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Companies intangibles: Unique versus generic



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ABSTRACT

Purpose: In the era of the knowledge economy intangibles are recognized by investors as pivotal value drivers. This paper proposes an intangibles-based tool for picking companies with value growth potential.

Design/methodology/approach: We suggest a model to select companies that effectively use unique intangibles (in contrast to the generic intangibles). To test whether these results can be explained by skill we implement a bootstrap procedure. Companies that are able to use unique intangibles efficiently are combined in a portfolio.

Findings: Only 22% of companies have the skills to use unique intangibles, but all of them are characterized by the efficiency of their use. The created portfolio demonstrates a higher cumulative return, Sharpe ratio and lower drawdown than S & P500. We also find the increasing importance of intangibles for investors during the crisis.

Research limitations/implications: Both the created portfolio and the benchmark (S & P 500 index) are analyzed without transaction costs. Also the benchmark construction is based on equal-weighted sum of company M/B ratios.

Originality/value: We take into account the quality of intangibles (efficiency of unique intangibles use) while previous research of portfolio forming methods is based on quantity of intangibles.

1. Introduction

The primary goal of a typical long-term investor is to pick a company with value growth potential. Because tangible assets cannot fully explain market value, researchers focus on intangible assets. Intangible assets are regarded as key resources that contribute to competitive advantages and enhance tangible assets (Edvinsson, 1997; Sveiby, 1997). The growing awareness of the importance of intangibles for value creation has resulted in an increase in intangibles-related investments. However, investors lack information about the outcomes of such investments when forming portfolios. This lack of information complicates the analysis of the value created by intangibles and therefore the process of picking companies. Also, a company's high current value does not necessarily imply its future growth. Long-term investors are interested in companies with value growth potential. Therefore, they need a tool to determine value growth potential on the basis of present performance and both tangible and intangible resources.

This paper therefore proposes an intangibles-based tool for picking companies with value growth potential. We test the validity of the proposed tool on the sample of US companies included in the S & P500 index. First, we distinguish two types of intangibles according to their uniqueness. We define company resources that are commonly used in an industry as generic intangibles. For example, all employees are trained to work with newly purchased manufacturing equipment. Commonly used new software that simplifies information diffusion between company divisions is another example of a generic intangible resource. We define company resources that are not commonly used in an industry as unique intangibles. For example, a company with a research center that

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patents new technology to reduce production costs produces a unique intangible asset. Reduced costs lead to value enhancement, which raises a company's investment attractiveness. Both generic and unique resources can be used efficiently or inefficiently. Second, we propose a way to measure the efficiency of generic and unique intangibles. We create this measure by comparing the efficiencies of the market and company portfolios of intangibles. Finally, we investigate whether the ability to use unique intangibles is random. The proposed tool combines all three of these steps.

Investment in companies with both generic and unique intangibles can be profitable. However, we suppose that the value of companies that rely mostly on generic resources have a strong correlation with market movements. Thus, we expect that commonly attainable knowledge does not create superior value. Consequently, the ability to produce long-term value is closely connected with the efficient use of unique intangibles. Our proposed model of efficiency of unique-generic intangibles (EUGIn) extends existing tools that pick companies based on tangible assets analyses and assumes the importance of the efficient use of unique and generic intangibles in relation to value creation.

The results of our analyses show the validity of the EUGIn model and its ability to pick shares with better future performance than the benchmark. The median S & P500 company has a negative efficiency for unique intangibles, and the total number of investment-attractive companies is small (22% of the sample). Nevertheless, the success of companies with a positive efficiency for unique intangibles is nonrandom. We also corroborate the importance of unique resources during the economic recession.

The remainder of this paper proceeds as follows. Section 2 introduces the nature of intangibles and their connection with stock markets. Section 3 discusses the theoretical framework of the EUGIn model. Section 4 describes the data and econometrical method that we use to prove the validity of the model. Section 5 presents and discusses the empirical results. Section 6 concludes with summation and discussion of the main results.

2. Theoretical background

A growing body of literature is dedicated to the definition, description, and measurement of intangibles as well as their influence on company results. Of this vast field of literature, we only consider the stream of intangible research connected with capital markets. This section contains a discussion of the term *intangibles* as used in the paper and a critical analysis of the previous research dedicated to the connection between intangibles and capital markets.

Intangibles have vague nature and heterogeneous structure. Therefore, the literature does not provide a single definition (Zambon, 2004; Clarke et al., 2011). The common practice is to interpret intangibles according to the research purpose. Herein we define intangibles according to the value approach, which appeared at the end of the twentieth century upon the integration of the value-based management concept with the intellectual capital framework. Stewart (1997) defines intangibles as intellectual material that consists of knowledge, experience, and intellectual property, which creates value. Edvinsson and Malone (1997) define intangibles as knowledge that can be transformed into value. Zeghal and Maaloul (2010) define intangibles more precisely as all the knowledge that a company uses in value-added creation. Kristandl and Bontis (2007, p. 1518), who provide one of the most comprehensive definitions, describe intangibles as “strategic firm resources that enable an organization to create sustainable value, but are not available to a large number of firms.” These resources are non-physical, non-financial, and are not included in financial statements. Some studies use the terms *intangibles* and *intellectual capital* as synonyms. However, we distinguish their meanings. According to our use, intangibles are connected with the nature of the phenomenon whereas intellectual capital is related to managerial and accounting issues. Therefore, because we investigate the intangible-based potential of value growth of companies, we solely use the term *intangibles*.

Ellis and Jarboe (2010) describe models of financing for companies with intangibles. They find that investment funds and banks take intangibles into account when making financial decisions, but current investment methods need substantial improvement. They argue that intangible-based investing requires better methods of intangible valuation. However, although the authors underline importance of intangibles, they consider them from a theoretical viewpoint.

Jagannathan and Wang (1996) modify a capital asset pricing model (CAPM) to include human capital. They demonstrate that the inclusion of human capital explains cross-sectional differences in average returns in contrast to the classic CAPM. They measure human capital returns using the growth rate of the average employee salary as a proxy. This indicator underlines the importance of intangibles in explaining the return on shares; however, intangibles consist of many elements, which we suppose theoretically all transform into share returns. Therefore, although the results of Jagannathan and Wang's research are of great importance, their research idea should be expanded.

Lev and Sougiannis (1999), Chan, Lakonishok and Sougiannis (2001), Chambers, Jennings, and Thompson (2002), and Anagnostopoulou and Levis (2008) use portfolio comparisons to show the relation between market-to-book (M/B) ratio and research and development (R & D) expenses. Chan et al. also analyzes advertising expenses as a part of a company's intangibles, which influence the return on shares. However, researchers usually ignore the other components of a company's intangibles in the portfolio formation process.

In summarizing the literature, we highlight the main drawbacks of prior research dedicated to the connection between intangibles and capital markets. As previously noted, existing studies usually focus on one component of intangibles, such as human capital or R & D expenses. Intangibles are complex and extremely heterogeneous. All of their components can influence a company's outcomes and should be taken into account in the investment decision-making process. However, intangibles are non-physical and non-financial in nature, and therefore their measurement is complicated (Kristandl and Bontis, 2005). An extensive body of literature analyzes the involvement of intangibles in the functioning of a company. This research commonly avoids the measurement of intangibles, however, and instead uses more valid indicators usually connected with value-added indicators (e.g., economic value

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