

Brand valuation: what it means and why it matters

Over recent years, intangible assets have become more important to businesses operating in a wide variety of industries. This in turn has put a premium on being able to come up with credible ways to value brands.
David Haigh and Jonathan Knowles report

There is now widespread acceptance that brands play an important role in generating and sustaining the financial performance of businesses. With high levels of competition and excess capacity in virtually every industry, strong brands help companies differentiate themselves in the market and communicate why their products and services are uniquely able to satisfy customer needs.

In an environment in which the functional differences between products and services have been narrowed to the point of near invisibility by the adoption of Total Quality Management, brands provide the basis for establishing meaningful differences between apparently similar offers. Competitive advantage now depends on being able to satisfy not just the functional requirements of your customers, but also their more intangible needs. It means understanding not just what your products can do for them, but also what they can mean to them.

Brands are ideally suited to this task because they communicate on a number of different levels. Brands have three primary functions – navigation, reassurance and engagement. Navigation – brands help customers to select from a bewildering array of alternatives. Reassurance – they communicate the intrinsic quality of the product or service and so reassure customers at the point of purchase. Engagement – they communicate distinctive imagery and associations that encourage customers to identify with the brand.

Branding is the process of transforming essentially functional assets into relationship assets by providing the basis for a psychological connection between the brand and the customer. This ability to endow a

product, service or company with an emotional significance over and above its functional value is a substantial source of value creation.

The past 20 years have witnessed a dramatic shift in the sources of value creation from tangible assets (such as property, plant, equipment and inventory) to intangible assets (such as skilled employees, patents, business systems and brands). This is reflected in the growing divergence between the net asset value of companies and their market capitalisation. The aggregate market-to-book ratio of the S&P 500 (the broad-based index of the 500 leading companies in the US) rose steadily from an average of around 1.4 at the beginning of the 1980s to around 3.5 in the mid 1990s. It accelerated rapidly in the late 1990s to reach a peak of 7.3 at the height of the dot.com bubble in early 2000 before falling back to its current level of 4.7 (February 2003).

A market-to-book ratio of 4.7 implies that the tangible assets of a business account for under 25% of the value that investors are placing on a company. Intangible assets account for the remaining 75%. In this context, it is not surprising that the topic of brand valuation is generating significant interest.

Forms of intangible asset

There is currently no standard classification for intangible assets. The pioneering work of Leif Edvinsson and Michael Malone put forward two basic classes of intangible asset: human capital and structural capital. Asked to distinguish them, Leif Edvinsson is said to have remarked: “Structural capital is what is left when the human capital has gone home for the night”.

Subsequent researchers have generated a number of different categories of intangible

asset. We believe that it is useful to identify four broad categories of intangible asset that support the superior market performance of businesses:

- Knowledge intangibles: for example, patents, software, recipes, specific know-how, including manufacturing and operating guides and manuals, product research including product trials data, information databases etc.
- Business process intangibles: these include unique ways of organising the business including innovative business models, flexible manufacturing techniques and supply chain configurations.
- Market position intangibles: for example, retail listings and contracts, distribution rights, licences such as landing slots, production or import quotas, third generation telecom licences, government permits and authorisations and raw materials sourcing contracts.
- Brand and relationship intangibles: these include trade names, trademarks and trade symbols, domain names, design rights, trade dress, packaging, copyrights over associated colours, smells, sounds, descriptors, logotypes, advertising visuals, and written copy. In addition, associated goodwill (the general predisposition of individuals to do business with one brand rather than another brand) should be included.

The relative importance of these four categories of intangible asset varies by industry. Pharmaceuticals is an industry in which knowledge assets are of particular significance. Retailing is an industry where business process assets (such as those developed by Wal-Mart and Dell) are major sources of financial value. Airlines is an industry in which market position assets (in the form of landing rights at popular airports) are primary drivers of competitive advantage.

In industries such as consumer-packaged goods, luxury items, media and some types of consumer durables, brands may well represent the single most important form of intangible asset. Even in sectors that are driven largely by technology and research, brands play a vital role in translating a company's technical competencies into market success. Effective management of brands is therefore an increasingly important element of business strategy and determinant of the valuation accorded to a business by investors.

