Valuing Intangibles Influences Cross-Border M&A

By Ellen Sheng

Intangibles, whether intellectual property, a brand, customer relationships, a patent, or a trademark, make up the majority of a company's value these days. Yet valuing these intangible assets is notoriously difficult. For corporate merger and acquisition deals, this key valuation often is fraught with differing opinions and confusion.

"Intangibles are often misvalued," said Baruch Lev, professor of accounting at New York University Stern School of Business. "The information about intangibles is terrible … these are not transparent markets," he said. Also, the fact intangibles usually are unique to individual companies inevitably makes them hard to value. The patents for drugs at Pfizer versus Eli Lilly are very different, making it hard to come up with a value from comparables like you would with other assets.

As the share of intangible assets on company balance sheets generally is higher now because of the growing importance of technology and branding, accounting methods have not kept pace. The balance sheet and income statement can provide a realistic value for a typical manufacturing operation, but for many companies today, particularly internet or tech players, the financials don't offer a full picture. Facebook, for instance, has some $14 billion in hard assets against a market capitalization of about $380 billion.

The task gets even trickier in international M&A, because different jurisdictions treat intellectual property and other intangibles differently. Recent tax changes in the U.S. and put forth by the Organization for Economic Cooperation and Development have made valuing intangibles even more difficult.

Different jurisdictions treat intellectual property and other intangibles differently.

One complication of international M&A deals with lots of intangible assets, such as intellectual property, is figuring out where the intellectual property resides, which often is not where the income is located.

"What you find frequently is that intellectual property within an organization will reside in just a few jurisdictions," said Philip Antoon, managing director at Alvarez & Marsal.

For instance, a company might have IP in the U.S. that it uses in various jurisdictions outside the country. Companies also may domicile the IP in a non-U.S. location, such as Ireland, from which it's then licensed to all using entities. When trying to come up with a valuation, many companies—or their accountants—will value the entity by looking at the overall profit margin of the company. The problem is, the entity doesn't actually own any IP.

Even companies that just want to know how much their intellectual property is worth may need to consider where the IP resides. Depending on this factor, companies could end up paying a lower tax rate. Also, different jurisdictions have different standards for IP and rules are quite specific. Software code could be eligible for amortization, but customer relationships may not be. "In a sizable acquisition, that could be worth tens of millions of dollars," Antoon said.

Recent tax and accounting changes add more uncertainty when it comes to valuing intangibles.

In a bid to stop multinational tech companies, such as Apple, Facebook, and Amazon from operating in member jurisdictions while paying little or no corporate income tax, the OECD introduced its base erosion and profit-shifting initiative, making it harder for companies to shift profits to low- or no-tax locations. Around the same time, the U.S. introduced mandatory repatriation and global intangible low-taxed income, which imposes a tax of 10.5 percent on certain profits earned by non-U.S. subsidiaries.

Tax authorities are now demanding more substance from holding companies.

As a result of these and other measures, tax authorities are now demanding more substance from holding companies that exist mostly to invest in stock, debt, or intangibles. Many countries also are trending toward requiring that income be attributed to the location where intangibles reside.

The result? A lot of guesswork and some delays.

Companies might be having trouble estimating the earnings they're planning to keep overseas. They'll face a one-time transitional tax on foreign earnings kept overseas, so there's no tax incentive to keeping funds offshore. But those with foreign operations will still need to keep some cash overseas and provide the appropriate disclosures.

PayPal's 2017 acquisition of TIO Networks, a Canadian payment processing company, for $238 million offers an interesting example of the intangible valuation problem. TIO's $238 million purchase price comprised $66 million in technology and customer-related intangible assets, $2 million of net assets, and goodwill of $170 million.

In November 2017, PayPal suspended TIO's operations after discovering a security problem on its platform. PayPal then wrote off $30 million of customer-related intangible assets. Such impairments to goodwill can be avoided through due diligence focused on the compliance issues often related to intangibles ahead of the deal closing.

Companies looking at international deals need to do a lot of spade work on how to structure the transaction. Complex valuations are just the beginning.

"All of a sudden, they're going to have to think about all the time and effort that will have to go in to just complying with these standards," Antoon said. "And I have seen that some companies aren't really ready for that necessarily. They weren't fully prepared for the onslaught of new compliance that they would have to deal with."

Ellen Sheng is a writer and editor with a focus on business finance, fintech, and U.S.-Asia investments.