Avasta

ENABLING CONFIDENCE THROUGH CLARITY.

# The Commercial Benefits of implementing the Intellectual Capital in the Boardroom (2022) Standard

August 9, 2023
MASB Summer Summit
Milwaukee, WI

# Today’s topics

1. Background
2. Fundamentals
3. Historic Examples
4. Case study
5. Discussion + Q&A

# 1. Background

How did we get here and why does the Standard exist?

# The overarching purpose of the Standard

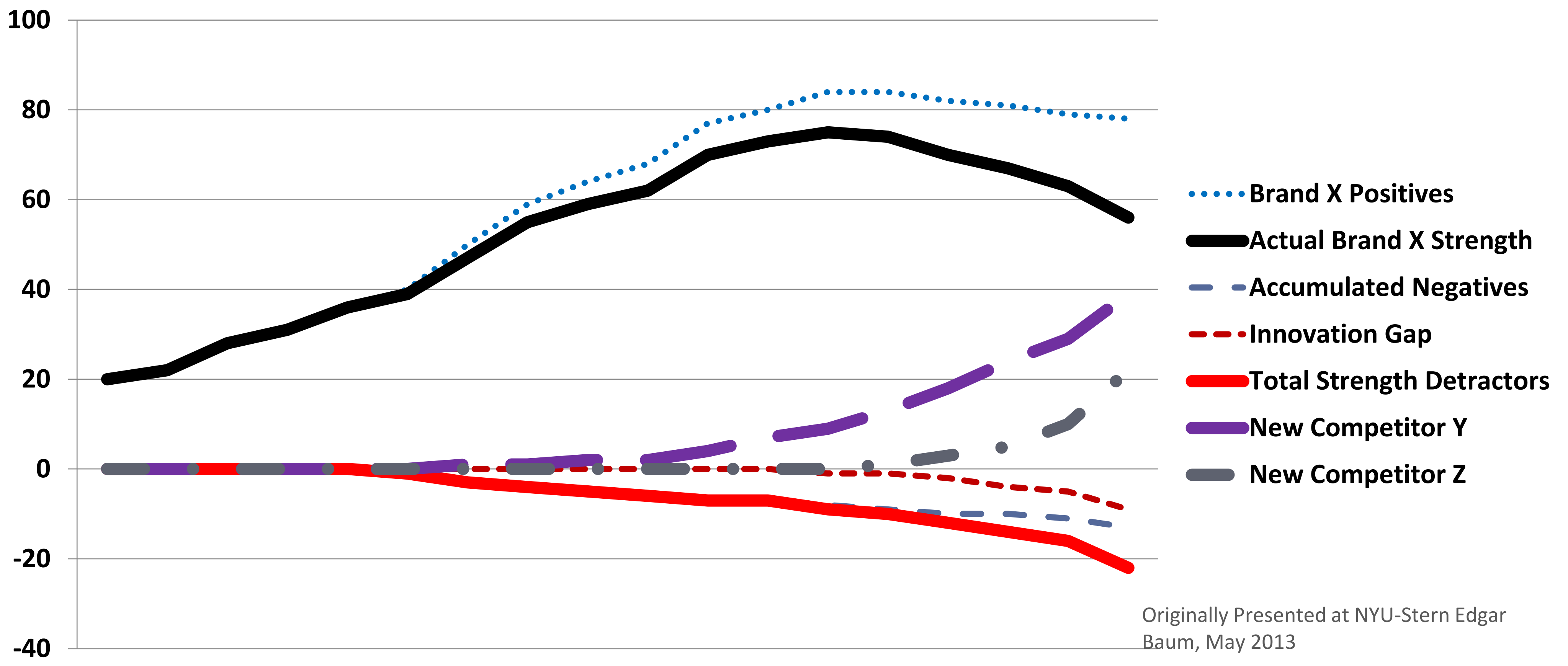
*"Corporate board directors are accountable for safeguarding shareholder value, which now includes appropriate oversight of intellectual capital (IC) value enhancement and risk mitigation.*

*…this standard articulates the process for adequate board oversight of IC management to benefit the company and also help insulate against board liability.*

*This Standard identifies the process steps and key principles for board directors to achieve those objectives in a non-proscriptive manner."*

Intellectual Capital in the Boardroom Standard (2022): Executive Summary

# How did this all begin?




Originally Presented at NYU-Stern Edgar Baum, May 2013

# Why does this matter?

- Historic financial models, valuation models are based on tangible business components
- Over 90% of current business value is intangible and nearly all business models fail at properly considering the role of intangibles
- The tangible economy is systematized and measurable. Until now, the intangible economy was not

