Insights
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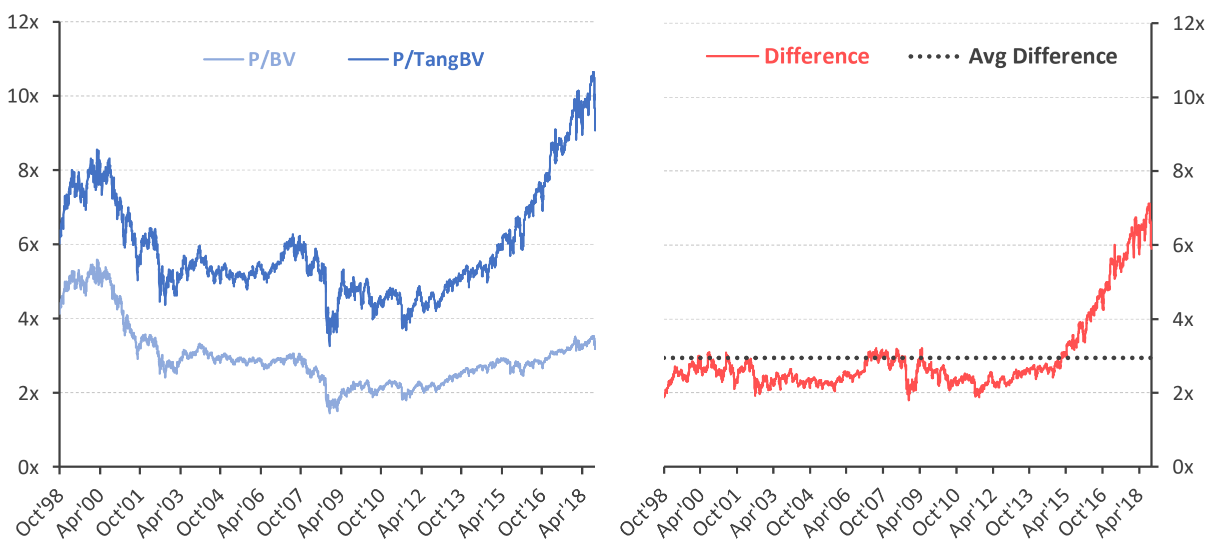
clearwater ADVISORS

Evolution of Firm Value Highlights ESG (Environmental, Social, Governance) Issues

The divergence in Price-to-Book Value and Price-to-Tangible Book Value reflects an evolution of firm value as investors now attribute the majority of firm value to intangible assets. It has been estimated that the value of intangible assets accounts for over 80% of the total value of S&P 500 firms up nearly 5-times over the last 40 years. This increase not only includes technology firms whose values comprise the application of algorithms, but also firms that have paid handsomely for acquisitions in hopes of, among other things, realizing synergy and cross-selling opportunities.

S&P 500: P/BV vs. P/Tangible BV

The divergence in valuation metrics based on book value reflects the evolution of firm value. In the current market, firm value is tied more closely to intangible assets. As a result, firm value is more susceptible to poor governance as market sentiment toward intangibles is acutely affected by governance issues.



Source: Capital IQ, Clearwater Advisors

As with all investment assets, the value of intangibles is tied to the ability of its user to generate attractive returns above the cost of capital. Poor governance can prevent firms from extracting full value from intangible assets. This is troublesome for bondholders who justify tolerating higher leverage in hopes of an issuer achieving acquisition-related synergies. An eventual write-down of intangible assets, as we observed with GE's $22 billion impairment charge last week, would increase balance sheet leverage through erosion of capital in addition to any leveraging effects that have already occurred due to decreased earnings power.

When thinking about ESG factors, consideration of governance issues is extremely important. Effective governance promotes workplace cultures and structures that enable firms to outperform. Managerial decisions also influence the implementation of policies and procedures that mitigate environmental and social risks making governance factors intertwined with these other ESG issues. So despite recent attention on ESG, good fundamental credit analysis has and will always consider governance issues. A push to encourage companies to publicly disclose ESG-related metrics only aids in evaluation of investment risks and determination of relative value.