A Conversation with Jonathan Low of Predictiv LLC on Appreciating and Leveraging Intangibles in Mergers and Acquisitions

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JC: *What company intellectual assets are typically undervalued and what difference does that make in an M&A setting?*

JL: Overall what is undervalued in M&A is anything that is not strictly defined by traditional GAAP (Generally Accepted Accounting Principles) accounting. Since we have moved decidedly in the last fifty years towards a service based economy that gives both acquirers and acquirees a lot of wiggle room and lot of potential difficulty. This is one of the reasons why when a merger and acquisition is announced the acquiring company's stock price declines almost immediately.

Price Waterhouse Cooper's (PWC's) research showed one of the reasons for the fact that 65% of acquisitions fail to achieve their published goals is because there so little understanding of these so-called intangibles. Most of these intangibles should be better understood than they are at this point of our development as an economy.

Intangibles that tend to be underreported or undervalued include:

- Workplace organization and culture
- Technology (particularly processes around technology)
- Human capital (which is kind of a bloodless description for workforce and its skill and knowledge),
- The ability to innovate,
- The ability to assess risk
- The ability to adapt

There is additionally a whole range of other intangibles that are better understood and are at least. defined in the US. Those include brand, reputation, alliances and networks, and leadership. There are probably a dozen factors on which research studies have been done but because of the stasis involved in the evolution of our accounting and financial management systems, they are not routinely or comparatively assessed across the economy. It tends to be very idiosyncratic. The companies that have a great reputation doing acquisitions, such as Oracle and GE, are better at accounting for this range of intangibles. They have developed templates and teams that focus on M&A's. A lot of other companies say "We see some synergies!", but it turns out that those synergies are not as readily achievable as was first thought nor are they very well set up to capture them.

JC: *What enables better acquiring companies to be more adept at grasping the value of intellectual and similar assets?*

JL: It has to do with the fact that some companies inherently understand that their intellectual assets can be leveraged and that doing so does affect performance, whether that performance be productivity, financial value added, or whatever. The difference gets back to another intangible, which has to do with organization and processes. If you focus beforehand on what goals you want to achieve and then try to figure out what elements, particularly in the post merger integration process need to be brought to bear to achieve those goals, you are more likely to achieve those goals.

JC: *Will a more strategic perspective yield better outcomes?*

JL: That is right. Apple just made a strategic acquisition of a music site called Lala, which indicates that it may be rethinking their whole approach to music acquisition on the Internet. When I read about the acquisition initially, I thought. “This is interesting.” A couple of days later more articles appeared saying that this is really a significant strategic acquisition on Apple’s part. One of the articles said that Apple was acquiring Lala for its payment and fulfillment systems. A New York Times article said this is more about increasing Apple’s ability to have people access their services from a variety of platforms, and not be required to be in front of a computer.

In terms of tools and methodologies to evaluate the impact, it is not even so much that you need specialized tools and methodologies, it is that you need to be thinking strategically about every element of your business, how they link to each other and how all of the elements in an M&A situation, particularly in the M&A integration phase, leverage each other so that you can optimize value. Some companies are able to think that way and some are not. This includes to what degree, from a leadership standpoint, are people working together and to what degree is the organization siloed and therefore different elements of the organization are jealously guarding their information and prerogatives. The optimal approach is instead thinking of an expanding pie, with the idea that "if I contribute to it I get to take part in that expansion."

JC: *How do you get people to think in the more positive way?*

JL: It is a cultural issue that gets back to what kind of atmosphere you create. Point number one is: Is it an atmosphere of fear and retribution or is it an atmosphere of “we are all in this together and we are going to build value for the long term." Point number two is: Do you walk the walk by designing compensation systems that reflect that overarching point of view or do you say one thing ("Our most important assets walk out the door every evening 5 PM) but in times of distress that is not how you behave. People's attitudes and knowledge – their antennas for hypocrisy and disinformation have become very finely attuned. People are more confident about their ability to find their own way and perhaps not be a fearful, particularly in an M&A situation about concerns such as "Am I going to lose my job or is my pension in serious jeopardy?"

We found in our work on employee engagement that one of the biggest mistakes that companies make is that they have a monolithic approach to employee attitudes. In fact, that factor is very finely and idiosyncratically defined depending on what subsidiary you work in and whether you are management or not management, union or non-union. The good news about technology is that you can get a handle on this. You can design messages that will have the greatest impact on the subset of the people you are trying to influence.