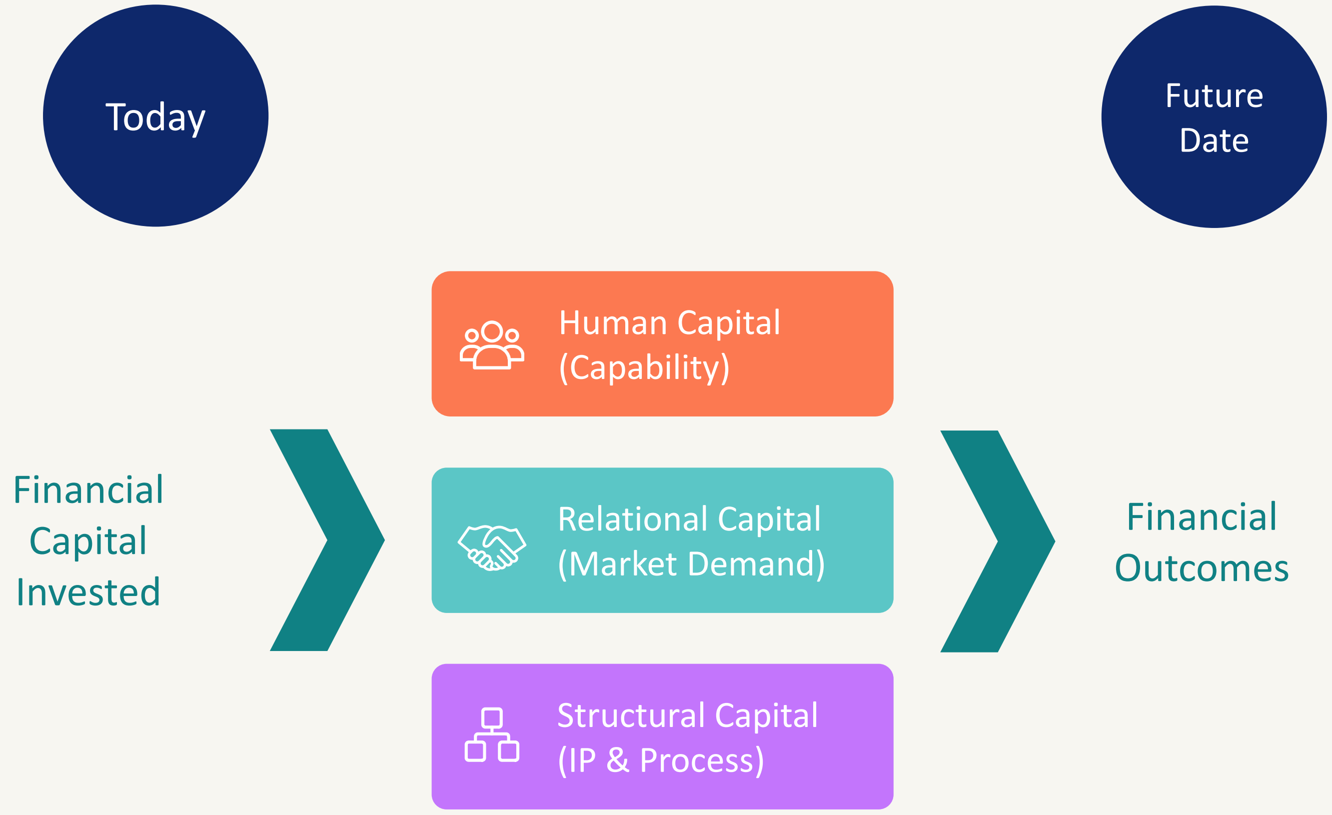
# Why was the Standard created?

- Insufficient definition of longitudinal non-financial success drivers and risk drivers documented and communicated to the board
    - Most forward-looking guidance doesn’t identify non-financial condition that are required
- Absence of a forward-looking baseline to re-evaluate changes in market or operational conditions on strategy and valuation
    - Short term budget cuts increase near term profit without illustrating long term impairment
- Too high a dependency on past results and growth rates assumed to be an indicator of future performance
    - As an example, growing revenue at a 20% annually may not have enough demand in reality

# Historic Lens


- Companies consistently mis-estimating growth
- Abruptly reaching revenue ‘ceilings’
- Remaining growth potential frequently unknown

# Applying ICB




- Can explain why, how and when the company will make money
- Identifies most effective pathways to reach goals
- Identifies residual value of past investments that are lost in annual reporting

# 2. Fundamentals

The dry stuff but hopefully helps us get on the same page

# Intellectual Capital (IC)

“The sum of everything everybody in an enterprise knows and has created and is capable of creating that provides value or contributes to competitive advantage. IC is formed from the subgroups of Human Capital, Relational Capital, Structural Capital and the Intellectual Assets that are the individual utilized or utilizable components within those subgroups."

