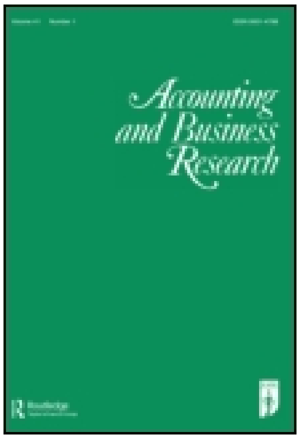

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Discussion of 'Intangibles and research - an overview with a specific focus on the UK'

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Discussion of 'Intangibles and research – an overview with a specific focus on the UK'

Alan Mackay*

I have been asked to give a practitioner's perspective. This is not an accounting practitioner's perspective; if anything, it is an investment practitioner's perspective. It cuts across all of the issues that you have been discussing. I will try to do that quite quickly, with just two or three points.

As background to my observations, I lead 3i's global healthcare practice so I see a lot of the information that Glaxo sees but at a much, much earlier stage, particularly in our venture capital business where I see the creation of intangibles.

I also focus particularly on public companies. I invest in, and sit on the boards of, established companies. We have a business called Quoted Private Equity, which is a strange label, but through it I see the issues that we all wrestle with in the public company disclosure domain.

At 3i I have nurtured for a decade now our interest in central and eastern Europe, where we have quite an active venture, with offices in Warsaw, Prague, Budapest and, most recently in Bucharest. It is one of the few places where with intangibles you could go negative and put a bracket around them. I do not know how often you discuss political risk or indeed the organised crime risk, but I see it very much in the flesh.

That outlines my role at 3i. I shall weave some of those perspectives into what I say. I should also say that I am not an accountant. I am a lawyer. I studied law in Scotland. I failed what they called accounting and tax law, if you can imagine such a thing, and at the same time, in the same year, won a prize in jurisprudence, which is the theory of law, because I'd written a little mini-thesis which lauded accounting and tax law as examples of good law! So I have opinions on everything, but do not know very much about the detail. I thought I'd just share that with you!

Looking forward, I am going straight from here to New York to a meeting which will negotiate this evening (New York time) from 8 p.m. through to 11 p.m., which is about 4 a.m. London time, on a particular transaction which everyone who is involved wants to get closed before Christmas. I shall return to that later as it is relevant to intangibles.

In my investment practitioner's perspective I should like to share with you three specific observations.

First, I have been in the investment business for some time. My very first day at 3i was Black Monday in 1987, which was an interesting place to start. Over the 20 years since then I have seen some incredible changes in perspectives from an investor's point of view. And it really has changed.

When I was first investing through 3i, as an equity investor taking risk capital investments in companies, we used to prepare an asset cover schedule for every investment that we made. Banks were worried about realisable values in the event of insolvency and liquidation. As an equity investor we used to prepare asset cover schedules as well, to see, after the debt was recovered, what would be available by way of distributions to the shareholders. We had to offset all the prior claims of all the preferred creditors. However, we spent a great deal of time in a great deal of detail going through the balance sheets of the companies in which we were about to take risk investments.

Fast forward to today, 2007, and particularly in healthcare – but also in media and some other sectors – the investment industry will apply multiples of EBITDA of 15, 16 or 17, for companies. There is certainly no asset cover on the equity. On the debt, there is only partial cover on any basis; either the going concern or the wind-up basis. On top of that, there is a whole range of amplifying risks like the roll-up of interest or PIK (payment-in-kind) notes where interest costs on debt are not paid but are accumulated as a charge. When I think back on it, the whole mindset of investment has shifted dramatically so that items which were intangible and which were not realisable assets and were not physical corporeal assets were unacceptable 20 years ago but are absolutely accepted now. That carries with it a whole range of knock-on effects in the way that people think and account for their investments and the valuation of assets.

I should also just highlight that in getting from 1987 to 2007 we obviously went via the 1990s,

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and particularly the late 1990s. I see my colleagues nodding, with their painful memory for our industry. This is not specific to 3i; things did go absolutely to excess in that dot.com bubble. We had, for all the talk of portfolio effect, to equalise some of the uncertainties around intangibles and some of the judgment calls on the less quantifiably measurable things. We had at 3i something like 3,000 investments, marking everything by best judgment, putting a value on each one of those, item by item, and being a little bit concerned at the over-value that external events were forcing. Yet 3i itself, across 3,000 assets, as a FTSE 100 company was trading at a 60% premium to its best judgment net asset value, as other people tried to look through that and make judgments about how conservative 3i was being.

