

Strategic Chronicle™

A Newsletter for Clients and Associates of KLM, Inc.

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Building Market Capitalization With Intellectual Capital Assets

We have been hearing more and more over these last few years that the most important assets for both new economy and old economy businesses are not the tangible assets conventionally reported on the company balance sheet, but the intangible, Intellectual Capital Assets which are not reported in any financial statement.

How can we understand this emerging truth? How can we make these intangible assets, known as Intellectual Capital, actionable so we can use them to drive corporate valuation and stock price? Here is a simple way to think about the subject:

- 1) Corporate valuation is equal to market capitalization, which in turn is made up of two elements:
 - a) The tangible assets, quantified as book value, and reported on the company balance sheet.
 - b) The intangible assets, which go largely unreported in financial statements and comprise the rest of market cap.
- 2) Corporate valuation can be enhanced by leveraging enterprise assets to create value and drive growth through:
 - a) The efficient leveraging of the tangible assets comprising book value.
 - b) The strategic leveraging of the intangible Intellectual Capital Assets.

“...for every dollar of value contributed by tangible assets, two to four dollars more are being contributed to enterprise value by the intangibles.”

Therefore we can actually drive corporate valuation by optimizing and leveraging both the tangible and the intangible assets within the enterprise.

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Over the last fifteen or twenty years, book value assets have been increasingly optimized in corporate America through the use of sophisticated management tools such as TQM, outsourcing, downsizing, right-sizing, and reengineering. We can thus assume that these assets are in good hands and well-optimized in most diligent enterprises.

But what about the knowledge-based intangible assets? Are they equally optimized? Unlikely. Learning to optimize the intangible assets is both the challenge and the opportunity before the executives and managers in today's corporations.

Even after the tough market of the last two and one half years, the market cap of Fortune 500 companies exceeds their book value by two, three or even four to one. This means that for every dollar of value contributed by tangible assets, two to four dollars more are being contributed to enterprise value by the intangibles. This is true across both old economy and new economy companies. This means that the value being contributed by their intangible Intellectual Capital Assets is significantly greater than the value contributed by their largely optimized physical assets.

This fact bears powerful witness to the reality and power of such knowledge-based assets, and to the importance of identifying and managing these Intellectual Capital Assets to cultivate new sources of value and growth for the enterprise.

As we continue the shift into a knowledge-based economy, the success of businesses both in the marketplace and with investors will be based upon intangibles – Intellectual Capital Assets - such as Brands, Knowledge, Innovation, Human Capital, and Intellectual Property. Given the tremendous power of Intellectual Capital Assets to influence the valuation of an enterprise, it is critical that executives learn to employ these assets to improve profitability and increase shareholder value.

For most organizations, acting on this insight will begin by identifying their respective intangible assets and obtaining the specialized expertise that will make their management actionable and accountable for leveraging these assets effectively. Given the potential upside impact on the enterprise valuation, the management of Intellectual Capital Assets should be handled with the same due diligence long devoted to managing tangible assets.

Now that these Intellectual Capital Assets have come into focus, it is a fiduciary responsibility of enterprise executives to ensure that such assets are recognized, performance metrics established, and that they are successfully exploited. Given the fact that intangibles can grow exponentially relative to tangible assets, it only makes sense to pursue this path as both the best and fastest way to increase enterprise valuation.

How Do We Think Strategically?

Within today's rapidly changing corporations, individuals at all levels are increasingly called upon to demonstrate their ability to think strategically. However, many are inadequately prepared to perform this task. Many new executives, and even those long within the executive ranks, are unsure how to properly engage in strategic thinking.

While there are many seminars and classes that provide the well-codified elements of management education such as project management, planning,

leadership, finance, sales, and communication skills, training in strategic thinking per se is largely absent.

What is strategic thinking today?

What Is Strategy?

The word “strategy” is originally from the Greek word *strategia* which refers to an act, device, or plan employed by a leader. Aristotle, the famous 4th century B.C. Greek philosopher stated it well when he said,

“...as there are many actions, arts and sciences, there ends are also many; the end of the medical art is health, that of shipbuilding a vessel, that of strategy *victory*, that of economics wealth.”
(italics added)

Thus, strategy is an act, device, or plan used to achieve *victory*, while strategic thinking is a way of thinking toward the end of “victory,” “success,” “winning,” or, in modern parlance, “competitive advantage.”

But how do we actually go about “thinking strategically,” and in particular, gaining a competitive advantage in the marketplace?

Operational Effectiveness

After two decades of refining the management tools that deliver operational effectiveness, many executives continue to confuse these tools with strategy and the achievement of competitive advantage.

However, they are easily copied by competitors who seek the same optimization of their operational aspects for their enterprise. These management tools do not

confer competitive advantage. They are the price of entry, but not the key to ultimate success.

All players in a market will strive for quality, the lowest price, and the best service, but these are easily copied by competition and fail to differentiate one enterprise from another in the marketplace. Thus we

“... many executives continue to confuse (management) tools with strategy and the achievement of competitive advantage.”

may say that operational effectiveness is a necessary, but not sufficient, contributor to enterprise success. Of course we must strive for the most efficient operation, and also to deliver the highest quality and the truest service, but our competitors can do the same. So, a focus on the management tools of operational effectiveness will provide no real advantage over our competitors.