**How to interpret:**

The non-physical ecosystem of of a company that generates value.  It goes beyond the legal and ownership limitations of a corporation and, measurably, takes into account the ecosystem in which the company generates revenue, why, when and how.

# Relational Capital (RC)

“The sum of the resources arising from the external relationships of the firm with customers, suppliers and R&D partners.

It comprises that part of Human Capital and Structural Capital involved with the company’s relations with such stakeholders."

**How to interpret:**

It is the entire demand ecosystem of a category of products and services that a company competes in using its brand(s) to and through channel partners to end customers/consumers.

A company has positive prospects if Relational Capital is higher than it can fulfill on, to a limit.

# Human Capital (HC)

“The sum of the professional and tacit knowledge and skill of its people that relates to the knowledge, skill and know-how that employees "take with them when they leave at night.”

**How to interpret:**

The collective capability and potential for the workforce of a company to leverage existing and create new revenue and profit driving solutions that are are tied to the individual and not a documented process.

# Structural Capital (SC)

“The sum of all the other intellectual assets (including intangible assets) that remain, both documented and undocumented, that members of the company consider to be proprietary, beneficial, and/or differentiating.  SC refers to the knowledge that stays with the firm "after the staff leaves at night", and comprises organizational routines, procedures, systems, cultures, and databases."

**How to interpret:**

The documentable R&D, registered patents, replicable processes (‘the company way’) that distinguishes the company in how it operates and brings its products to service and market.

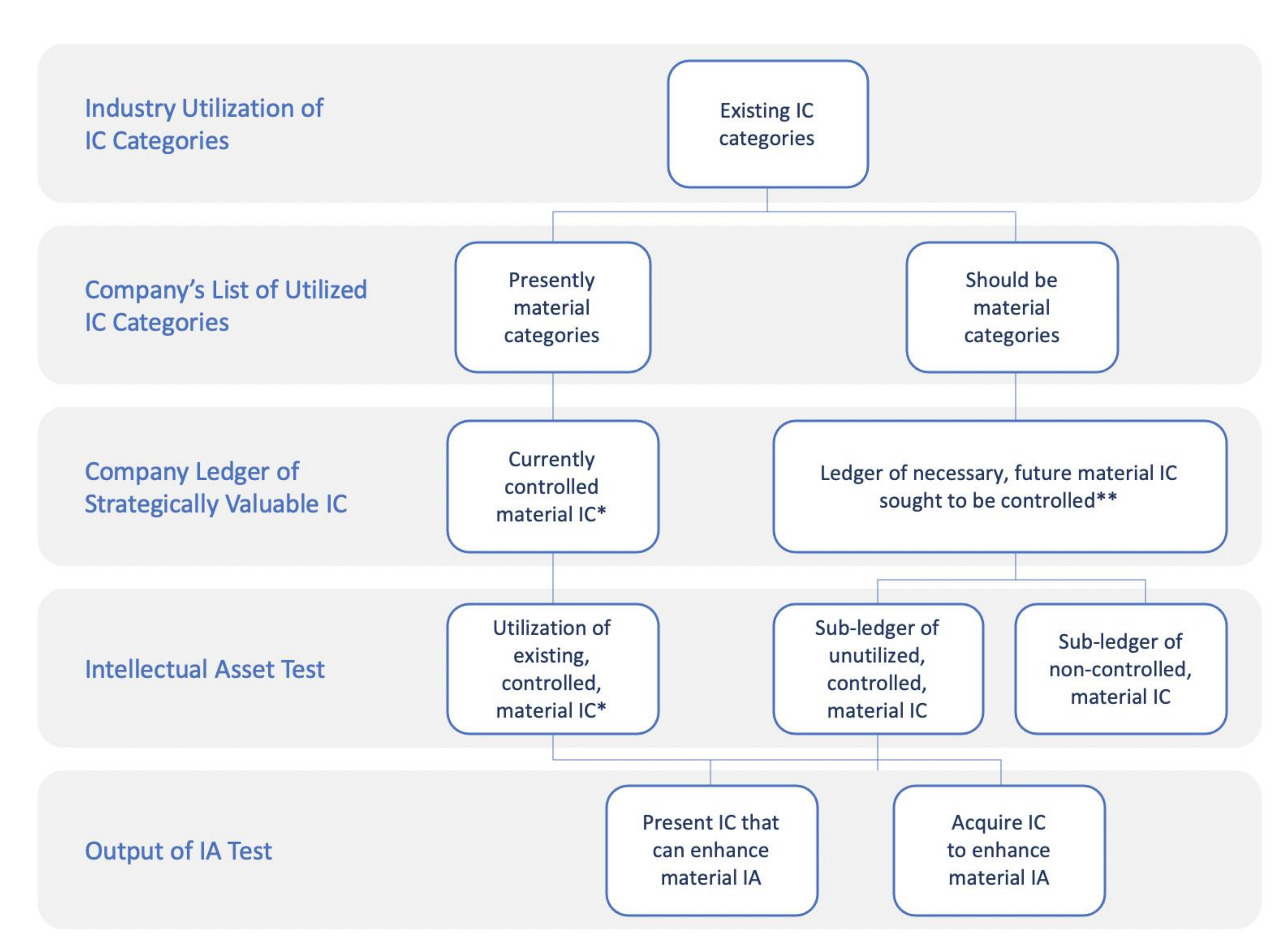
Customers can often distinguish the differences in structural capital between competitors.

