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When interest eats away Goodwill

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Abstract

Higher market interest rates are putting pressure on the premiums companies once paid for acquisitions. Write-offs are looming.

Zusammenfassung

Höhere Marktzinsen setzen die Prämien, die Unternehmen einst bei Übernahmen gezahlt haben, unter Druck. Es drohen Abschreibungen.

For many years, all was well at Svenskt Stål AB (SSAB). The Swedish group grew, also through acquisitions. In 2007 and 2014, the steel specialist bought its competitors Ipsco and Rautaruukki. In return, SSAB dropped a few crowns.

Goodwill remains on the balance sheet until the book values can no longer be maintained. However, the corporate leaders of acquisition-friendly companies regularly avoid admitting that they have bought subsidiaries at too high a price.

This can be seen in the so-called goodwill, an item on the assets side of a company's balance sheet. It shows the premiums that companies once paid on the net assets of the new subsidiaries when they were taken over. In the case of SSAB, this was goodwill of 33.6 billion Swedish kronor last year.

But at the end of the year, only 349 million kroner, or a good one per cent, were still reflected in the balance sheet. The reason: the steel group had written off almost all of these hopeful assets by the end of the year.

Hopeful values, because goodwill is supposed to reflect future synergies and cash flows after acquisitions. However, as stock market experts know, these can only be estimated. And estimates are subject to errors - everyone knows that.

Full purchase price is reflected

Despite great uncertainty as to whether acquisitions will pay off, companies are allowed to report the full purchase price (net, after deduction of assumed debts) after acquisitions, as permitted by the balance sheet rules. This is the case even if the managers pay high premiums on the net assets of the acquired company. This is a regular occurrence: when Microsoft once acquired Nokia's mobile phone division, with the German Bayer after the takeover of the seed producer Monsanto or with the merger of the industrial gas giants Linde and Praxair.

Goodwill remains on the balance sheet until the book values can no longer be maintained. This would be the case, for example, if a presumed sales price of business units on which the goodwill has been recognised is no longer close to its book value. Or if business prospects deteriorate to such an extent that plans for the expected cash flows have to be more or less significantly scaled back.

However, both occur almost only in theory. Corporate leaders of acquisition-friendly companies regularly avoid admitting that they have bought subsidiaries at too high a price.

There are a few tricks for this. Planning horizons can be extended. And the business units to which the goodwill is allocated can be re-tailored.

These business units are often designed in such a way that no comparable market transaction can be found - where there is no transaction, there is no market price. Exceptions confirm the rule. The fact that business in Russia, for example, is likely to be worth much less in the long term than was assumed a few years ago can hardly be hidden.

But why did SSAB devalue? This is where a third component comes into play, which finance managers should not ignore and gloss over: the current level of market interest rates.

Red figures after devaluation

SSAB stated that the "background to the impairment was higher interest rates and a more cautious method of impairment testing". After the massive goodwill impairment, the steel group slipped into the red.

Just like SSAB, AT&T, for example, recently reported losses. Also "due to higher interest rates", the traditional US telephony company wrote off 24.8 billion dollars on its goodwill at the end of the year. In the fourth quarter, AT&T therefore posted an operating loss of 21.1 billion dollars.

But what effect does the current interest rate level have on goodwill? Unlike other assets such as the vehicle fleet or real estate, goodwill is only depreciated irregularly by companies. Although there were plans to reintroduce a regulation on proportional depreciation that was in force until just under 20 years ago,[1] , these have since disappeared into the drawer again.

Therefore, it is still up to the companies to determine the value of the goodwill. In this context, the managers benefited from the fact that market interest rates had fallen over many years. Cash flows expected in the future were therefore regularly worth more when discounted to the current balance sheet date. This inhibited depreciation.

Now, costs are rising in many cases and customer demand is often declining, which in itself should lead to a weakening of cash flow expectations - at least in individual cases.

