Goodwill and intangibles

November 2019 - How can you perceive the invisible?

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Forensic Accounting

HSBC Global Research

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Introductions

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Why we think investors should look closely at intangibles

Invisible but getting bigger

Goodwill and intangibles although often ignored, represent a significant proportion of many companies' balance sheets

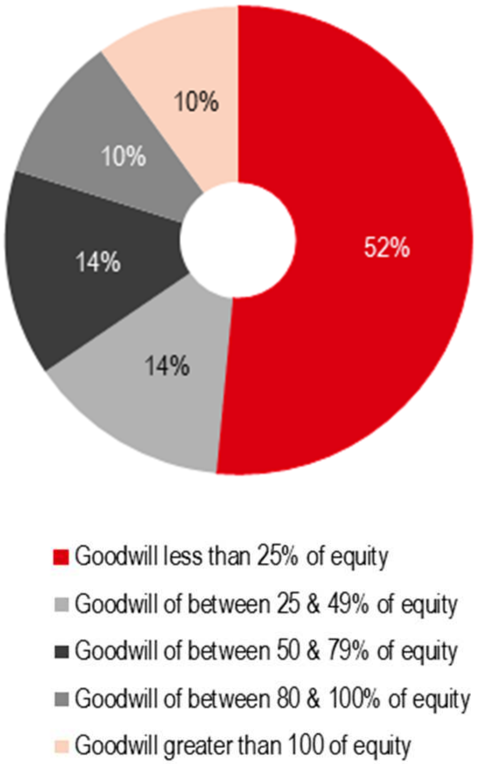
> *Total goodwill for all listed firms worldwide is USD8trn, according to Bloomberg. That compares to USD14trn of physical assets. Dry? Yes. Irrelevant? Far from it.*
>
> The Economist, August 2018

- **Intangible assets on balance sheets are increasing**
- **In 2009, the FTSE350, plus Euro Stoxx 600 combined total net intangible assets was GBP720bn**
- **By 2019 that had risen to almost GBP1.4 trn.**

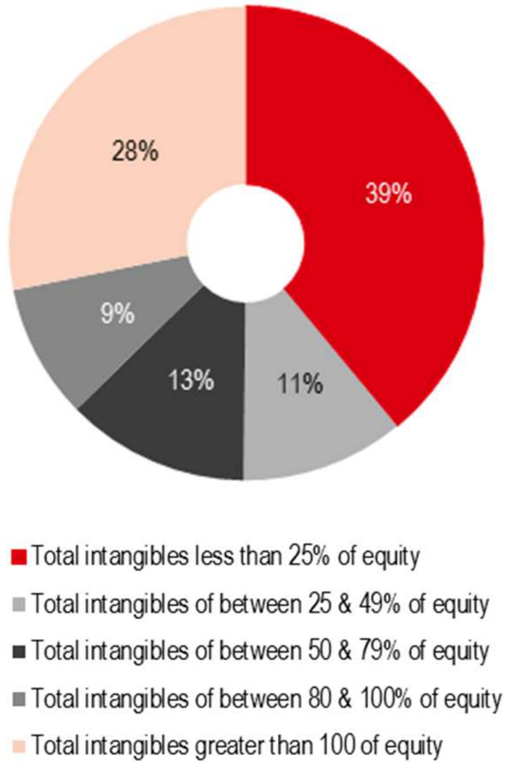
Significance to balance sheets

Analysis of the Euro Stoxx 600 (as at June 2019)

Companies - goodwill as proportion of equity



Companies - total intangibles as proportion of equity



Source: Refinitiv Datastream, Refinitiv Eikon, HSBC calculations

Abstract assets often subtracted

Intangibles may be non-cash, but it is unwise to ignore

We think that opportunities and risks may be missed if investors:

- completely ignore, or strip out, intangibles from their analysis;
- do not, distinguish what the intangibles on the balance sheet represent and, therefore, whether it is appropriate for amortisation costs to be excluded from earnings and (consequently metrics); and
- do not consider the level of accounting choice and management subjectivity that exists both when these balances arise, and on an ongoing basis.

It is advantageous to understand the accounting as this can alert investors of warning signs of:

- larger impairments, which are usually sudden, painful and often result in an abrupt decline in share price;
- performance issues in relation to acquisitions; and
- issues in relation to the financial control and governance of a company.