# What is the Standard?

- An initial benchmark between commercial, accounting and legal realities over time to align the forward-looking strategy, executive leadership, and the Board around the drivers of corporate value through the lens of Intellectual Capital
- A set of scalable self-directed guidelines for reporting at the level of sophistication required that are repeatable and communicable within the company
- A reporting Ledger that facilitates reconciliation and reporting between Intellectual Capital, financial performance, accounting recognition and legal protections

# What does the Ledger do?

- Creates an across-the-organization definition of market opportunity risks
- Formalizes the internal interpretation (strategy) of what will drive revenue and profitability in the future while mitigating risks
- Regular tests current and potential market demand using the Brand Evaluation Standard to identify optimal strategic pathways and addressable risks



# How is this different from present practices?

- Implementation of the benchmark Ledger identifies what the conditions in the Capitals would need to be to hit future <u>financial</u> targets
- Identifies how long past investments and asset creation can maintain residual value for with and without sustained investment
- Gives a common basis for evaluating the importance of investments and activities that are not generating financial returns presently but are necessary to do so in the future

# 3. Historic Examples

How applying the Standard can explain past results

# Example

- In 2009, Nortel declared bankruptcy with their stock dropping by 79% on the announcement from their already low levels
- During bankruptcy proceedings, the IC and IP of the portfolio (almost none of which was on the balance sheet) was valued and sold for $4.5BN, more than the market cap at the time of the bankruptcy announcement
- All revenue forecasts were based on equipment sales without any underlying attribution to the brand, patents, and 3rd party dependency for service contracts

**ICB Perspective:**

The IP (Structural Capital) can be documented and 'valued' based on the present and future demand (Relational Capital) in the market

Given that there was a significant install base of Nortel products, it was possible for the Leadership and Board to know the demand footprint for the entire Nortel ecosystem if they had actually measured the dependency on channel partners for their revenue on Nortel's brand and IP

# Example

- In 2015, KraftHeinz IPOd after being private for several years
- As part of their S1, they communicated the value of their brands in their portfolio using FASB guidance at the time
- Within only a couple of years, many of the brands had to be written off because their performance had fallen at least 10% relative to 2015 valuations
- The stock nosedived and has never recovered

**ICB Perspective:**

The brands were valued based on historic performance, trends, and margins and and assumed that the past would be a guide for the future

Had they leveraged the ICB Standard and the Brand Evaluation Test that it called for, they would have identified that younger, generational cohorts had very low attachment, purchase intent, and habits to sustain historic results (*confirmed by consumer research after the brand value writeoffs*)

# Example

- For decades the company has had a policy of investing 20-25% of trailing revenues in R&D
- This has frequently resulted in annual revenue's being significantly (20%+) being dependent on products that have been researched and commercialized in the previous five years
- This practice has enabled the company to remain relevant in an industry where most technology is replaced within 8-10 years

**ICB Perspective:**

Qualcomm demonstrates a company that operates under many of the principles from the Standard

The continuous investment into Human and Structural Capital enables the company to direct demand, Relational Capital, towards next generation products to keep the company constantly relevant