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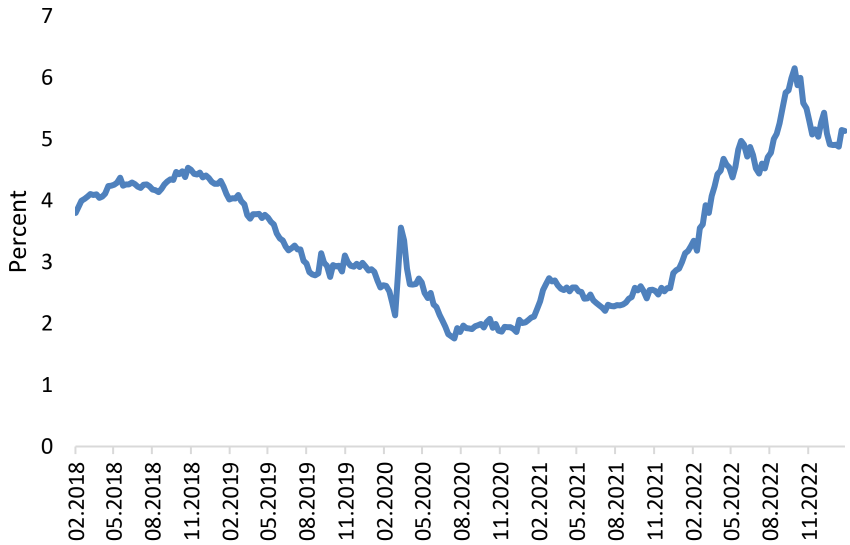
[1] https://www.flossbachvonstorch-researchinstitute.com/en/studies/goodwill-the-genie-is-still-in-the-bottle/

Reduced present values

However, the so-called cash value of the cash flow is certainly decreasing in view of the noticeable rise in interest rates. Measured in terms of yields on ten-year, medium-quality corporate bonds, interest rates have more than tripled from their low and have recently remained at a significantly higher plateau (chart 1).

Chart 1: Corporate bond yields*



*measured against USD Global Industry (BBB) BFV Curve 10Y, source: Bloomberg, Flossbach von Storch Research Institute, as of February 2023. **Historical performance is not a reliable indicator of future performance.**

For financial statements prepared in accordance with the International Financial Reporting Standards (IFRS) or US Generally Accepted Accounting Principles (US GAAP) applicable to capital market-oriented groups, this has a significant impact on the level of discount rates.

For example, a cash flow of 100 million euros or dollars expected over five years and flowing for the first time in one year and then once a year thereafter is currently worth a good 485 million at a discount rate of one percent. At an interest rate of five per cent, this current value is reduced to just under 433 million.

The value in use determined from such a cash flow is compared with the book value of a business unit. If the value in use falls below the book value, the goodwill of the business unit must first be written down.

The cash flow expected in the company's planning, discounted at market interest rates, is therefore central to determining the recoverability of the goodwill reported in the balance sheet.

If the book value in the example is 475 million, there is no need for impairment at a discount rate of one per cent, as the value in use is ten million higher. At a discount rate of five per cent, however, the company would have to devalue by 52 million (book value of 485 million minus value in use of 433 million).

The closer the expected cash flows and the value in use based on them have been to the book value in the past, the more the risk of having to write down the value in the event of a higher market interest rate increases. Many companies are likely to pay this price of time now or soon, and could possibly catch one or two inattentive observers on the wrong foot.

At the beginning of a devaluation cascade

Investors are keeping an eye on goodwill, which is often referred to as a "shaky position" - at least for a number of companies. This can be seen in the stock market value. If this is close to or even below the goodwill reported in the balance sheet, the market expects a devaluation. In these cases, investors already distrust the valuation of the company.

It is important to know: When groups write off their businesses, goodwill (if any) always comes first in a cascade of write-offs. Goodwill is therefore a very "soft" item in the long-term assets on the balance sheet.

If the market has already anticipated such a write-down, as indicated by a low stock market value compared to goodwill, then write-downs are no more than a confirmation of the then regularly preceding decline in the share price of the company in question.

But it is also common for investors to be unaware of the risk of goodwill impairment.

