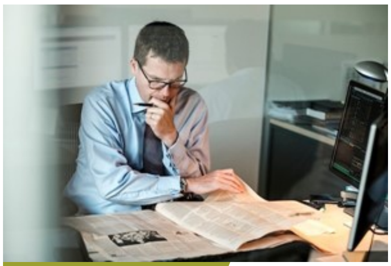


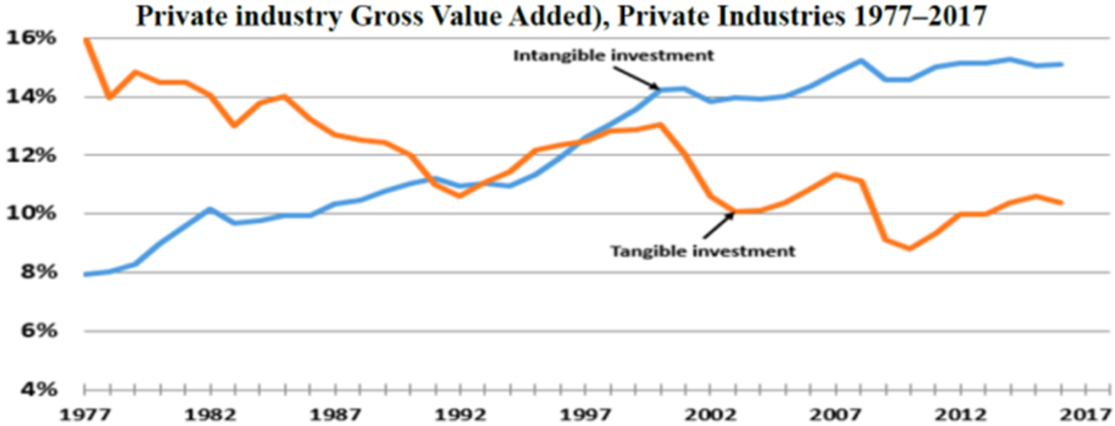
Friday Morning Coffee

Nr. 74 — Intangibles & Value Investing

One argument we hear quite often on why value investing would be no longer relevant is the growing importance of intangible assets in today's businesses. When Benjamin Graham, the father of value investing, initially applied his investment principles he looked at the liquidation value of a business. He evaluated, based on the accounting figures, how much cash would be left for him as a shareholder if the tangible assets of a business would be sold and all the debt paid down. If that liquidation value was significantly higher than the current stock price, he invested. The tangible assets include real estate, factories, machinery, cash at the bank, inventories and customer loans. Almost a century later, businesses have changed and the real value of a business lies more and more in the intangible assets of the business. Intangible assets includes the skills of employees, technological knowhow, R&D, and brands owned by the business. By nature, these skills are difficult to measure accounting-wise and can only be partly reflected on its balance sheet. Critics argue that value investors are notoriously failing to recognize intangible assets in their valuation models and hereby ignore one of the biggest value drivers of a business.

Intangible assets have indeed become much more important for businesses than they ever used to be. In a recent paper "Explaining the Demise of Value Investing" by Baruch Lev from Stern School of Business and Anup Srivastava from Haskayne School of Business shows the importance of the shift of investments by US corporates from tangible to intangible investments :

Figure 2: Investment Rates in Tangible and Intangible Assets (Investment Relative to Private industry Gross Value Added), Private Industries 1977–2017



Source: "Explaining the Demise of Value Investing", Baruch Lev, Anup Srivastava, papers.ssrn.com, August 25, 2019

We agree with the analysis, however we disagree with the conclusion that value investors are unable to identify the value of intangibles as drivers of value.

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There are 2 reasons of why we disagree :

1. We are not balance sheet investors

Value investing is much more than investing in a low price-to-book ratio. Most value investors, including us, are not balance sheet investors but focus on the earning power of the business measured by the cash flows this business is able to generate over time. The way accounting regulation dictates Intangible Assets to be booked on the balance sheet is indeed not very relevant for the value investors we are.

2. We are not simply looking at the accounting earnings

We see the investments in intangibles as an investment in the future of the company that needs to deliver cash flows over time. Depending on accounting standards and corporate accounting practices, these investments may be capitalized and depreciated over time. They may also be expensed immediately creating a burden on short term earnings. So a company investing heavily into its R&D and expensing this cost may well see depressed earnings in the short run as its invests into its future. Its valuation is hereby looking temporarily high for example in terms of price-earnings-ratio. At one stage however this period of heavy investments needs to yield returns and show up in the cash flows of the business. That is the reason why, at ECP, we consider ourselves as entrepreneurial investors, not blindly selecting stocks by looking at available valuation ratios. It takes more work and due diligence on the companies to assess their earning power correctly.

While the raise and accounting treatment of intangible assets certainly pose challenges to value investors, we certainly believe that fundamentally driven value investors like us are recognizing their importance and have integrated the analysis of intangibles in their investment processes. It is too easy to conclude that Value Investing is demised due to the raise of intangibles.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
September 27th, 2019