This should herald the golden age of marketing. Instead it has given rise to what Peter Doyle, the former Professor of Marketing at Warwick University in the UK, has dubbed the "marketing paradox". In the preface to his

highly-acclaimed book *Value-based Marketing* (2000), he wrote: "Many senior managers have noticed a paradox in how firms perceive marketing. On the one hand, every chief executive and mission statement puts marketing at the very top of the agenda ... At the same time, marketing professionals, marketing departments and marketing education are not highly regarded ... The paradox will never be resolved until marketing professionals justify marketing strategies in relevant financial terms."

In similar vein, Professor Don Lehmann, Professor of Marketing at Columbia University in New York, has observed that: "When marketing people talk about what they do, the variables they cite aren't the ones that the CEO cares about. Customer awareness, customer satisfaction and market share are all metrics, and they are nice to know about. But the CEO is more concerned with shareholder value, market capitalization, return on assets and return on investment. In marketing, people don't talk that way."

We believe that two things are necessary to support the effective communication of the contribution of brands to business performance: a more precise definition of the brand asset; and a robust methodology for quantifying the shareholder value that is generated by the brand.

What exactly do you mean by brand?

One of the great challenges in marketing is that there is no uniform definition of brand: the term is used differently by different people to encompass a relatively broad range of assets. In our experience there are three different concepts all of which are sometimes referred to as the brand.

First there are logos and associated visual elements. This is the most specific definition of brand focusing on the legally protectable, visual and verbal elements that are used to differentiate one company's products and services from another and to stimulate demand for those products and services. The main legal elements covered by this definition are trade names, trademarks and trade symbols. However, in order to add value, trademarks and trade symbols need to carry associated goodwill in the minds of customers based on the experience or reputation of high quality products and good service.

This definition of brand is useful in the context of licensing agreements because it covers the core elements of the asset being licensed.

For brands that are operated by their owners, academics and practitioners often use two broader definitions.

The first of these is a larger bundle of trademark and associated intellectual property rights. Under this definition, brand is extended to encompass a larger bundle of intellectual property rights. Marketing intangibles such as domain names, product design rights, trade dress, packaging, copyrights in associated colours, smells, sounds, descriptors, logotypes, advertising visuals and written copy are often included in this wider definition.

Some commentators have interpreted the intellectual property rights included in the definition of brand very widely indeed. In fact, tangible as well as intangible property rights have been referred to as integral components of brands. Some argue that the Mercedes brand would be incomplete if it were separated from the other tangible and intangible assets used to build Mercedes products. The reason that some argue a larger bundle of intangibles should be included in the definition of brand is because consumer loyalty is created over a long period by many touch points and consumer experiences.

Protagonists of a more holistic definition of brand ask whether the Mercedes brand would command such fierce loyalty and price premium without the benefit of Daimler Benz design, engineering and service. Similarly they argue that the Zantac brand would be incomplete without the Ranitidine patent. The Guinness brand would not be Guinness without the genuine recipe and production process. This more holistic view is consistent with the opinion that brand is a much broader and deeper experience than the logo and associated visual elements.

And that takes us to the holistic company or organisational brand. The debate as to which intellectual property rights should or should not be incorporated into the definition of brand often leads to the view that brand refers to the whole organisation within which the specific logo and associated visual elements, the larger bundle of visual and marketing intangibles and the associated goodwill are deployed.

A combination of all these legal rights together with the culture, people and programmes of an organisation all provide a basis for differentiation and value creation by that organisation. Taken as a whole they represent a specific value proposition and provide the basis for strong customer relationships.

This is the broadest definition of brand. It stresses the need for consistent communication with all stakeholder audiences. Rather than just increasing the preference of customers for buying the company's products and services the brand becomes a tool for affecting the

preference of other audiences to do business with the organisation. For example, the brand may favourably affect staff, suppliers, business partners, the trade, regulators, and providers of capital. The benefits of a strong organisational brand are increased demand and distribution but also lower costs of materials, personnel, debt and equity.

For the purposes of this article we refer to the first definition as trademark. The second definition we refer to as the brand. The third definition we refer to as the branded business.

Approaches to brand valuation

There are two critical questions to answer in brand valuation. The first is exactly what is being valued. Are we valuing the trademarks, the brand or the branded business? The second important question is the purpose of the valuation. An important distinction can be made between technical and commercial valuations.