Our research has shown that over a number of industries people, even though they may work for the same company and have the same type of positions and skill sets, can have very different attitudes. Two individuals who may have the same educational background and the same job technically, but have been with the company for different periods of time (say, less than two years or more than fifteen years) are going to have totally different attitudes in an M&A situation. Some may view it as an opportunity and some may view it as a threat. Some may view it as a disruption and some may view it as an adventure. Companies have to put more work into determining the value to be derived from the workforce they are acquiring as well as the impact an acquisition is going to have on workforce they are already managing.

It is common sense if we stop to think about it. It is just that very few companies make the effort to do this sort of categorization. If say, a company is making a strategic acquisition in southern Europe. Do they say, "What do we know about our employees in southern Europe? If that acquisition is going to affect employees working in northern Europe, what do we know about them? What might their reaction be? What impact might that have on productivity or technology adaptation? It is simply taking the time to ask the questions and thinking strategically so that we connect the dots and say, "We have justified this acquisition to our board by showing that we perceive we are going to get a 22% ROI within five years, but in order to do that on a practical level, here are the following things that are going to have to happen." Who is going to make them happen and what are the likely obstacles to making that happen? How can we start immediately to overcome those obstacles?   Invariably the greatest obstacle is human fear, resentment and frustration to say nothing of loss of knowledge, particularly tacit knowledge about how an organization works.

We have designed models where you can grade it along those lines. We can do this in a way that allows us to look at segments and cross tabulate the segments. We can then look at position, length of service, union versus non-union, which subsidiary do you work in, what level you are, even in your position, administrative support, field, hourly, first line manager, middle manager, professional non-supervisory, senior manager executive, technical staff. Companies have this information. They rarely use and apply it. You can get attitudes on development, ethics, customer issues, engagement, diversity, pay and benefits, quality, respect, safety, training, etc.

One of the companies for which we did this was trying to understand employee engagement. They had as a program they instituted that they thought "was a nice thing to do". They paid tuition for people to get advanced degrees and training. It did not cost them very much. They did not think it was very significant. When we did surveys of employees about what were the most meaningful things about their jobs, that program was far and away was the most important thing to them. Some of these people were in tears about how much it meant to them, that the company would pay for them to do this. Literally thousands of people had taken advantage of this program, which cost almost nothing in the greater scheme of a multi-billion dollar global corporation. The gains come from making the effort to pull those nuances out of this huge wave of data that many corporations have and seeing how to apply those understandings in a variety of settings, particularly in an M&A setting, where disruption is invariably a by-product because people's first, second and third question is what does this mean to me.

JC: *How can we manage this degree of complexity?*

JL: Technology has given us the ability to quantify these impacts and measure them against outcomes that matter to the company. We can look at it at a corporate, subsidiary, business unit, or work group level and it can all be measured. We no longer have to be focused on the longer, broad scale return on investment type metrics, which are relatively meaningless from an operational level, and more focused on impact is taken place on my programs, on specific outcomes that I care about as a corporate manager.

One of the things we learned is that very few corporate managers are managing day to day against stock price because they have so little influence on it. But they know that many things that they do ultimately contribute to stock price performance. Again, it is making the effort to understand your organization, to filter this information and then to apply it internally.

JC: *What do we need to be focused on as far as intangibles?*

JL: One thing we find when questions are asked about how intellectual capital affect merger and acquisitions scenarios, as far as we are concerned the valuation exercise is almost irrelevant. Valuation is going to be a negotiation. It will be based on GAAP accounting or international accounting standards. The real impact is going to be on evaluating and measuring the impact on these various intangibles, performance management systems, organizational design and so forth. That can all be done. It is about will. It is not about ability.

One of the greatest intangibles is strategy execution, i.e., what does it take to execute strategy. In an early study we did, *Measures That Matter*, executives ranked strategy execution ahead of quality of strategy. When we asked these executives about this, they said. "Ninety percent of the world uses the Window/Intel technology platform. Hardware is become interchangeable and fungible. We all have access to the same information. The only strategic differentiator is ability to actually make it happen. Even if you have a weak strategy, if you can execute it, you are much better off than your competitor that may have a brilliant strategy but has no way of achieving it. "

That gets back to the M&A conundrum. We believe in the economic tumult in the creation and destruction of economic value as being essential to the ongoing health of the capitalist system but we have become sort of lazy at doing the hard work necessary to understand the building blocks of that creation and destruction process.

JC: *Who ultimately has to do the heavy lifting here?*

JL: The good news is that as a society we have gotten smarter about management and we are less freighted with judgment about who is up and who is down in an organization. One of the quiet revolutions of the last twenty years is that organizationally we are much more inclined to work as teams that contribute to a solution, rather than siloed individuals who have their particular responsibilities, and when they are done they throw them over the transom for the next person.