Where and how do we get competitive advantage?

Differentiation and Competitive Advantage

Competitive advantage only arises from establishing differentiation. While the management tools of operational effectiveness ultimately deliver sameness and homogenization among competing enterprises, competitive advantage is the principal outcome of successful differentiation.

The more competitors stake their strategic thinking upon being the lowest price producer or delivering the highest quality, the more they start to look alike in their marketplace, thus losing their competitive edge over one another.

Remember, competitive advantage arises out of meaningful differentiation from the other players in the marketplace. Thus the strategy that delivers marketplace advantage must be founded upon being different in some genuine way. Such strategic differentiation is based upon choosing and tailoring activities that deliver a unique mix of value which cannot be easily duplicated.

Wise strategists create unique value by refusing to base their strategic thinking on homogenization, following, and imitating. Instead, successful strategists combine activities from among their core competencies that fit together in unique ways to reinforce each other and build value. They realize that creating unique value in this way locks out imitators and creates true competitive advantage.

The New Strategy Model

If strategy is about an act, device or plan that delivers competitive advantage, then it is the ideal complement to the operational effectiveness delivered by modern management tools that deliver homogenization around price, quality, and service to all players.

Of course, the drive for enhanced effectiveness will always be necessary. But it will never be sufficient to provide the sustainable competitive advantage that we can achieve through strategic differentiation.

“The more competitors stake their strategic thinking upon being the lowest price producer or delivering the highest quality, the more they start to look alike in their marketplace, thus losing their competitive edge over one another.”

Carefully orchestrated and integrated differentiation is the premier device of strategic victory. It cannot be easily reverse-engineered nor copied by competitors. Strategic differentiation, achieved through choosing and tailoring activities to deliver a unique mix of value, is the strategic competitive advantage of choice.

In summary, strategy and strategic thinking are fundamentally about combining activities that fit together to reinforce each other, deliver marketplace value, and thus provide true competitive advantage.

Management tools are for optimization and operational effectiveness. Strategic thinking achieves competitive advantage through differentiation and the delivery of unique value.

Thinking this way is thinking strategically about the enterprise.

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Brand Valuation Basics

Since the late 1990s, the need to establish dollar valuations for Intellectual Capital Assets has driven the development of a handful of valuation methods. These methods are nearing formal recognition by the Financial Accounting Standards Board (FASB), and are headed toward inclusion in the standard repertoire of the Generally Accepted Accounting Principles (GAAP).

Essentially, there are four approaches to valuing a Brand, and one or more of them may be applicable in any individual instance.

The four approaches are:

- 1) Cost Approaches
- 2) Market Approaches
- 3) Income Approaches
- 4) Brand Strength Assessment Approaches

Which method or methods are the right method(s) to use depends greatly upon the individual situation and the perspective from which the valuation is to be addressed. Invariably, Brands must be looked at from all approaches.

Arguing from Cost

A cost-based approach is the obvious one from the financial and accounting perspectives, given that it complies with standard accounting practices for valuing assets.

This approach is conservative and, importantly, it should be noted, it assumes that the asset in question declines in value from the moment of its acquisition. While it is a useful element in performing a comprehensive Brand Valuation, possibly to set the low-end, its primary use is with traditional, tangible or physical assets. A cost-based approach is not well-suited to set values on intangible assets – which typically do not decline in value from the moment of inception, but rather, when well-managed, actually increase in value with their very use.

The protocol here is to list all the individual costs

which can be documented as the expenses incurred in creating the Brand from its earliest inception to its state at the time of valuation.

This method overlooks new, intangible asset value which may have been contributed to the Brand since its inception through Brand-building activities. It also fails to provide any allowance for future replacement costs.

Arguing from Market Value

This approach argues from what the Brand could be sold for in a market. This approach often assumes future benefits and values which are yet to be captured by the Brand.

Brand Valuation against market value is most easily addressed in public companies through the analysis of market capitalization. In this case, the Brand Value is equal to all or some of whatever market capitalization remains

after subtracting the book value assets from total market capitalization. In cases where Brands have been carefully developed, the Brand may account for all of the remaining market capitalization.

As well, a market-valued Brand may be benchmarked against another Brand in the same market for which a Brand Valuation has previously been set – possibly in an acquisition where the Brand Value has been recorded on the Balance Sheet as “Goodwill.”

Arguing from Income

This approach identifies “Brand after-tax operating income” to set a value, stating that Brand Value is the ability to produce after-tax income.

Various specific methods exist for setting an income-driven valuation, including:

- 1) Price premium over an unbranded or minimally branded entity in the marketplace.
- 2) An estimate of an annual royalty rate under a Brand Licensing Agreement.
- 3) Formal comparison of “Brand after-tax

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net income” between the target Brand and an unbranded or low-branded marketplace entity in the same category.

Arguing from a Brand Strength Assessment

The most comprehensive approaches are those that argue from an analysis of a set of factors assessing a Brand within its Primary Competitive Set and/or other peer Brands.

