ARE BALANCE SHEETS WRONG?

A Roundtable Discussion of Goodwill and Intangible Assets

In 1975, intangible assets (including goodwill), accounted for about 17% of the total value of S&P 500 companies. In 2018, it was about 84%.

So what does this significant increase mean for companies and how they are valued—especially when using book values? Recently, members of the Brandes Institute Advisory Board and investment professionals at New York-based Donald Smith & Co. (DSC) had a roundtable discussion on the topic.

The full-length piece is designed to:

- raise awareness of goodwill and intangibles and potential risks
- underscore the benefits of fundamental analysis on a company-specific basis
- call into question the effectiveness of “rules-based” or “factor-based” investing approaches based on a single metric such as price-to-book ratio
- encourage investment professionals to conduct their own investigations

Accounting lies at the heart of a discussion of goodwill. Over the last several years, the Financial Accounting Standards Board has changed the rules for how companies can account for goodwill. Recently, escalating merger and acquisition (M&A) activity has boosted goodwill levels. Beyond the rise in goodwill, more U.S. companies are reporting increases in the value of other intangible assets.

Richard Greenberg, CFA, Co-Chief Investment Officer at DSC, said, “You don’t know how much risk there is to the earnings and book value until you have a downturn. As we saw in 2008, tangible equity is something bankers still look toward when they evaluate the financial creditworthiness of companies.”

Among the dangers associated with goodwill are impairments. Accounting principles now demand that companies review goodwill each year. An impairment occurs “…when there is deterioration in the capabilities of acquired assets to generate cash flows, and the fair value of the goodwill dips below its book value.”

What are Goodwill and Intangibles?

Goodwill is an accounting measure. The easiest way to understand it is with an example. If a company is worth $11, but it’s acquired for $20, the acquiring company would book $9 to its balance sheet as goodwill. Goodwill is one type of “intangible” asset. Other intangibles include patents, customer databases and client lists, brands and logos, algorithms and trademarks.

While goodwill is recorded on a company’s balance sheet, impairments show up on the income statement. In February 2019, Kraft Heinz Co. (NASDAQ: KHC) announced a $7.3 billion goodwill impairment, according to The Wall Street Journal. Shares of Kraft Heinz fell about 27% following the announcement. (To be fair, in addition to the impairment, the company also revealed it missed consensus earnings estimates for the fourth quarter of 2019.)

Kim Shannon, CFA, President and Co-Chief Investment Officer at Sionna Investment Managers, said, "Price-to-book (P/B) value is becoming a dodo bird tool for value investors. Valuations are so high based on P/B overall. And tech stocks
have no book value to speak of. It’s all becoming very distorted.”

“Balance sheet-based valuation is reaching the end of its tether because accounting has lost its way,” said Dr. Aswath Damodaran, Professor of Finance at New York University. “Acquisitions and buybacks are ravaging balance sheets. The other reason book value is falling apart is every time you do a buyback and retire the associated shares, your book value collapses. My estimate is 1/8th of all U.S. companies had negative book value in 2017.”

Bill Raver, Managing Director, Alban Row Investments, said, “In a day and age when factor investing is popular, I wonder if soft assets are an overlooked driver of investment returns.”

“There is the conception that value investors traditionally anchored on price to book, but for value investor practitioners today, I wouldn’t be surprised if the majority are using primarily a form of adjusted earnings or cash flow-based valuations to approximate economic reality,” said Mauricio Abadia, member of the Brandes Institute Advisory Board.

Bryan Barrett, CFA, member of the Brandes Institute Advisory Board, added, “It’s incumbent on the fundamental analyst to dig in and find out where the accounting isn’t keeping up with the business…. Roundtable participants agreed investors need to thoroughly investigate companies and determine if rising levels of intangible assets are a problem. John Piermont, CFA, Research Analyst at DSC, said, “Balance sheets are wrong in both directions. Some issues are overstated because of goodwill and intangibles that result from increased M&A that has happened on a really large scale and continues to be a reflection of accounting. But you could also argue that there are companies that don’t engage in M&A that have real intangible assets that don’t show up on the balance sheet.”

So what should investors look for? Beyond making adjustments to book value and analyzing goodwill and intangibles, participants suggested investors also focus on the following when valuing a company:

- Management skill and incentives
- Industry dynamics and a company’s role within that industry
- A company’s research and development
- Price to cash flow and other metrics
- Returns on capital with and without intangibles
- A company’s competitive advantages

Published in 2018, the book *Capitalism Without Capital: The Rise of the Intangible Economy* addresses how increasing intangibles are reshaping investing and the economy. Among the book’s key points:

1. There has been, and continues to be, a long-term shift from tangible to intangible investment.
2. Much of that shift does not appear in company balance sheets because accountants tend not to count intangible spending as an investment, but rather as day-to-day expenses.

The book’s authors contend, “Investors will have to find information well beyond the current financial statements that purport to describe current businesses.”

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The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

Price/Book: Price per share divided by book value per share.

Price/Cash Flow: Price per share divided by cash flow per share.

Price/Tangible Book: Price per share divided by tangible book value per share.

Free Cash Flow: Total cash flow from operations less capital expenditures.

Return on Capital: Net income minus dividends divided by total capital; used to assess a company's efficiency at allocating the capital under its control to profitable investments.

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