For example, on 13 February this year, the American financial services provider Fidelity National Information (FIS) wrote off 17.6 billion dollars in goodwill on its Merchant Solutions division. Apparently this caught investors on the wrong foot: at any rate, the 15 per cent drop in the FIS share price that immediately followed this news speaks for itself.

Especially in the case of high devaluations of goodwill, the CFOs like to argue that these are not cash-effective. This was also the case with FIS in its communication to investors.

This is formally correct. However, the write-offs reduce the shareholders' equity, and thus their proportionate asset value (book value) in their company. Moreover, with a goodwill impairment, companies admit that they have not been careful with their shareholders' money in the past. This is because the former acquisition that led to the goodwill was cash-effective.

Equity in focus

But what role does goodwill play in corporate balance sheets? Measured in terms of all assets, this position does not play an outstanding role on average, but it is not a subordinate one either. In the S&P 500, 8.8 percent of all assets, in the Stoxx 600 4.3 percent and in the MSCI World 5.0 percent were goodwill.

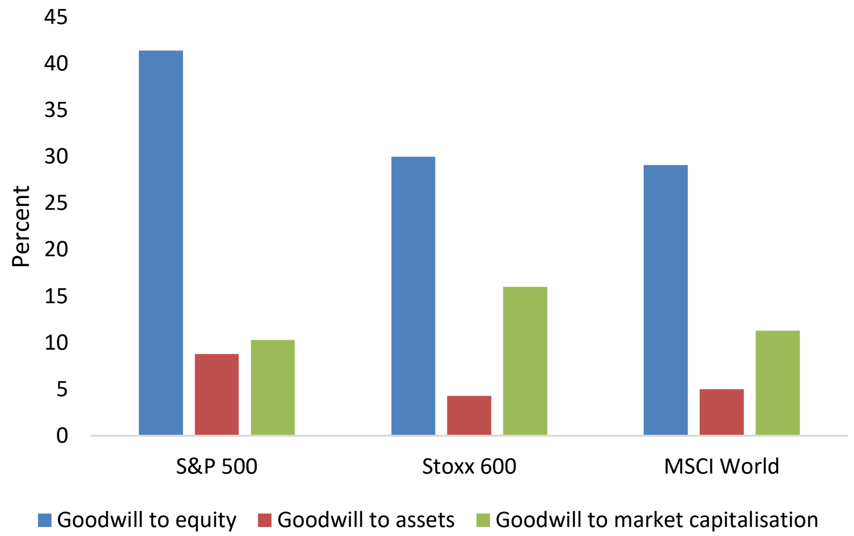
It should be noted that the ratios would be higher if financial service providers such as banks, with their consistently very high assets, were not taken into account. For example, the ratio of goodwill to assets in the S&P 500 would rise to 10.2 percent if the six largest financial groups in the index were excluded.

Overall, goodwill represents 10.3 per cent (S&P 500), 16 per cent (Stoxx 600) and 11.3 per cent (MSCI World) of the market capitalisation of the three indices.

However, it is primarily the relationship to equity that is worth noting, as depreciation has the greatest impact on equity in relative terms.

In the S&P 500, the ratio of goodwill to equity was recently a good 41 percent, in the Stoxx 600 around 30 percent and in the MSCI World a good 29 percent (chart 2).

Chart 2: Goodwill to equity, assets and market capitalisation in the S&P 500, Stoxx 600 and MSCI World