# 4. Case Study

Global B2B company seeking to understand their potential for growth

# Avasta’s present implementation of the Standard

STEP 1

## Capital Audit

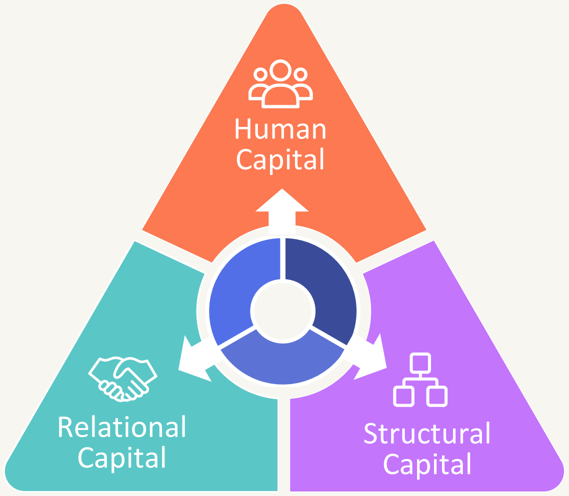
- Human Capital
- Relational Capital
- Structural Capital

STEP 2

## Strategic Mapping


STEP 3

## Strategic Priorities Model




STEP 4

## Deliverables

- Value Ledger (ongoing reporting asset)
- Investment Roadmap
- Recommended reporting practices
- Projected financials

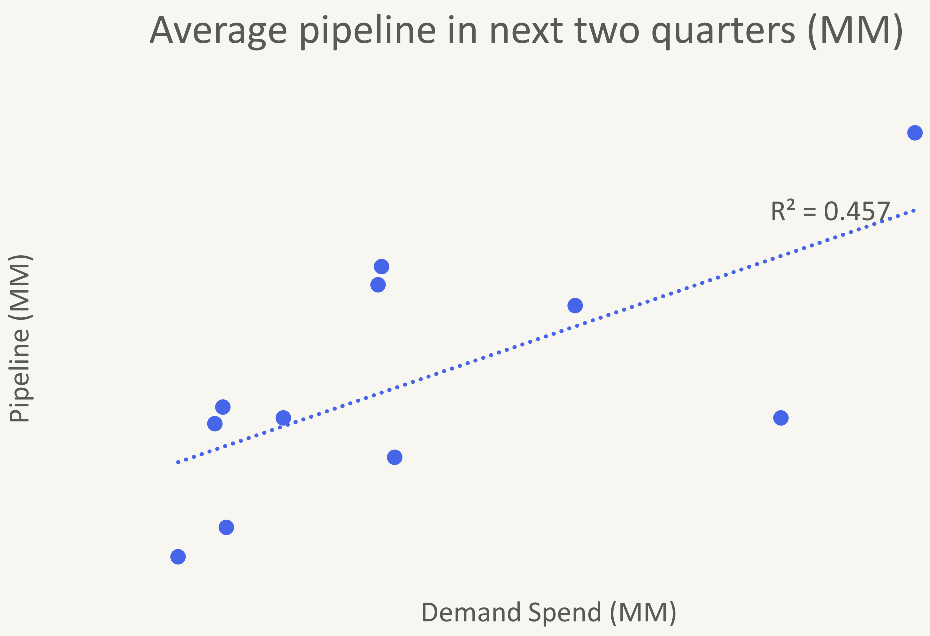
Human Capital
Relational Capital
Structural Capital

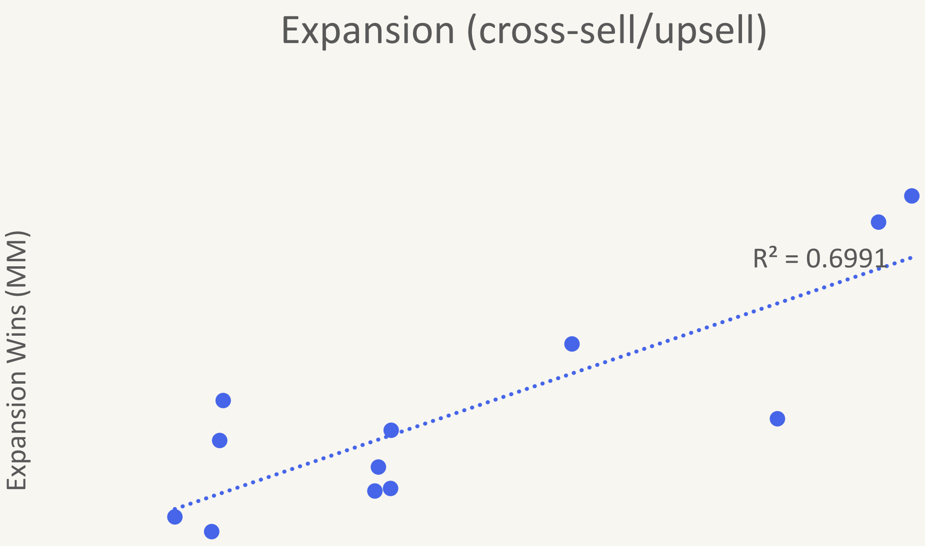
# ICB Application Deep Dive

| | |
|---|---|
| Human Capital | Overinvested in salespeople<br>Insufficient incentive to cross-sell upsell |
| Relational Capital | Underpenetrated in channel partners<br>Master brand not recognized across product portfolio |
| Structural Capital | Majority of R&D not commercialized by company<br>Customers could not buy across organization |