When we are talking to people, we are talking to groups of people. These are people from financial units, from marketing backgrounds, from corporate communications responsibilities, etc. We almost never have a single client anymore. The real challenge is that the meetings get so big because there are so many people that have a stake in this kind of decision making.

It is a conundrum because on the one hand we have a meeting with twenty people in the room, which is unwieldy, but on the other hand, that is real. There should be twenty people who should be contributing to these sorts of decisions.

Then the question is: “Do you have a framework for that sort of discussion and for eliciting actionable wisdom?”

Everyone is faced with the same issue, which is making bigger decisions in a shorter length of time, with less information. In that scenario, you almost have to have more people because there are so many pieces of the puzzle that are missing and where there is great pressure to take into account more points of view in order to get a better outcome.

JC: *How do you mobilize all of these people in a time constraint environment to both participate and reach decision making necessary to get the outcome?*

JL: I think it is easier in the post merger integration environment. First of all, people are motivated by self interest. “If I am not perceived as a team player I could be left out when the game of musical chairs ends.” Secondly there is an understanding from an institutional standpoint that urgency is required, so more people are willing to focus in order to get through the period of chaos, in order to build value and prevail against determined competitors who look forward to taking advantage of the confusion that reigns in a post merger environment.

We can debate what the best structure is, but having a unit, a group of individuals, or a team responsible for coordinating, managing and encouraging is crucial. Otherwise it is like a street fight.

The kinds of issues a company needs to take on include how does it increase productivity, profitability, more efficiently utilize resources, and enhance stakeholder engagement as well as how does it affect areas such as employee satisfaction and customer satisfaction? What is it going to do regarding risk: Will it increase or decrease risk? What is the impact on shareholder value? What is the impact on capital utilization, on reputation and brand image? If you want each operating unit responsible for those issues, and they operate independently, they will never get anything done. These have to be managed strategically.

JC: *How does an understanding of intellectual assets affect the redesign of the new organization, structure and processes?*

JL: Somebody has to aware that these influences on the organization’s ability to create value exist. Those involved are not necessarily defined by the management information system or by GAAP accounting. You have to have a team of people aware of with an interest in optimizing those variables.

JC: *Who needs to be involved in this reframing?*

JL: The answer to that question lies with who the individuals are with the breadth of experience who understand that management value creation is the result of a systemic approach to managing. These people need to be open to the fact that in acquiring a new organization, you may be acquiring ways of operating that are unfamiliar but superior to the ones that you are using. Similarly you may be acquiring problems that you may not have been aware of. Are you able to adapt? Are you able to fit it into a strategic framework so that you are is able to down the road. The kinds of people who need to be involved are less defined by their job description and more defined by their psychosocial approach to change and to management success.

The only concern I have on focusing solely on "young go-getters" is that you also need to leaven that energy with the experience of people who have been around for a while who can say, "You are not thinking of about this element of the way that this organization works." You need a mix of people from a length of service position and a breadth of experience standpoint. They have tacit knowledge and institutional memory that may remain at the heart of the organizations value and you don't want to lose that.

JC: *How does a newly combining company need to engage in rebranding itself?*

JL: There are a lot of cautionary tales here. One is Macy's, which has become the behemoth of retailing. When they acquired Marshall Fields in Chicago, and May in Los Angeles, they decided that they were going to brand everything as Macy's, without fully understanding what the Macy's brand meant, nationally and globally, and without fully understanding what they had lost with these local brands. They did not consider the benefits, albeit at a slightly elevated cost, of retaining some of those traditional brand names. Subsequent data have shown that this misunderstanding has contributed in some cases to disappointing results.

If you resided in Chicago, where did you go every go every Christmas? You went to Marshall Fields. Macy's means nothing in that market. That has happened again and again. When you are becoming that large, there is a certain amount of institutional arrogance that takes place. You tend, understandably, to believe the best about yourself rather than saying, "Yes, we have been financially successful, but our name does not mean that much to a lot of people. It is not so much that they are going to competitors because they are angry with us. They don't care." Macy's has rethought its branding approach. They have given a lot more autonomy and authority to local and regional managers to create some of that local flavor that drove sales.

There is an acquirer and an acquiree. In our society, the thinking is that the acquirer won. It is a winner take all view, with the idea of that since we are the acquirer, we must be right, rather than we have some strengths but we might learn something from these companies that we are acquiring. There may be some benefits, particularly when it comes from branding and reputation.

This is a caution for larger acquirers. For example, there is a resistance to an Oracle becoming a sole provider in a crucial, strategic set of applications. We are starting to see more and more resistance to Google. They are just too monolithic, certainly so with Microsoft a decade ago.