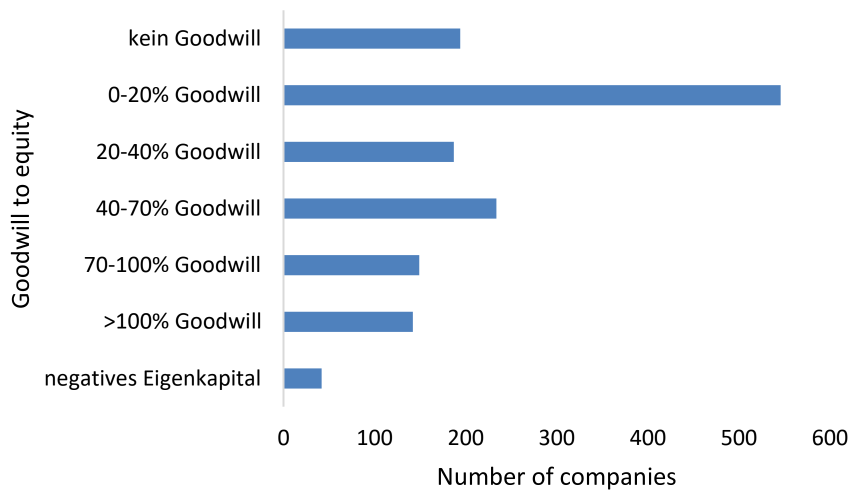


Most recently available data; source: Bloomberg, Flossbach von Storch Research Institute, as of February 2023.

On average, therefore, the ratios to equity are already remarkably high. However, this is not relevant for all companies. For example, almost 200 companies in the MSCI World do not report any goodwill at all.

Goodwill plays a large to very large role in more than one-third of the companies in the World Index, with equity ratios of more than 40 percent to well over 100 percent in some cases (chart 3).

Chart 3: Distribution of goodwill to equity in the MSCI World



Most recently available data from 1494 companies, source: Bloomberg, Flossbach von Storch Research Institute, as of February 2023.

From all three indices, 49 companies can currently be identified that have a goodwill of more than 70 percent measured by their market capitalisation (Table 1).

Table 1: Companies with a goodwill to market capitalisation ratio of more than 70 percent

Companies	Goodwill to Market Capitalization (%)	Goodwill to Equity (%)
Telecom Italia SpA	304	100
Lumen Technologies Inc	301	121
Fresenius SE & Co KGaA	208	97
Fresenius Medical Care AG & Co KGaA	155	103
Teva Pharmaceutical Industries Ltd	154	203
ams-OSRAM AG	154	109
CK Hutchison Holdings Ltd	150	44
Faurecia SE	138	76
Nexi SpA	135	114
Liberty Media Corp-Liberty SiriusXM	132	132
Just Eat Takeaway.com NV	120	55
Vodafone Group PLC	117	54
Anheuser-Busch InBev SA	104	139
Elis SA	99	122
Caesars Entertainment Inc	98	285
Securitas AB	97	140
Invesco Ltd	96	50
TUI AG	96	2906
United Internet AG	95	69
Warner Bros Discovery Inc	95	69
Alstom SA	93	101
DaVita Inc	93	339
Elanco Animal Health Inc	92	85
Orange SA	92	68
Worldline SA/France	90	99
Wendel SE	90	84
Telefonica SA	89	58
Vivendi SE	89	50
JDE Peet's NV	88	108
Fidelity National Information Services Inc	88	125
Liberty Global PLC	88	37
Eurazeo SE	82	52
SPIE SA	82	195
Hewlett Packard Enterprise Co	82	87
Asahi Group Holdings Ltd	81	88
Embracer Group AB	79	81
WPP PLC	77	193
Global Payments Inc	77	104
AltaGas Ltd	75	69
ISS A/S	74	208
Gen Digital Inc	74	773
HK Electric Investments & HK Electric Investments Ltd	73	69
Western Digital Corp	73	83
Bayer AG	73	105
Koninklijke Philips NV	72	77
Adecco Group AG	72	105
Siemens Energy AG	71	81
Walgreens Boots Alliance Inc	71	91
Takeda Pharmaceutical Co Ltd	70	76

most recently available data, basis S&P 500, Stoxx 600, MSCI World, figures rounded, source: Bloomberg, Flossbach von Storch Research Institute, as of February 2023. **A high or low ratio of goodwill to equity is not in itself an argument to buy or sell a share.**

So investors are sceptical here. A goodwill impairment would therefore not be surprising and the impact on the share price would probably be limited.

Conclusion

The increased interest rate level may have a negative impact on profits and balance sheets of companies reporting goodwill from acquisitions.

In particular, the share price performance of companies for which the market does not yet expect any or only minor devaluations could be negatively affected. Identifying these requires individual analysis.

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