by MLC Asset Management

Source

[1.] Baruch Lev. *Harvard Business Review*. Book Reviews/388. Volume 92, Issue 2. Summer 2018, pp. 388-389

[2.] Prof Jonathan Haskel, *The rise of the intangible economy: how capitalism without capital is fostering inequality*. Imperial College Business School.

The rise of asset-light capitalism

Asset-light companies, in industries ranging from technology to consumer products and pharmaceuticals, now dominate economies. Their way of creating value is so different that entire legal, financial and regulatory eco-systems are struggling to keep pace.

AROUND THE middle of the 1990s, something of historic significance occurred, but went largely unremarked at the time. Physical-asset-light, intangible-asset-dominant companies assumed market capitalisation leadership in the S&P 500 index from their physical-asset-heavy counterparts.

Think of it as the property, plant and equipment (PP&E) world being overtaken by the information, ideas and images (I3) world.

Advanced economies that, less than a century earlier, measured wealth and power through the value of rail, oil, ships, power plants and infrastructure now saw more value derived from intangible assets – assets that are not possible to touch.

Recent estimates suggest that the US private sector's annual investment in intangibles surpasses US$2 trillion, or roughly double the annual investment in tangible capital.[1.]

In the realm of economics and markets, intangible assets, like all other assets, are sources of future value. But, unlike PP&E, they lack physical embodiment.

Intangibles include patents and trademarks, software and information systems, brands and original designs, artistic products, and organisational capital – that is, companies' systems, processes and incentives that enable them to create value, like Amazon's and Netflix's customer recommendation algorithms.[1.]

Intangible assets create most of the profits and value for business enterprises these days. Tangible (physical) assets are mostly commodities – available to all competitors – and thus unable to create substantial value.[1.]

Just in case anyone thinks that intangibles are largely the domain of technology companies, they are in fact ubiquitous in every sector and industry: Coca Cola's major asset, its brand, is an intangible asset.

An upshot is that a veritable earnings growth chasm has opened between capital intensive and capital-light businesses over the past decade.

Flipping economics on its head

A feature of intangible companies is their seeming defiance of the law of capitalism that outsize margins in any industry invite competitors eying a slice of the economic pie.

In this scenario, motivated competitors gnaw at giants, ultimately narrowing overall industry margins and reducing behemoths to a more mortal size. Sometimes, disruptors go so far as felling giants all together. Think of mighty Kodak's downfall as it failed to respond to the digital challenge.

But the opposite seems to be happening.

While the bigger companies – the likes of Google and Facebook – are getting bigger, smaller businesses are faltering because they struggle to get investment. Frontier companies are breaking away from the laggards and the data suggests these divisions will only widen.[2.]

Capitalism is not supposed to function this way. Competitors should be emerging that erode and corrode. Instead, bigger companies are more likely to have resources to allow them to benefit from synergies between intangible assets.

In creating the iPod (remember them), Apple combined MP3 technology with licensing agreements, record labels and design expertise to produce a winning product. This ability to combine different technologies and then scale up helps these companies to dominate markets - and the gap widens.[2.]

Source

[3] Baruch Lev. *Intangibles*. Stern School of Business, New York University. July 2018.

[4] Hendrik Bessembinder, *Do stocks outperform treasury bills?* Department of Finance, W.P. Carey School of Business, Arizona State University.

[5] According to McKinsey, an American firm that was very profitable in 2003 (one with post-tax returns on capital of 15-25 percent, excluding goodwill), had an 83 percent chance of still being very profitable in 2013. In the previous decade, the odds were 50 percent.

[6] The number of listed US corporations has fallen by approximately half in the last 20 years, according to Credit Suisse research.

Accounting standards need to change to be useful to investors

Intangibles are so profoundly different that entire legal, financial and regulatory eco-systems are struggling to keep pace.

For investors, being able to forecast future earnings and value companies with some degree of confidence is all-important. Current accounting standards are falling short as they relate to intangibles earnings and valuations.

In the US, practically all expenditures on internally-generated intangibles – R&D, information technology, brand creation and enhancement, business designs and processes, employee training and other human resources development costs, "big data" creation and exploitation, customer acquisition costs etc – are immediately expensed, whereas expenditures on similar but acquired intangibles (including in-process R&D) are capitalised[3] as assets on balance sheets.

The antecedents of the sweeping intangibles' expensing can be traced back to a 44-year Financial Accounting Standards Board (FASB) standard mandating the immediate expensing of R&D (SFAS No. 2, 1974, "Accounting for Research and Development Costs"), which was enacted prior to the emergence of economy-changing, intangibles intensive industries.[3]

It really is odd that the major value creators of modern businesses are treated as salaries or interest expenses, whereas the "commoditised" tangible (fixed) assets – marginal value creators because they are available to all competitors – are capitalised.[3]

The need to change the accounting rules for intangibles would seem to be compelling.

Most of the strategic, value-creating resources of business enterprises, such as patents, IT or brands, are currently expensed and, therefore, not recognised as assets in financial reports, thereby understating the earnings and assets of intangibles-growing firms, and overstating the earnings and assets of intangibles light enterprises.[3]

Reported earnings are the single most widely-followed measure of firm performance. Therefore, it is logical that accounting earnings provide a basis for valuation.[3]

An intangibles-induced deterioration in the quality and relevance of reported earnings indicates a significant harm to investors and other financial report users. There simply aren't readily available, uniformly measured and audited alternatives to reported earnings available to investors.[3]

The intangibles-induced relevance loss of reported earnings should be of concern not only to their intended users - investors - but also to corporate managers, whose performance is often evaluated by investors on reported earnings.[3]

Winners are concentrated

The current wave of businesses driven by information, ideas and images has changed the nature of competition and sources of competitive advantage.

That said, it would be unwise to simply invest on a thematic basis assuming that all intangible-dominant companies are equal.

Big winners drive overall returns to a generally underappreciated extent. A Hendrik Bessembinder study[4] showed that just 4 per cent of companies accounted for 100 percent of US equity market wealth creation since 1926.

Seeking the select group of winners also makes intuitive sense, given the increasing winner-takes-all dynamics evidenced by profitability and returns on capital at top firms staying higher for longer,[5] increased corporate concentration,[6] and the ability of cash-rich incumbents to purchase upstart challengers.

It is unlikely that even the most long-term investors today are investing on a multi-decade time horizon.

Nevertheless, the historic record showing a few winners ultimately driving returns and challenges posed by behind-the-times accounting standards emphasises the importance of active investment discrimination. ■