

# Intellectual Capital for Communities In the Knowledge Economy

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## Intangibles at risk? The new economic context



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A Passion to Perform.

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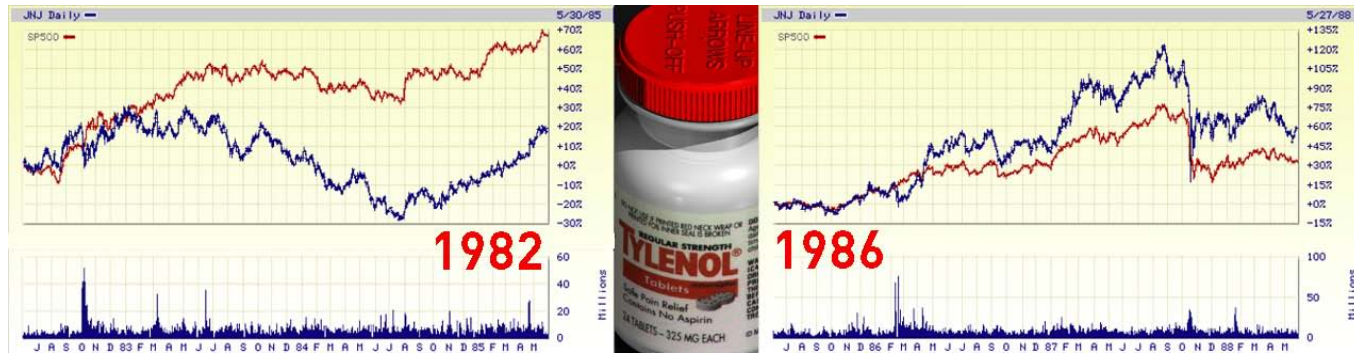


# Overview

- Intangibles
- Risk management
- Risk transfer via the capital markets
- Closing thoughts



# Case Study – Johnson & Johnson



Source: Steel City Re, LLC

- In September and October of 1982, several people were poisoned by cyanide-laced Tylenol
- Johnson & Johnson had no visibility into its supply chain, inadequate control of its process and was not able to communicate the scope of the problem
- J&J lost 30% of its market capitalization
- More poisonings from tampered with Tylenol occurred in February 1986
- J&J had implemented business process changes and was able to communicate the limited scope of the problem
- 0% market capitalization loss
- Stock rose as shareholders began to understand the value of the changes

**Lesson: Reputation for safety is a critical intangible asset**



# Case Study – Hewlett-Packard



- Chaos in the boardroom
  - Feb 2005 Carly Fiorina removed
  - Patricia Dunn becomes 3<sup>rd</sup> chairman in five years
- HP loses 30% of its market capitalization
- February 2007 – HP initiates governance transparency program
- Stock resumes climb



