PERSPECTIVE

Tangible Assets

Inherent virtues

The burst of the dotcom bubble has proved that the essence of intangible assets lies in the strength of the real sector.

The growth of the Internet and the hype about the new economy has prompted many management gurus to lay a strong emphasis on building strong intangible assets. The essence of their argument is that companies should build competencies in areas such as design, supply chain management and brand building and leave the 'dirty' job of constructing and running factories to contractors. Indeed, the stellar performance of companies like Cisco and Enron in the 1990s, provided strong support for this argument. With the fall of Enron, which burnt its fingers while attempting to convert itself from a brick and mortar to a new economy outfit, this argument looks very weak. On the other hand, the good old 'smoke stack' companies, with their physical assets, look safer to investors, even if they do not offer superlative returns.

In their enthusiasm to propound the virtues of intangible assets, what consultants and academics seem to have forgotten is that life cannot go on without physical goods. The brush and paste with which we start the day, the morning coffee we have, the breakfast, lunch and dinner we eat all involve 'tangible' items. We ride to the office in 'physical' vehicles. A modern office consists of 'physical' assets such as chairs, tables, workstations, air-conditioners and coffee vending machines. True, we do consume services such as Internet access, banking, courier and haircuts. But if we carefully reflect, we would realize that we consume much more of goods than services. This argument is applicable to both developing and developed countries. In developed countries, services account for a major portion of the GDP. But this does not imply that people in these countries do not need physical goods. It only means, physical production has shifted to low wage locations. The point to note is that someone has to manufacture goods. The entire world cannot operate on a 'virtual' paradigm!

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When Enron decided to move out of electricity generation into electricity trading, it thought it was being smart. Indeed, before its recent collapse, it was quite arrogant towards the bigger companies in the energy industry, which owned a lot of physical assets. Former Enron CEO, Jeff Skilling once commented (*Fortune*, December 24, 2001) on old economy companies, "These big companies will topple over from their own weight." Today, Enron has toppled but many of these old economy companies still exist! Moreover, companies like Cisco, which have been considered the ultimate experts in strategic outsourcing and supply chain management were left clueless when the US technology sector recently went into a slowdown. This forced them to take massive write-offs.

A point often overlooked is that it is usually much easier to evaluate the quality of physical assets than of intangible ones. Physical assets can be valued with a fairly high degree of accuracy using different methods such as book value, market price or replacement cost. But valuation of intangible assets like brands involves several assumptions, which often turn out to be wrong. In many cases, there is a huge gap between projected and actual cash flows. Moreover, the accounting practices of companies built around intangible assets are often controversial. For example, AOL capitalized its advertising expenditures for several years arguing that they were capital investments. The dividing line between expenditures, which will yield a one time benefit and those which will yield benefits over a period of time is extremely thin. In the case of the 'smoke stack' companies on the other hand, accounting practices can be much more transparent.

It is time to take the brick and mortar companies more seriously. These companies may not look that glamorous. They may also not achieve super normal growth rates. But they are safer bets. They have physical assets like real estate and plant and equipment, which cannot evaporate even if the markets crash! These assets can generate cash during bad times. And cash, as we all know, is the ultimate hedge against risk. But intangible assets such as corporate reputation can vanish overnight if things go wrong. This is exactly what has happened with many of the new economy outfits. So, has the time come to say "Three Cheers" to the brick and mortar companies? ▯

AV Vedpuriswar, *Dean,*
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Reference # 1-2002-05-01