Valuable Advice from Workshop 1

Intangible Assets Driving Success and Failure – the Risks and Rewards of a Critical Asset Class

Held on Wednesday 10 April

Executive Summary

(L-R) Ian Fletcher, Rob Campbell, Sarah Kerr (Chair) & Paul Adams

This workshop revealed that many businesses and their boards of directors may have an inadequate understanding of the intangible assets under their control, the value of those assets and how best to protect those assets. Intangible assets include items such as data, content, brands, software code, confidential information, regulatory approvals, design assets and patents. This lack of awareness of intangible assets is partly due to accounting standards, which focus on tangible assets and often ignore intangible assets, which is where the majority of real potential for growth and value lies in modern companies.

The panel explained that over the past 40 years there had been a massive migration of value into intangible assets and in addition that the increasing importance of intangible assets is not a fad and is not going away. Identifying, valuing, managing and protecting intangible assets is something all directors, investors, advisors and company managers need to understand and address.

The Speakers

Rob Campbell, Chair of SkyCity Entertainment Group, Summerset, Tourism Holdings and WEL Networks, and director of Precinct Properties

Rob has more than 30 years' experience in capital markets and is a director of or advisor to investment fund and private equity groups in New Zealand, Australia, Hong Kong and the United States.

Ian Fletcher, Managing Partner, InPhySec Security Ltd

Ian was director of the GCSB from 2012 to 2015. He was also a trade negotiator for the EU, Chief Executive of the UK Patent Office, and Director-General of the Queensland Department of Economic Development. He is now the managing partner of cyber security firm InPhySec Security Ltd.

Paul Adams, Chief Executive Officer, EverEdge Global

Paul Adams is the CEO of EverEdge, a global advisory and transaction firm specialising in intangible assets. Paul is one of the world's top intellectual property strategists and received the Global IP Leader Award in 2012. He managed intellectual property for Brunswick New Technologies and was the founding incubator manager of The Icehouse Incubator.

CHAIR: Sarah Kerr, Director, Lowndes

Sarah is a director at Lowndes with more than 20 years' experience as a corporate lawyer, 12 years as a partner, and with experience in English and US law firms in Frankfurt and London. She advises on mergers and acquisitions, joint ventures, shareholding arrangements and high value commercial contracts.

What They Said

Paul Adams explained that intangible assets include patents, trade marks, approvals, confidential information, data, code and content. Paul said that 87 per cent of all company value today is in intangible assets yet these assets are largely absent from company balance sheets. Consequently many companies and directors are not focussing their attention on where the real value creation is happening in their business or where the real risks are. For example Paul indicated that eight out of 10 companies could not even prove they owned their intangible assets. They also could not tell which assets were doing the work and this meant they didn't have a comprehensive understanding of the risks to their business. He used the workshop's hotel venue as an example. It would be insured for fire because it could burn down but not for theft, as it was impossible to steal such a large building. However its valuable customer data, although not vulnerable to fire would be highly vulnerable to theft – the complete opposite of what you would expect by looking at a tangible asset such as a building.

Paul discussed how an Australian mall owner had carried out a valuation of its intangible assets (including, importantly, customer data) and concluded that these assets were worth more than the value of the mall owner's real estate interests. Qantas recently had the data in its loyalty programme valued at $4.5 billion - half the value of the airline.

In 1975 intangible assets amounted to about 17 per cent of capital value in businesses. Now it's at 87 per cent, Paul said. Take out real estate and that figure rises to 95 per cent. Paul said most of us continue to overlook intangible assets, partly because humans have an innate cognitive bias favour of physical things and partly because accounting standards cause businesses to overlook them.

So consider a very tangible business, like a steel mill. Imagine it without its intangible assets: customers, suppliers, compliance approvals, contracts. "Pretty soon you realise it's not an asset at all; the physical mill itself is a liability, the real value is the ability to be able to run it safely and efficiently and that is all intangible," he said.

Traditional accounting will often value a business on multiple of EBITDA but the true worth of intangible assets can be many times its pure financial results. Paul made the point that intangible assets were infinitely scalable and this meant they could be more valuable to some parties than others. Take the example of a small business with no physical assets, no revenue and 12 employees, called Instagram. It sold to Facebook for $1bn.

He cited another example of a company looking for a first build investment of $100m. One of the big four accounting firms valued it at $40 million, which made the raise non-viable. EverEdge valued the company's intangible assets and presented that valuation to a major New York bank who secured $400 million in investment for the company. The company later went on to raise an additional $750 million in debt.

Ian Fletcher said, much as von Clausewitz had described war as politics by other means, internet crime is business by other means. If you have valuable data — and even if you actually know where it is stored, and if that is in a country whose laws you are comfortable with — and you do a penetration test once a year you are unlikely to win against a business working to extract your data 24/7. He also warned businesses not to leave security to their IT providers.

Ian's advice for businesses considering risks to their data was to locate it. "It's not in 'the cloud' — that is a metaphor, not a location: It's on a server somewhere. Imagine a worst case and look for it, know who is using your data and decide what you will do about it.

He also advised keeping up with legislative standards. He said the EU's General Data Protection Regulation was an emerging global standard that was likely to be adopted more widely, and that ISO 27001 was a solid benchmark tool. And he advised minimising 'custodial data' such as credit card records held for third parties.

If a company's data is protected, it is more valuable; if it is unprotected it is an 'impaired asset'.

Rob Campbell said company directors' main job was to direct the capital allocation of their company but if they didn't understand the current and potential value of intangible assets they could not do that effectively.

Boards were usually well-equipped with accountants who were "mired in past accounting practices" and this view of a business drove their annual reports and capital market valuations. Stock market analysts worked the same way from a similar skillset.

Rob said directors did not often explain a company's story well. "It's not a communications issue, but an understanding issue. What you can have accepted as your value is where Paul's role is critical."

He said a board of directors of a company might represent a cost to that company of $1m dollars and that perhaps companies should consider the skills on their board as an intangible asset and assess whether the board was properly structured.

Sarah Kerr said directors were responsible for all assets and liabilities under their care and control and should apply the same rigour to intangible assets as they do to tangible assets. She made the point that the stakes for directors' responsibilities were now higher. When companies have failed in the past there haven't necessarily been funds available for litigation against directors but the recent *Mainzeal* decision has demonstrated the presence and activity of litigation funders in New Zealand, who are prepared to fund actions against directors.

A member of the audience asked for examples of metrics that could be used to measure whether or not a company was sufficiently up to speed with issues associated with intangible assets. The panel agreed it was early days yet and keen minds were still grappling with the issue. Ian said he had been part of an EU team which had considered these sorts of issues for a year and still couldn't come up with an answer.

Paul said the first thing companies could do was step out of denial, and make intangible assets a line item on their books. He said that out of 750 company engagements by EverEdge, only one customer had identified their intangible assets as a business risk.

Paul noted that the top five risks of intangible assets were: leakage or theft of confidential information; being unable to prove ownership of intellectual property; not owning one's own brand; hazardous use of open source software; and threatened or actual intellectual property-related litigation.