I would say that over time we have gone from the '70s and '80s where investment perceptions around assets with intangibles were irrelevant and it was all about hard assets, and then we've gone through some craziness. And we have come back recently, over the last five or six years, to a more conservative view as an investment industry, whether it involves private equity or public equity views on intangibles. Let's just keep a lid on the exuberance!

The second point I'd make as an investment perspective is to share with you how we actually do in practice value things, particularly the venture capital industry globally.

A couple of hundred billion dollars a year move around in that marketplace. This amount is applied by people striking a deal to invest in one idea or another: 'We will give you $30m to do this and we will have 30% of the equity in your company.'

The British Venture Capital Association (BVCA), or the European equivalent (EVCA), or the American NVCA, all say the same on intangibles – so while technically the International Accounting Standard IAS 38 or the UK Statement of Standard Accounting Practice SSAP 13, or indeed International Financial Reporting Standards generally, may all disagree about recognition and capitalising or expensing – the investment industry says, 'if there is any conflict between the way we think about valuing something and any of those rules, whichever standard is applicable, then the standard dominates, and our subjective view subordinates.' Yet in reality I do not see that. I cannot join this up. So for me in reality there is disconnect between net asset value (NAV) and fair market value because if, in my example, we put $30m into an idea, a new drug or launch of a new media brand, and we take 30% of the equity, with an imputed enterprise value of $100m for this thing, then the whole venture capital industry for some time will hold the $30m investment and account for it as a $30m investment despite the fact that that $30m is being spent and burned away and losses are being incurred, and the NAV of the entity is rocketing down. And then, at some point, it will look for an event, or some kind of rationale, upon which to pin a new value. But there is quite a disconnect for quite some time between the entry imputed valuation and what is happening in the real world with that particular company. And again, I am not technical enough to rationalise and re-join that disconnect. But I would remark, from what I heard today, that it is there and it is for me a quirky little thing.

Again, the message I would say is that the investment industry, as a whole, is becoming slightly more conservative over the last five or six years.

Yet whatever way you look at it, it's not a NAV-driven mindset in private equity, or indeed in the investment industry as a whole – it has moved away from the most conservative perspective. It has at times been a bit ludicrous, yet I would say actually the zeitgeist, the shift in the last five years across most of the investment mindsets, is to something slightly more conservative. If I try to explain that – and this will be my third and last perspective to share – the most important practitioner insight I would leave is that, from an investment mindset, all this debate around intangibles and valuation, actually boils down to entry, which means the time that you invest, and exit, which means what you think you are going to get for your asset when you realise.

Again, this is not a technical thing, but philosophically all the going concern mindset around expensing assets, about amortising them, or valuation uplifts or adjustments, really does not apply in investment industries. Absolutely everything feeds off entry and exit. And again, looking back to where I'm going in the next 12 hours, we are going to try to close an investment. It's an asset in which we, 3i, are investing. There are two other new institutions wanting to invest in that asset. The value range that we have been debating is quite huge, between $370m and $460m. In reality it is much narrower; it's around $400–420m. Tonight, by 11 p.m. New York time, 4 a.m. here, we will have resolved that and will have shaken hands on it.

However, whatever we shake hands on as the figure for that company will have many knock-on impacts. It would be impossible for me to articulate that to you in the technical language of intangibles but it will have a very direct impact in the accounting for at least ten entities: for 3i and the other two current investors; for the two incoming investors; for the company itself in which everyone is investing; and indeed all the way back through the limited partners and the investors in those funds; and goodness knows how many pensioners and life insurance policy-holders behind.

This does not give you any answers, but as a perspective the investment industry is preoccupied by entry to exit, and then will justify that as a judgment call over three years, five years or ten years, whatever the holding period is. The actual essence of the intangible and how you build up the argumentation, frankly is not prevalent in the judgment call around how these values are set. I will leave it at that.