

As seen in *M&A Today* December, 2005 Issue:

Getting Top Dollar for Intellectual Capital

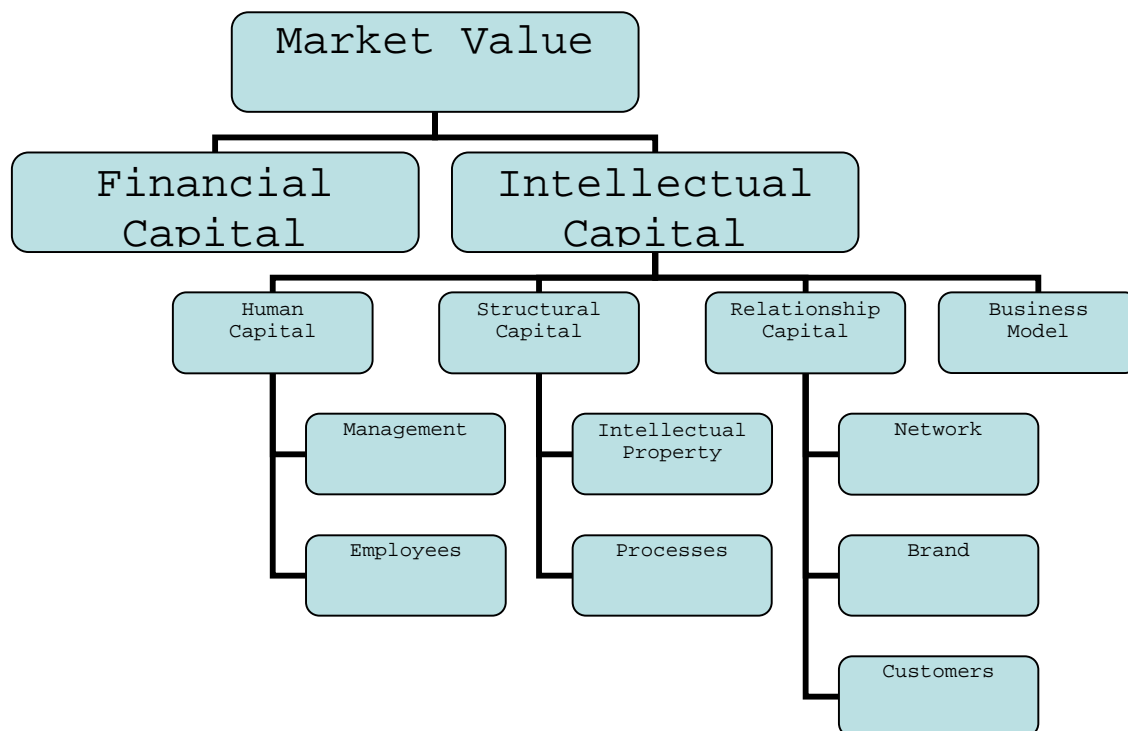
By Mary Adams and Michael Oleksak

In our work with corporate executives over the last 25+ years, we have experienced first hand the shift away from the industrial era to a new economic paradigm based on knowledge. Today, even “traditional” companies do not derive much competitive advantage through their property, their factories, their inventory. Competitive success today is much more often won through factors like people, processes, knowledge, brands and relationships. As this shift has occurred, companies have often struggled to manage and communicate the value of these intangible yet valuable intellectual assets—value that can and should be factored into M&A negotiations.

Professionals in the M&A business are actually on the front line of the value dilemma of this knowledge age: *monetizing intellectual capital*. Much of the value in public and private companies today resides in intangible assets that don't appear on a balance sheet and are hard to quantify. Yet your clients (and you!) rightly seek to get paid for this intangible value. While some intangible assets (such as patents and brands) can be valued with a traditional appraisal, much of the value creation potential of a company lies outside these asset categories. So what can be done? We would like to help you increase your own understanding of intellectual capital so that you can better identify and communicate the intangible value of your clients' businesses.

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. Interestingly, the early leaders in creating this definition and the field of intellectual capital were not academics but rather business people that 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 ten 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. The definition that these gentlemen and many others in the field have identified is easiest understood through the graphic below:



As you can see, intellectual capital goes beyond physical and financial capital to include human, structural and relationship capital. These are the intangible assets that 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 partners.

Intellectual Capital in M&A

How can these concepts help the M&A professional? We asked that question of our new partner, Peder Hofman Bang, who founded Intellectual Capital Sweden AB (ICAB) seven years ago together with Edvinsson. Peder explained that having clear, specific and objective information about each component of intellectual capital can make a huge difference in an M&A situation.

He told us the story of a large marketing communication group that was looking to sell two media consulting firms that they owned. They got interest from a major British media player. The talks dragged on but the British bidder just couldn't get comfortable with the future potential of the company. The sale was put on hold.

The seller felt that these two companies had much better prospects than their competitors but they struggled with how to communicate this potential. Financial statements looked backward and did not give a full picture of the companies' intangible value. They decided that an external review would help and engaged ICAB to perform an IC Rating™ on the two firms. This rating was developed by ICAB to provide a detailed, standardized evaluation of all the major components of intellectual capital. The system has been validated through experience with over 200 companies around the world. Some of the key findings were similar for the two companies and included:

- The client lists were very strong and back by high degrees of client loyalty
- The workforce was committed and capable. There was only minor dependence on key employees
- Both companies were weak in converting good practices into formal business processes

The sellers used this balanced, third party analysis to go back to the market. This time, the company received three bids. In the end, the British company that had passed on the deal the first time won the deal, paying a 7x p/e multiple for both companies at a time when comparable companies were selling around 5x. Peder explained,

“The British firm felt that the forward-looking intellectual capital report made the difference for them. They got excited about what they now saw as potential synergies. They thought they could quickly implement their own processes in the media firms. They saw strong potential in new sales to many of the existing clients. They also gained an appreciation of how the culture at the target companies would fit with their own company, which had been a worry of theirs.”

Lessons Learned

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
- It can support the case for a much higher valuation

Intellectual capital is the currency of the future. Learn to identify and communicate the value of the individual components of intellectual capital. Build your knowledge of this field to earn your share of the upside going forward.

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