These approaches were popularized during the early to mid-1990s by two British concerns, Financial World magazine, and Interbrand, a Brand consultancy based in London.

Interbrand developed a three-year average of after-tax profits to set “Brand profitability” as a single measure, or as a measure to be factored by a Brand Strength Multiple.

British accounting standards are more permissive than those in the U.S., in that they are known for allowing the inclusion of intangible assets on balance sheets so long as the asset may be separately identified. In England, this is true not only for Brands obtained through acquisition, as in the U.S., but also for internally developed Brands.

Setting Brand Value

All of these methods possess their strengths and weaknesses. Increasingly the trend is toward the application of Brand Strength Assessments because they require a thorough Brand Analysis, and then to balance that valuation against the other less-comprehensive approaches to set final Brand Value.

Because the goal is both the ability to capitalize the intangible asset under consideration and set its value as a benchmark against which to measure future Brand-building activities, it is in all parties’ interest to set the least prejudicial value.

PepsiCo Goes Natural

PepsiCo, Inc., the massive food and beverage conglomerate with a market capitalization of \$73 billion and annual revenues in excess of \$27 billion, has announced their intention to migrate their snack food and beverage offerings to a more healthy profile, and to encourage the moderate consumption of snack foods.

Steven Reinemund, chairman and CEO of PepsiCo, recently announced the adoption of this surprising new corporate strategy for the conglomerate, indicating their intent to make at least 50% of their product offerings “nutritious,” while simultaneously encouraging consumers not to overindulge in PepsiCo products, much as brewers of beer have been encouraging the “responsible consumption” of their products.

PepsiCo (will) make their products more nutritious by cutting fat and adding healthy ingredients, and ... they will begin encouraging consumers to view snack foods only as “treats” and occasional “indulgences.”

PepsiCo’s action may be at least partially motivated by increasing concern among both the public and health officials about the health dangers of poor diet and obesity. The Office of the Surgeon General of the United States reports that obesity has reached epidemic proportions in the United States, with a shocking 61% of the population overweight, and 300,000 deaths per year attributable to obesity.

As snack food makers and fast-food chains come under fire, it is only natural that they will begin to moderate their position to head off potential problems and even lawsuits as experienced by the tobacco companies when public opinion shifted against tobacco because of its health risks.

In response to mounting concern, Mr. Reinemund is driving a new sense of corporate responsibility. Quoted on the front page of the Wall Street Journal, he stated that PepsiCo would make their products more nutritious by cutting fat and adding healthy ingredients, and that they will begin encouraging consumers to view snack foods only as “treats” and occasional “indulgences.”

PepsiCo is the fourth largest food and beverage company in the world, trailing only Nestle, Kraft, and Unilever. Their immense house of Brands includes such well-known names as Pepsi, Mountain Dew, Lay's and Ruffles Potato Chips, Gatorade, Tropicana, Fritos, and Quaker Cereals.

Can the maker of such notorious snack foods as Fritos Corn Chips and Cap'n Crunch Cereal shift its Brands to stand for a natural profile? Pepsi's intent is not to become a natural food company, but to become more healthy than they presently are. Apparently Pepsi's acquisition of Tropicana during 1998 has given the company both insight into healthier products and expertise on how to make and market them.

Nevertheless, one of PepsiCo's biggest challenges will be to secure the Knowledge Capital necessary to truly understand what a more natural consumer wants. But perhaps they haven't set the hurdle too high. Their definition of healthier is that servings would contain no more than 150 calories, 5 grams of fat, 1 gram of saturated fat, and 250 milligrams of sodium. Fritos presently contains 160 calories, 10 grams of fat, 1.5 grams of saturated fat, and 170 milligrams of sodium. In this case, it is mostly about reducing fat. When physicians report that they are seeing 4 and 5 year old children who are more than 20% overweight, we will have to be thankful for any progress PepsiCo makes across its many Brands.

Previously, corporate giants in the food and beverage industry have been motivated to market healthier products, gained largely through the acquisition of natural food players, to get a piece of the booming natural and organic market. PepsiCo's desire to create healthier products appears to stem more from a sense of social responsibility for their own Brands, and of course if it catches on, Pepsi's Brands will certainly have first mover advantage in the grocery store.

As well, this will be a test of the basic principle of Brand Elasticity which state that a Brand can only be stretched so far beyond it's original properties before it will snap back with incredulity and rejection from the marketplace.

If Fritos become healthier will the consumer welcome the change? Lay's Potato Chips are building a franchise around the low-fat "Baked Lay's," but will it stick and gain market share or will consumers return to the salt and oil for "full flavor?"

PepsiCo has in their favor that fact that many of their products are already fairly natural, standing somewhere between Fritos and whole wheat flour. Tropicana Pure Premium Orange Juice, Quaker Oats, Life Cereal, Aunt Jemima, and even Gatorade verge upon naturalness. Die-hard natural food consumers may still withhold their favor over issues surrounding processing, preservatives, or food colorings, but the bulk of the American population could loose weight and become healthier on PepsiCo's initiative.

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