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Three Reasons to Shed Your Idle Assets

Selling idle operating assets below net book value for cash is at worst irrelevant and at best will boost the value and hence the stock price of a company.

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It's psychologically difficult for management to sell idle assets. Senior executives often rationalize the decision to hold onto assets well beyond their productive usefulness with seemingly valid reasons. But upon further review, often these are merely excuses.

Three particularly counterproductive excuses are: 1) "we don't want to book a loss"; 2) "we don't want our competitor to compete with us by using our assets"; and 3) "it's not the right time to sell." For each of those rationalizations I offer a counter argument to help management overcome the tendency to hoard. By following these principles, executives can drive their company toward being a leaner and stronger business.

"We Don't Want to Book a Loss"

Despite considerable evidence showing that investor reactions are driven by long-term implications of strategies and actions, many executives of publicly held companies obsess over quarterly earnings per share reporting. Whether the executives bring this upon themselves or they are reacting to either their short-term incentives or the demands of investors, it can be unhealthy.

In the context of idle assets, the losses incurred from the disposition of assets at prices below net book value (NBV), can drive down EPS. Managers that dwell too much on EPS typically embrace a false belief that these losses will cause the stock price to fall. This misconception can be harmful, especially during a downturn when cash is most needed.

Indeed, numerous studies of empirical evidence have shown that selling idle/non-operating assets below NBV for cash is at worst irrelevant and at best will increase the value and hence stock price of a company.

Owners love the cash proceeds from selling assets that are not producing profit. Oddly enough, they also love the accounting "loss" that goes with it, because it shelters income from taxes. Most importantly, shareholders love managers that adopt an ownership mindset, which includes generating cash-flow by continually cleaning out unneeded assets.

“We Don’t Want Our Competitors to Compete with Us by Using Our Assets”

Some executives express concern that selling old assets opens up the opportunity for competitors to buy the assets at a discount on the second-hand market and use them to compete. Although it’s a sound move to avoid assisting competitors, hoarding assets you don’t need as a means of cutting off the supply to competitors is far from practical.

If assets are being sold because there’s inadequate demand for the services that employ them, then competitors should face the same inadequate demand. If competitors choose to compete at a low price because they’ve purchased assets at a discount, what stops the original owners of the assets from doing the same? If the industry has excess capacity, then competitive forces will pressure industry pricing to decline and those who resist the trend will lose market share and forgo profitable business.

What if the asset is purchased by a low-cost startup? An existing industry player should be able to price at least as competitively as a startup, because the existing player has an idle asset sitting on the fence. The incremental startup costs for a new competitor includes laying out cash to buy the asset. That requires the startup to price its services higher, whereas an existing player has less incremental cost to incur because it already owns the asset.

There may, of course, be another question: “Yes, but the new mom-and-pop competitor doesn’t have the same overhead that the existing big player has, so their costs are lower.”

That should not, however, be a factor in the decision. The short-term decision to take any new business, especially in a downturn, should only consider incremental costs associated with the transaction, which should be lower for the established player with economies of scale.

Fixed overhead is incurred regardless of whether you take on the new business or not. Fixed overhead costs should only be considered when determining the long-term strategic decisions of whether you want to stay in that business and how much overhead you need to support it.

“It’s Not the Right Time to Sell”

In the minds of most managers, the time is never right to sell idle assets. When markets are strong, management often wants to hold onto assets just in case they’re needed to meet demand. During a downturn, they resist selling them because the price for the assets seems too low.

Timing any market is something few people, if anyone, can consistently do. As a result, people tend to buy high and sell low, which is counter to the best interests of shareholders. I recommend not trying to time the market, but rather develop a rules- based approach to purchasing new assets and selling old one. These rules should be tailored to the company and industry. But they should always have the objective of maximizing the long-term cash flow of the business.

Companies should consider a large-scale asset-disposal campaign that sends investors a message that this is a one-time event to “right-size” the asset base that will be followed by a new ongoing emphasis on asset utilization.

That will help investors to better understand the true capital requirements for the business and, in many cases, will increase the rate of return investors will expect from new investments. The alternative of disposing of non-operating idle assets in small increments to avoid the optics of accounting losses will give investors a false impression of the true economics of the business.

In conclusion, the disposal of idle assets can provide significant value beyond the cash proceeds received. In many cases, the secondary benefits of reducing the cost of maintaining, managing, housing, and auditing idle assets can contribute significantly to the value of a business.

To realize such value, CFOs should first focus on economic measures of profit instead of accounting profits. Those economic measures incorporate a capital charge, which improves the incentive to maintain appropriate asset utilization. It becomes more apparent that if an asset is idle and non-operating, then management should sell it, even at an accounting loss.

Secondly, be skeptical of “strategic” reasons for holding onto idle assets. The secondary consequences are rarely understood or fully considered. Don’t be vague. Instead, take a fact-based approach in deciding whether to sell or not sell assets based on what creates the most long-term value for the business.

Lastly, when one of Wall Street’s best-known financiers, Bernard Baruch, was asked how he made so much money, his reply was “by selling too soon.” In other words, don’t try to time the market. Over the long-term you will create the greatest value by embracing a rules-based approach to upgrading the portfolio of assets.

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