Understanding the plumbing

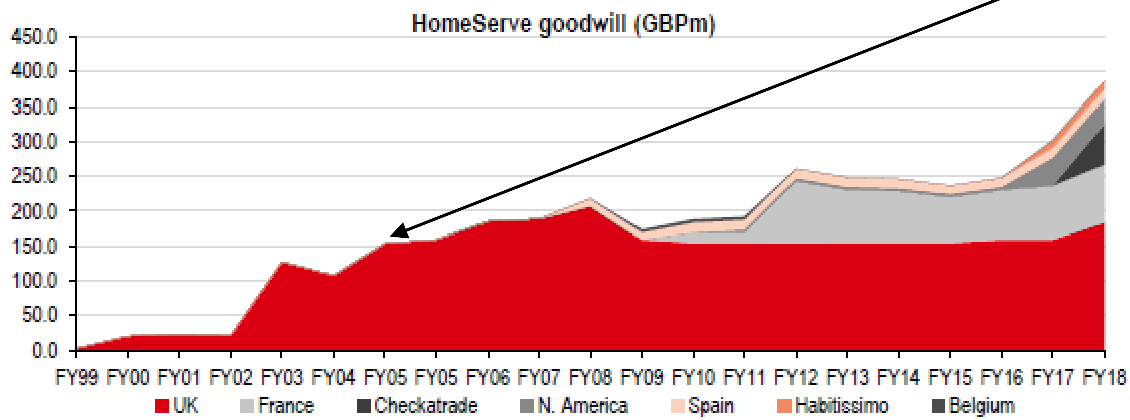
Looking back – HomeServe as a example:

Looking back at each annual report

- Balance of the goodwill;
- Additions (taken form the acquisitions note);
- Deducted any impairments;
- Note any changes to CGUs; and
- Review the assumptions (in particular changes).

IFRS adopted

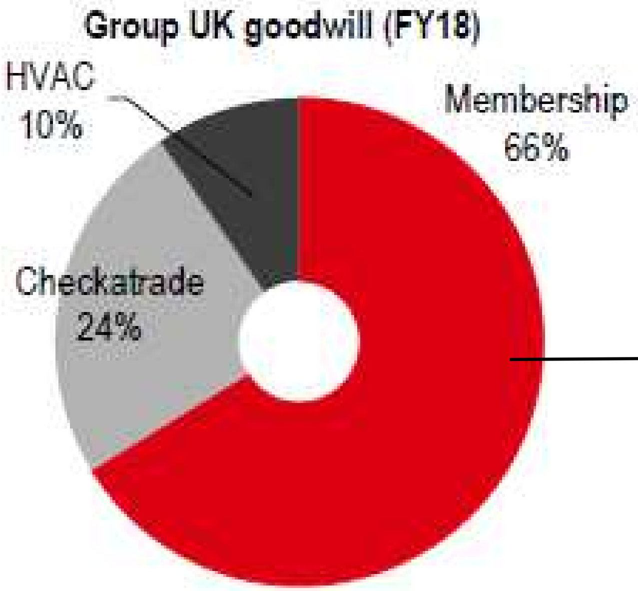
UK including Checkatrade make up >60% of group goodwill



Source: Company data, HSBC calculations

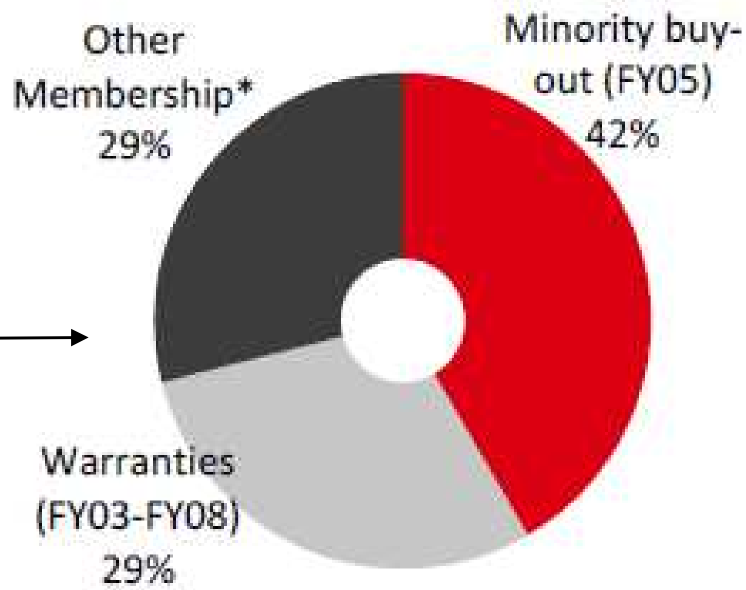
(cont)