# ICB Application Deep Dive

Human Capital
Relational Capital
Structural Capital



# ICB Application Deep Dive

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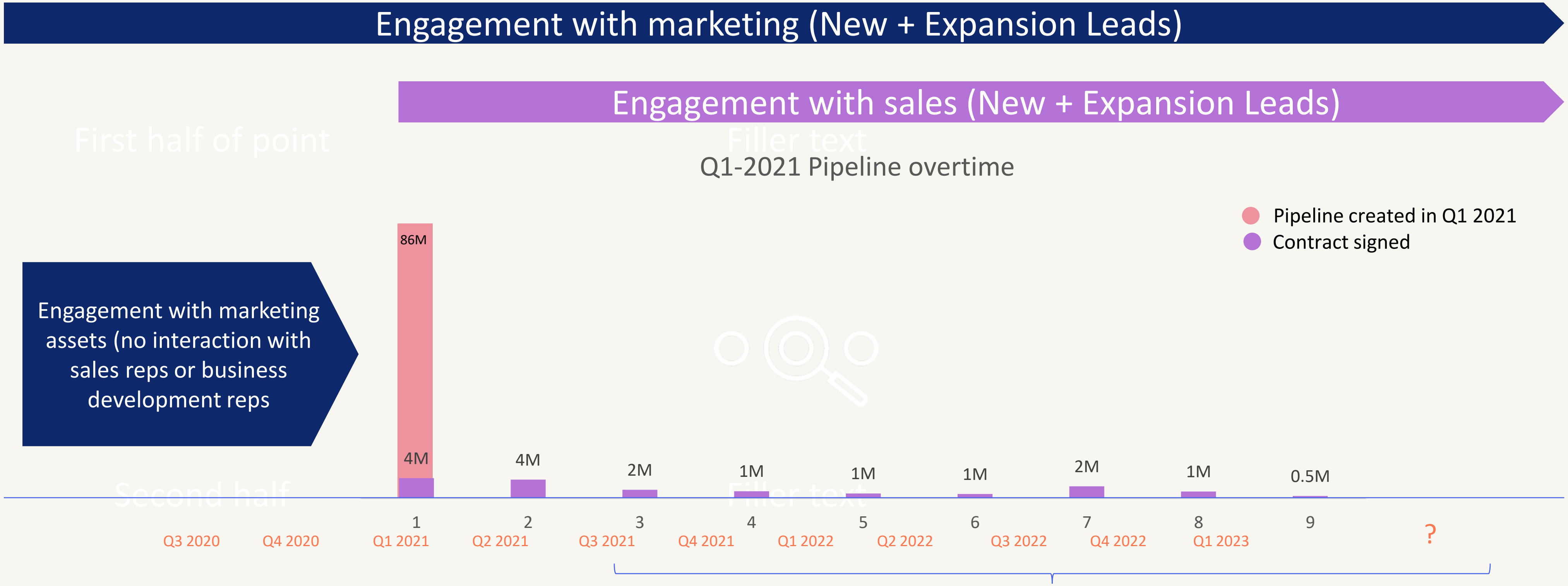
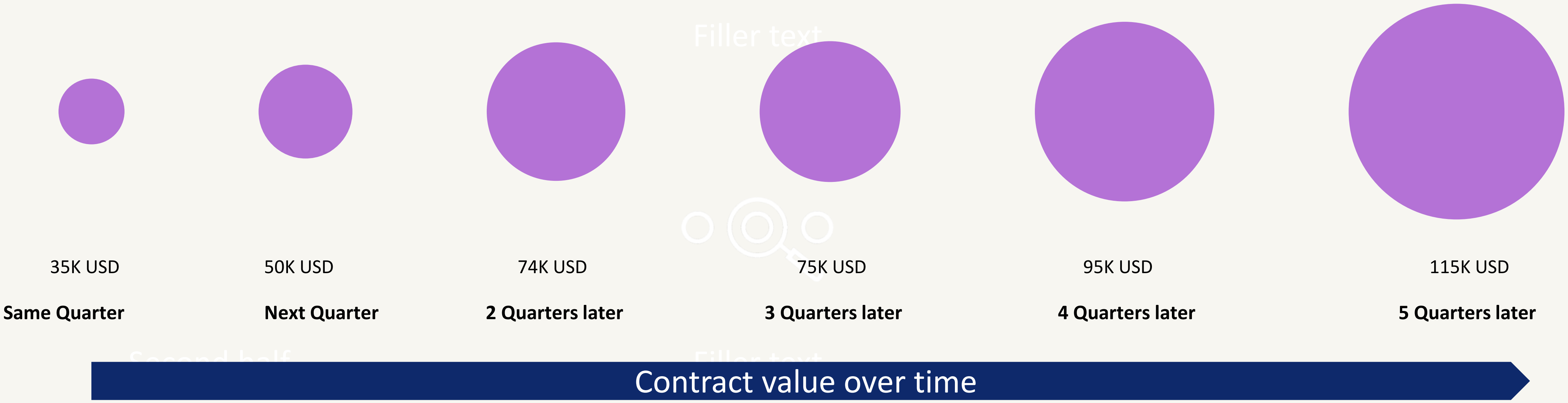



