this definition and the field of intellectual capital were not academics but rather business people who were struggling to understand and manage companies that were rich in intangible assets. One was Thomas Stewart, who has been writing about intellectual capital for the past 10 years as he has moved from Forbes Magazine to Wired and on to the Harvard Business Journal, where he is currently serving as editor. Another was Leif Edvinsson, who created intellectual management systems as a senior manager at Skandia, a large financial conglomerate in Sweden.

Their definition of intellectual capital defines the unseen, but critical assets that cannot be found on a balance sheet with physical and financial capital.

Intellectual capital includes the following four components: human capital — both employees and managers; organization capital — knowledge, including intellectual property, know-how, processes and software; external relationship capital — brands and relationships with customers, and external partners such as suppliers, distributors and development partners; and business recipe — both the market opportunity and the strategy devised to take advantage of that opportunity.

These intangible assets form the core of a company's value in today's world. The creation of intellectual value starts with having a smart, capable workforce that can deliver value today

and fuel innovation for tomorrow. Ideally, the knowledge inside the heads of employees is converted to methodologies, business processes and intellectual property that can be managed and controlled by the company. In today's global and networked economy, the final critical capital element of intellectual value is the relationships that a company has with its customers, its vendors, and its business and/or outsourcing partners.

Measuring intellectual capital

Although intellectual capital cannot be seen, it can be measured, but often not with a historical cost perspective like that used in accounting. Measurement methodologies differ but most take the form of an assessment. Intellectual capital assessments take a structured and consistent approach to analysis of the individual components of intellectual capital. The most compelling approaches include feedback from the knowledgeable external and internal stakeholders of the company. The analysis is consolidated so that intellectual capital can be viewed as a portfolio. Some systems, such as IC Rating, actually assign a specific grade (like a bond rating) to the current strength of intellectual capital. This type of methodology also examines the future potential of intellectual capital and identifies areas of risk.

For the venture capitalist, an intellectual capital assessment can be helpful in a number of the phases of ownership:

- Before a venture capital investment is made, an assessment can give a clearer sense of value. It can also provide the strategy roadmap to capitalize on the strengths uncovered and weaknesses revealed in the assessment.
- During the period of ownership of the company, assessments can be conducted to determine whether the current strategy is effectively increasing the company's intellectual capital and value.
- Finally, the results of an assessment performed in the later stages of ownership can be shared with potential investors before the sale in an effort to make the company more transparent and to increase the selling price.

Venture capital success story with intellectual capital

Peder Hofman-Bang, one of the leading global authorities on intellectual capital assessment, tells the story of a venture fund that had invested in the first round of two similar companies. When it came time for the next round, the venture investors decided to use an objective rating of the intellectual capital of the two companies to help them make their investment decisions. The ratings showed one company to have a much stronger intellectual capital portfolio. The fund invested in the second round for the strong company and cashed out at a 60 percent return on investment. The weaker company received funding elsewhere but eventually went bankrupt.

Being able to break down intellectual capital into specific components and communicate the status and value of each component can be a very powerful value enhancement. Some of the benefits of this approach include: It establishes a framework and vocabulary for discussion; it provides valuable information that cannot be gleaned from traditional financial reports; it focuses on future potential, not past performance of a company; and it can support the case for a much higher valuation

The rigor of an objective assessment is a welcome addition to the investing world. While venture investing will never be a science, it is only prudent to apply more discipline where possible. After all, VC funds need a liquidity event within a certain time frame to generate a return for the fund's investors. Maximizing the return on the portfolio company's intellectual capital can be a key component to success and a higher return on a venture capital investment.

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