

62.1 An exercise on market capitalization and goodwill

Review the comparisons of market capitalization and net asset values in Box 62.2 and consider possible causes for the large differences in the importance of goodwill in the share prices of the different companies.

BOX 62.2

Market Capitalization and Goodwill: Four Sample Companies

company activity	office rental £M	public transport £M	department store £M	professional training £M
Market Capitalisation	1 295.2	1 436.0	11 771.8	321.3
Net Asset Value	(654.7)	(542.5)	(1 646.8)	(10.6)
Goodwill	640.5	893.5	10 125.0	310.7
Goodwill as % of share value	49.5%	62.2%	86.0%	96.7%

Response

The members or shareholders of a company have a claim on the net assets of the company, as shown in the company balance sheet. They also have the right to claim all future profits of the company. This right, known as goodwill, has a value and is included, along with the claim to net assets, in the company's market capitalization (the combined value of all shares in the company).

The proportion of goodwill to net asset value in a company's market capitalization will depend on how buyers and sellers in the stock market view the company's capacity to grow future profits, and its dependence on the use of assets. In our examples the extremes are the professional training company, which can generate profits from a very small asset base, and the office rental company, which depends mainly on the exploitation of its property assets, rather than the exploitation of its employees. The first therefore has a very high and the second a much lower proportion of goodwill in its market capitalization.

It is more difficult to comment on the two intermediate firms, although for all companies the goodwill element in their market capitalization is surprisingly high – more reflective perhaps of stock market conditions at the time of writing, than of any truly rational consideration of their future prospects.