More than 50% of won revenue takes 2+ years to book and recognize

Human Capital
Relational Capital
Structural Capital

# ICB Application Deep Dive

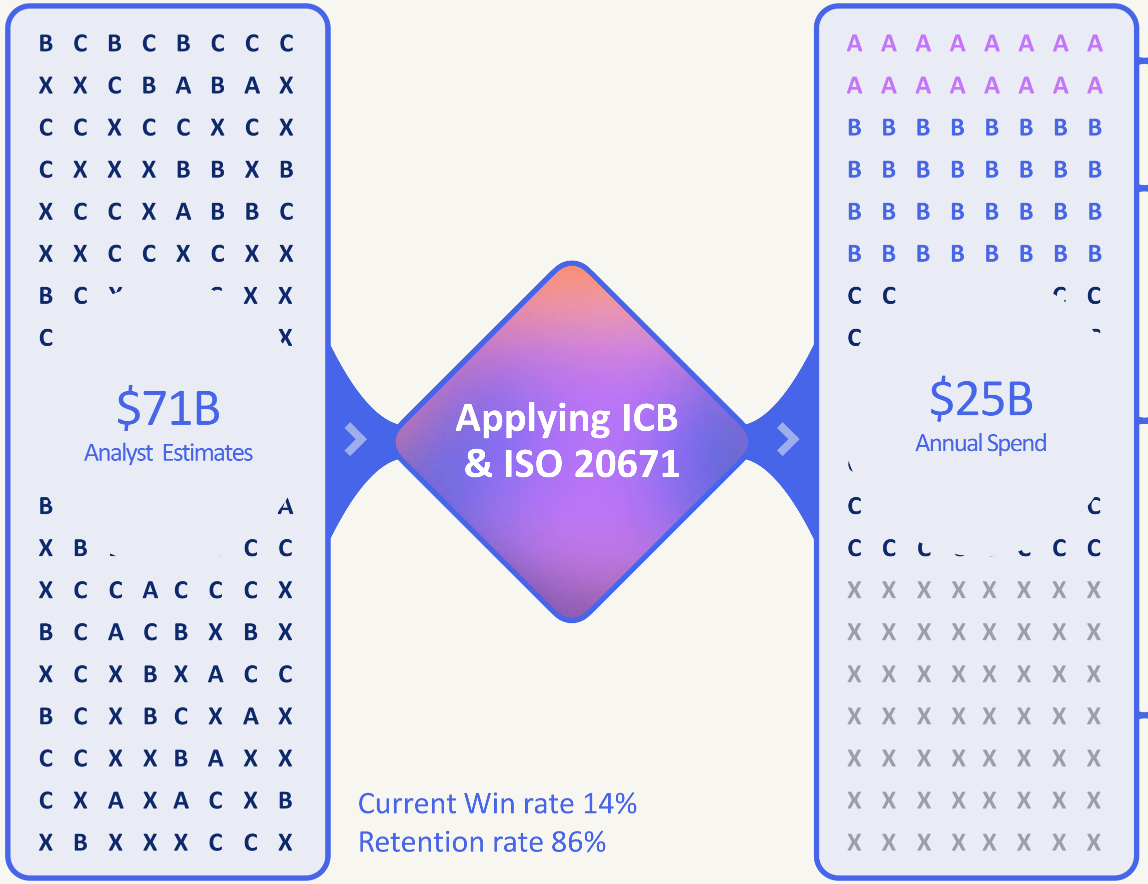



# ICB Application Deep Dive

- Company had aspirations for increasing annual run rate by 45% over 5 years to ride the wave of significant industry growth
- However, something was truly off: the company hadn't had any success in growing during the previous two industry growth waves
- In fact, Revenue hadn't grown, and annual budgets had been flat or declining for over 5 years