Institutions and organizations have a sense of their own well being and a keen antenna to threats to their own well being. They will respond when they feel that in the M&A context the growth of an entity threatens their strategic options.

A lot of this is because we have focused, as a society and economy on traditional micro and macro economics. In the intervening years there has fortunately been more focus on behavioral economics. There has been a trend away from the notion that the market is all seeing and all knowing; that everything that happens in an economy is good simply because it happens.   There are a lot of what we call information asymmetries that allow people to take advantage of inside knowledge that is not good in the longer run. These process need to be managed.

JC: *Is there is a process for rebranding when two entities combine?*

JL: There are many processes for rebranding. But it is not clear how many companies embrace them. We certainly saw that with financial services in the last decade, particularly in Europe, i.e., Banco Santander, Royal Bank of Scotland, HSBC. There is a gobbling up of assets without a concomitant understanding of the risks inherent in those acquisitions and without enough research into what benefits would result to the clients of those institutions. As a result, in less than a decade, these institutions are finding that they do not have a large support network because they never really meant anything to anyone, at least in their insulated state. They have destroyed a lot of value. We now find ourselves this week with most of the large European governments exercising truly confiscatory actions against the compensation of a large swath of their management of those institutions. I think this a direct correlation.

We talk a lot about thinking as if you are in a chess match – thinking three or six moves ahead. But very few organizations do it.

JC: *Are there organizations that have gotten it "right"?*

JL: Proctor and Gamble is justifiably held up as an organization that has done a pretty good job of morphing over the years. They have gotten into beauty and other alternative sidelines as alternatives to their basic business. Some they have kept, some they decided have not paid off. GE is the classic example. They got heavily into entertainment about fifteen years ago. Now they are divesting themselves of their entertainment assets.

There are iconic companies that have remained iconic for good reasons. GM has clearly lost its way but GM may prove to be a phoenix. It may arise from the ashes.

If there is any unifying characteristic, it is adaptability, lack of sentiment with regard to defining core strategic purpose. The best organizations are not defined so much by the industry they are in as by their ability to manage, their ability to make strategic choices.

JC: *How can a company attractively package itself for sale or divesting business units from the point of view of its intellectual assets?*

JL: First they have to understand that we are operating in a truly global market place. We have Indian companies that have acquired iconic brands like Jaguar and Land Rover. Similarly, Chinese companies like Lenovo that acquired the IBM personal computer business. Any notion that management had that the potential acquirer of this business has to look like, speak like and think like them has to be disregarded. To receive optimal value, a manager has to be thinking about who might be the best in a global economy to benefit from acquiring this asset. There may be a strategic buyer from Indonesia that you never heard of for which this asset might provide the highest value. This view is of a more complex world, but one which provides more opportunity. Companies need to be thinking about what is going on outside what we know as a US based corporation. Do we have any individuals within our organization, or amongst our advisors who can enlighten us? Optimal value is not going to come from North America, unless in a specific instance. If you are limiting yourself to North America and northern Europe, you are limiting the return you are going to receive.

There has to be more transparency and honesty. Nobody is going to fake anyone out any more. What are our assets? What are our liabilities? Why are we unloading? All of this gives potential acquirers sense of why an entity is no longer of great value to that particular organization. Then the organization needs to look around the universe to see who is most likely to be able to optimize this specific collection of assets. This means thinking in a much broader, more comprehensive way about the notion of value.

JC: *Besides the transparency element, is there anything else that you would emphasize as far as packing assets?*

JL: There is much more awareness outside of what we used to consider to be the impermeable boundary of the organization. There is much more movement by executives so there is much more knowledge about internal functioning. There has to be much more clarity about potential benefits to an acquirer. You really have to make the business case or a variety of business cases to a number of potential buyers.

You have to rethink how the entity is organized with potentially more reshuffling and rethinking about what an asset is. Repacking is not just a new coat of paint. It is potentially about recombination to create more value. This is not a static entity any more. It needs to be thought of as a more plastic asset.

Jonathan Low Bio:

Jonathan Low is a Partner in Predictiv, a consulting firm specializing in the valuation of intangibles such as intellectual capital, brand, reputation, leadership and alliances. Jonathan has recently created PredictivAsia with partners in China. .

He is the co-author of *Invisible Advantage,* was co-editor of *Enterprise Value in the Knowledge Economy* and was a contributor to *Business Power: Creating New Wealth from IP Assets*. His work has appeared in *The Wall Street Journal, The New York Times, Forbes, Business Week* and other publications. He has been a featured speaker at numerous conferences on intellectual asset-based management hosted by academic and business groups.

He is a graduate of Dartmouth College and Yale University's School of Management.