Is It Worth It?

How to protect intangible value.

BY **ROBERT B. MORRISON**

How might a business with few tangible assets but significant profits and goodwill be worth no more than the combined values of those tangible assets? The answer is *intangible*.

The value of a business enterprise in excess of its tangible value most likely emanates from intangible assets, such as customer relationships, technology, in-process research and development, a trained and skilled workforce, and intellectual property. The value and sustainability of a closely held company's intangible assets may depend on one or two key controlling owners. To the extent that intangible assets and value might walk away from the business when one or more of the principal owners does, the transferable values of those assets come into question.

Consider the following very real scenario: You started a business enterprise shortly after graduation. You hired your best friend from college as your first employee. After 20 years, the business has grown and is very successful. You may have even given your friend some ownership of the company.

Your friend, a Type A personality, has been in charge of client and customer development and sales. The sales force now has 20 managers that report to your friend. They work customers and prospects around the globe. You, on the other hand, are a Type B personality and have been responsible for product development. In fact, you are so talented that you are—and always have been—the only person involved with product development. You hold the key to what makes your existing and up-and-coming products in such demand.

Your company begins to gain notice from potential suitors. Numerous buyers have conducted due diligence only to make maddeningly low offers. You cannot understand why the offers are so low when the company has a long track record of stellar revenues and earnings growth. Ultimately, no transaction occurs as the offers are just too low.

One day your friend returns from a long sales trip and announces that he is leaving to start a competing business. Soon you begin to notice that several of the more productive sales managers leave your company and join your ex-friend's company. You also notice that the orders you have been taking from certain customers every year are now declining. Finally, you learn that the name of your ex-friend's business is suspiciously similar to your company's name. In an epiphany, you suddenly understand why the offers from the potential buyers were so low.

Appropriately, the suitors recognized that a lot of the value of your company rested in intangible assets that were not protected or, more directly, were not owned and therefore were not transferable by your company. Buyers will not pay for assets that the seller cannot convey. The primary income-generating asset of the company is its client relationships. The company had no long-term contracts with its customers and the relationship between the company and its customers rested with your ex-friend and the members of the sales force. The customer relationships belonged to them, not the company. Therefore, the suitors discounted the value of these regardless of the length of the relationships. This value may have been protected through noncompetes with the ex-friend and the key sales managers and contracts with the customers.

The company name has positive recognition in the marketplace. However, with a similar name, your ex-friend is capitalizing on your company's reputation. The suitors saw this risk and discounted the value of the trademark and trade name accordingly. The value of the trademark may have been protected by registering it with the state, if not with the U.S. Patent and Trademark Office.

You and you alone know the "secret sauce" that makes your products desirable in the marketplace. If something happened to you, all of that critical knowledge might be in jeopardy. Again, the suitors identified this as a significant risk to the company's future profits and further discounted the value of the business. The value of the special sauce may have been protected by more depth in product development personnel and meticulous and detailed product specification documents.

If the intangible assets of a company are not protected and may dissipate, the value of the company may be no more than that of its tangible assets. Buyers will materially discount the value of assets that may not be transferred or that may not be fully exploited. Value-maximizing owners of closely held businesses should consult with their attorneys and take advantage of some of the tools available for transferring ownership of the intangible assets to the corporate entity, thereby protecting their individual values. **TBJ**

ROBERT B. MORRISON *is the chairman of the Business Valuation Committee of the American Society of Appraisers. Founded in 1936, the ASA is known as the only professional appraisal organization that requires all of its members to maintain the U.S. Congress-recognized certification for the Uniform Standards for Professional Appraisal Practice. For more information, contact him at bob.morrison@morrisonvfs.com.*