The core Membership segment makes up two-thirds of UK goodwill



Source: Company data, HSBC calculations

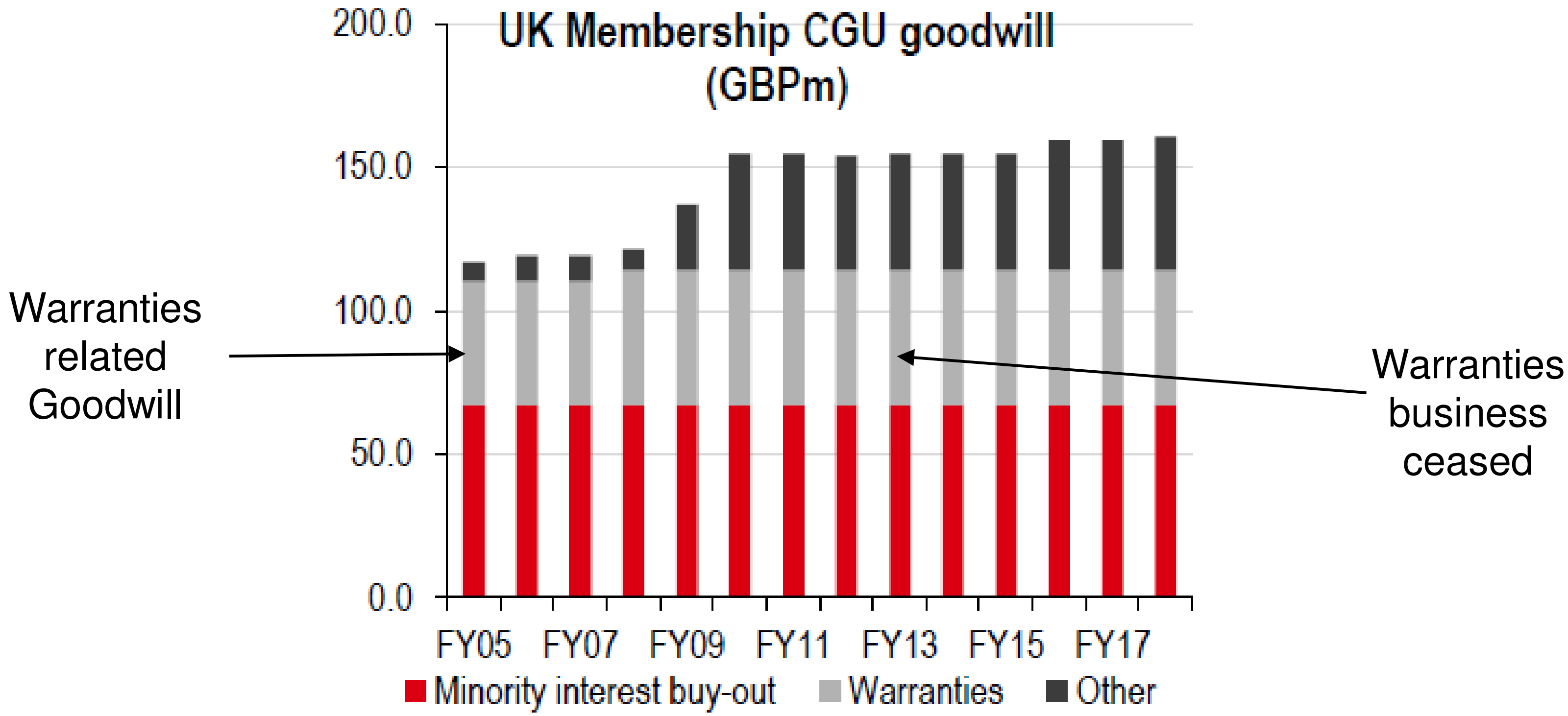
Within Membership there is the legacy of the FY05 buy-out and Warranties business



*Includes various plumbing and drainage contractors. Source: Company data, HSBC estimates

(cont)

It is possible to back out legacy warranties goodwill of around GBP47m…



Source: Company data, HSBC calculations

Nuggets can be found

Hard to rely on the auditors

Auditors are often criticised for their work on intangibles. In the UK the FRC's criticism focused upon deficiencies in challenging management assumptions and estimates:

> “ *…we found issues relating to a lack of understanding of macroeconomic factors affecting the valuation… when considering impairment of goodwill, a lack of challenge over expected future cashflows [sic] and the discount rates applied to reflect the cost of capital.*
>
> The Financial Reporting Council, November 2019

But nuggets can be found…

Review the audit committee and audit reports

Example – when auditors give you a sign that limits are being reached

> “*We are also satisfied that the Group’s discount rate assumptions are determined based on acceptable valuation methodologies. These assumptions are towards the higher end when compared to the ranges determined by our internal valuation specialists but are considered reasonable.”*

Lies, damn lies and EBITDA

Capitalise to defer, then ignore

Examples:

- Securitas' proposed improvement programme:
  - Defers IT programme costs
  - Improves margin from 5% to 6%
  - Inconsistent with previous similar programmes (which were expensed rather than capitalised)
  - Question of whether the value of the intangibles generated will be recoverable.
- HomeServe's accounting treatment of customer lists:
  - Purchased lists – included in underlying EBITDA
  - Lists acquired via M&A – excluded from underlying EBITDA.

The amortisation debate

Thank you

Disclosure appendix

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*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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