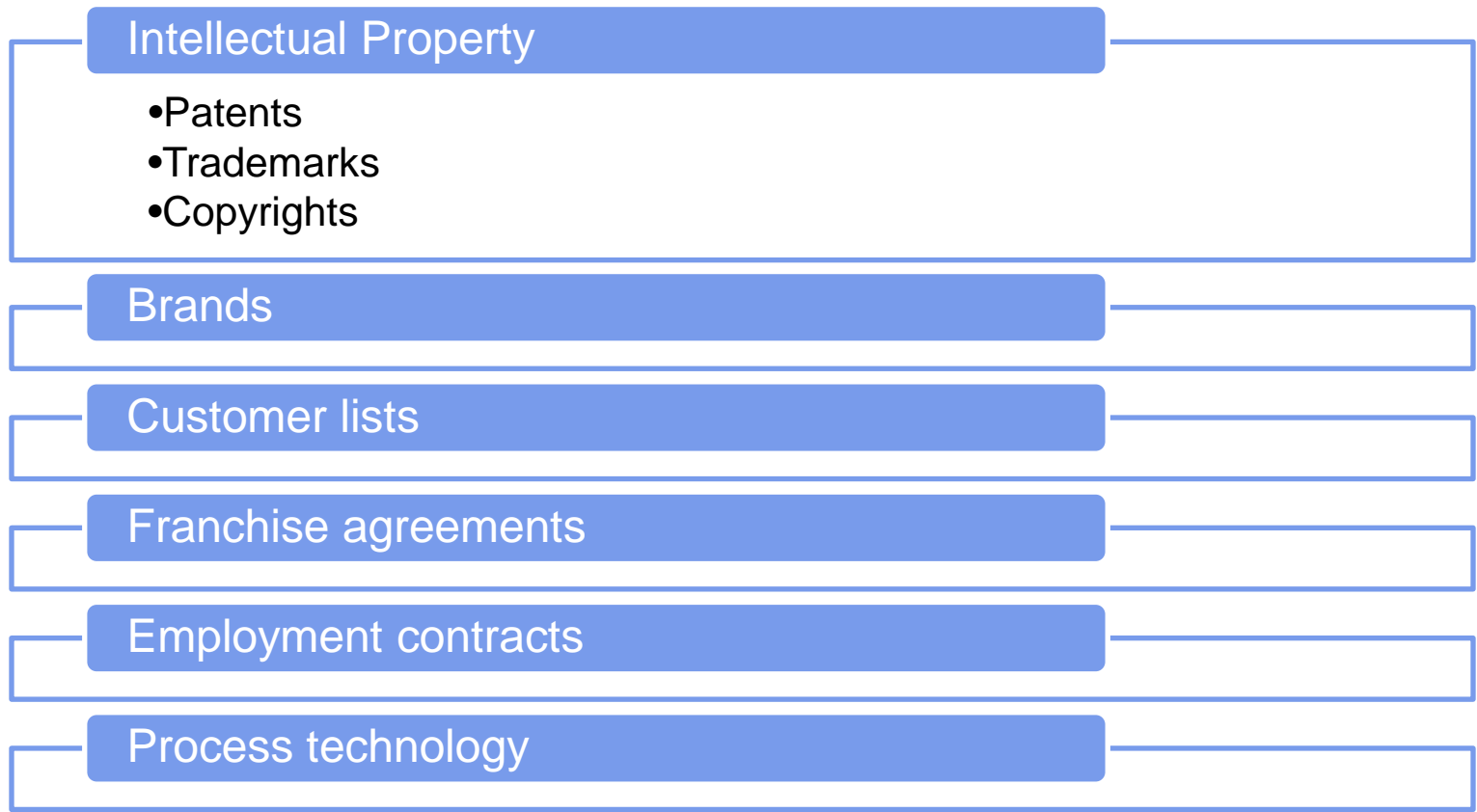
Source: Steel City Re, LLC

**Lesson: Good governance is a valuable intangible asset that must be managed**

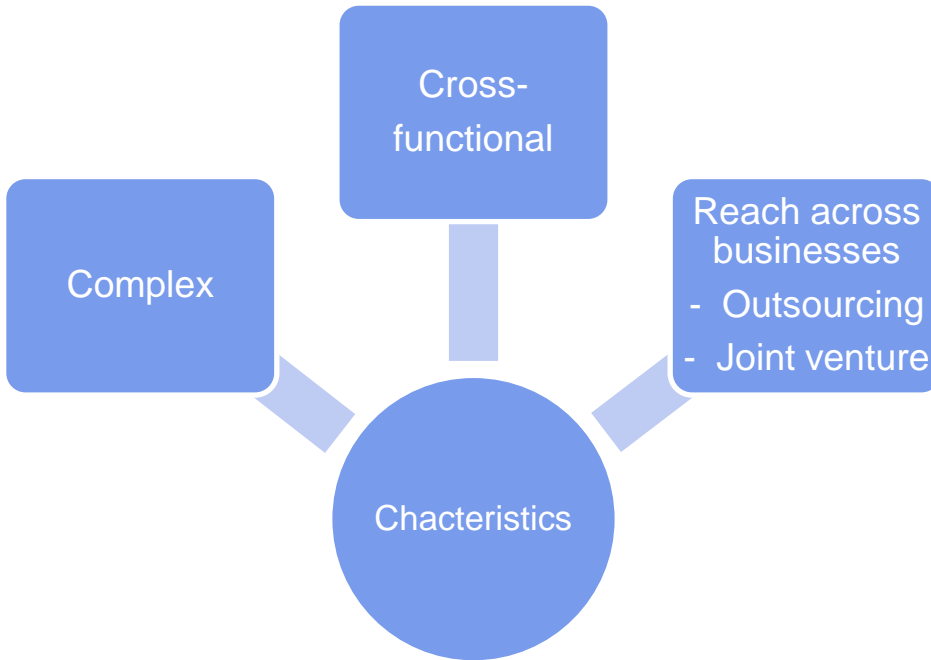


# Intangibles

## A non-exhaustive list:



# Intangibles



## ■ Examples

- Your customer's impression of you is impacted by how your call center in Bangalore treats them
- The quality of your products depends on the factory in China that manufactures them

## ■ Implications

- Need heuristic approach to managing intangibles
- Need to understand the business process that supports them
- Recognize that your reputation may not be in your control



# Risk Management

## Approaches to managing risk

Avoid exposure entirely

Loss prevention

- Employee training
- Business process

Loss reduction

- Minimize the effects of a problem once it happens
- Process
- Communication strategies

Risk financing/risk transfer



# Risk transfer via the capital markets

## Risk-linked securities

### “Traditional” CAT bonds focused on wind and earthquake risk

- \$23 billion market, but only \$2 billion of issuance though mid 2008
- Major catastrophes increase supply
- Secondary market activity up 35% year over year
- Representative transaction:
  - USAA sold \$125 million of BB-rated three year hurricane and earthquake risk at L+675 and \$125 million of B-rated risk at L+1150

### Intellectual property/infringement risk CAT bonds difficult to do

- No consensus on how to model risk
- Moral hazard issues
- Adverse selection
- Belief that actuarial data don't exist or are not valid





# Risk transfer via the capital markets

## Intangible asset based finance and securitization

### ■ Securitization

- Typically franchise fees, royalties, product distribution agreements
  - e.g., Domino's Pizza \$1.85 billion recapitalization
  - 2 AAA-rated tranches
  - 1 BB-rated tranche
  - MBIA & Ambac wraps
  - Lehman-led

### ■ A difficult year

- Lehman implodes
- Credit markets seize
- MBIA 5 year CDO spreads increase from 320 in 12/07 to 3100 in 12/08

### ■ Not much getting done





# Risk transfer via the capital markets

## ■ Roadblocks

- Lack of consensus on valuation of intangibles
- Difficulty in “ring fencing” intangibles
- Lack of consistent disclosure about intangibles
- Moral hazard





# Closing thoughts

- In the new economy, intangibles account for 50 – 75% of market capitalization
- Intangibles by their nature cross functional, divisional and organizational boundaries
- Globalization and outsourcing magnify the complexity
- A heuristic approach is needed to understand intangibles, and the risks associated with them
- Markets for financing and risk transfer involving intangibles are just beginning to develop