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| YoY Revenue Growth | 12% | 26% | 3% | -12% | -4% | -12% | -15% | 0% | 3% | 3% | -2% | -5% | 4% |

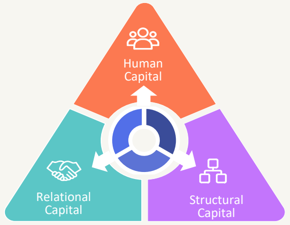
# ICB Application Deep Dive

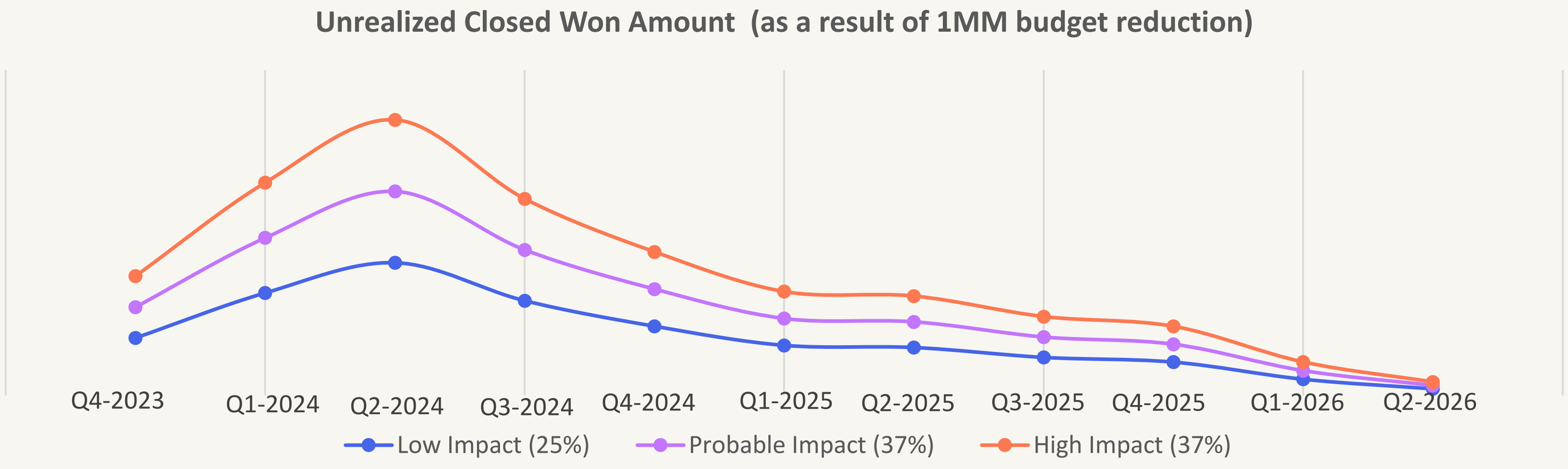

Current Win rate 14%
Retention rate 86%

| SHARE OF MARKET $ | COLLECTIVE SPEND | WINNABLE | WINNABLE VALUE |
|---|---|---|---|
| 33% | 8.4B | 13% | $3.1B |
| 17% | 4.2B | 7% | $1.6B |
| 24% | 1.4B | 6% | $0.6B |
| 26% | 0 | 0% | |

# ICB Application Deep Dive




- While the company had lofty ambitions, understanding what it would take to meet those ambitions were not reflected in strategic planning
- In fact, the company was looking at further cutting costs: “cutting to achieve growth”




On net cash basis, 1MM gains in reducing spending is lost within 6-9 months.

Lifetime cash flow losses (net of cost of sales) per 1MM reduction in marketing budget:

Low: 1.4MM
Mid: 2.7MM
High: 4.0MM

# ICB Application Deep Dive: Outcomes

- A relationship between Intellectual Capital, Financial Investment, and the achievability of financial returns was established
- The company’s historic forecasting models were completely out of touch with reality
- Marketing was severely underfunded and could be increased 4X before starting to become less efficient AND target revenue would still not be met

# 5. Discussion + Q&A

Questions welcome!

# Thank You!

Avasta

# Clarity is power.

Let us help you **harness it.**

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