Technical valuations are generally conducted for balance sheet reporting, tax planning, litigation, securitisation, licensing, mergers and acquisitions and investor relations purposes. They focus on giving a point in time valuation that represents the value of the trademarks or of the brand as defined above.

Commercial valuations are used for the purposes of brand architecture, portfolio management, market strategy, budget allocation and brand scorecards. Such valuations are based on a dynamic model of the branded business and aim to measure the role played by the brand in influencing the key variables in the model.

We recommend that the starting point for every valuation – whether technical or commercial – should be a branded business valuation. This provides the most complete understanding of the commercial context of the brand.

A branded business valuation is based on a discounted cash flow analysis of future earnings for that business discounted at the appropriate cost of capital. The value of the branded business is made up of a number of tangible and intangible assets. Trademarks are simply one of these and brands are a more comprehensive bundle of trademark and related intangibles.

There are a number of recognised methods for valuing trademarks or brands as defined here.

We can look at historic costs – what did it cost to create? In the case of a brand one can look at what it cost to design, register, and promote the trademarks and associated rights. Alternatively, one can address what they might cost to replace. Both the historic

cost method and the replacement cost method are subjective but we are often asked to value this way because courts may want to know what a brand might cost to create.

It is also possible to consider market value, though frequently there is no market value for intangibles, particularly trademarks and brands. Generally speaking, therefore, the most productive approach to brand valuation is to employ an economic use valuation method, of which there are a number.

First there is the price premium or gross margin approach that considers price premiums or superior margins versus a generic business as the metric for quantifying the value that the brand contributes. However, the rise of private label means that it is often hard to identify a generic against which the price or margin differential should be measured.

Economic substitution analysis is another approach - if we didn't have that trademark or brand what would the financial performance of the branded business be? How would the volumes, values and costs change? The problem with this approach is that it relies on subjective judgments as to what the alternative substitute might be.

The difficulties associated with these two approaches mean that the two most useful economic use approaches are the earnings split and royalty relief approaches.

Under a royalty relief approach we imagine that the business does not own its trademarks but licenses them from another business at a market rate. The royalty rate is usually expressed as a percentage of sales. This is the most frequently used method of valuation because it is highly regarded by tax authorities and courts, largely because there are a lot of comparable licensing agreements in the public domain. It is relatively easy to calculate a specific percentage that might be paid to the trademark or brand owner.

Under an earnings split approach we attribute earnings above a break-even economic return to the intangible capital. This involves four principal steps. The first is an appropriate segmentation of the market to ensure that we study the brand within its relevant competitive framework. The second step is to forecast the economic earnings of the branded business earnings within each of the identified segments. These are the excess earnings attributable to all the intangible assets of the business. The third step is to analyse the business drivers research to determine what proportion of total branded business earnings may be attributed specifically to the brand. The final step is to determine an appropriate discount rate based

on the quality and security of the brand franchise with both trade customers and end consumers.

In our experience, it is very important to express the final valuation number in context. This means explaining exactly what has been valued, using what method, and what the key insights are as to the influence of the brand on the key operating variables of the business.

In this context, it is useful to remember that value is a function of three primary variables – profitability, growth and risk. Investors care about the level of free cash flow generated by a company (profitability), the prospects for increasing those cash flows (growth) and the volatility of these cash flows (risk).

Understanding the contribution of brands to shareholder value therefore depends on being able to express the impact of brands on profitability, growth and risk. The traditional view of customers as the only relevant audience (implicit in the price premium approach above) fails to recognise the full value-creating power of brands because it confines the impact of the brand to the price premium that the branded product is able to sustain.

It is important to understand the impact of a brand on four major audiences in order to quantify the scale of its financial significance. These four audiences are consumers, suppliers, staff and investors/financiers. For each of these audiences we analyse both the extent and the nature of the awareness and image profile that the brand enjoys, and capture the impact of these on the behaviour of that audience. With consumers, the impact of brand health drives both profitability and growth. With suppliers and staff the impact of brands is evident in lower costs and therefore higher profitability. With investors and financiers, the benefit of strong brands is seen in lower funding costs.

This broader perspective on the business is of significant value when the client has responsibility for business and brand development because it illuminates the principal value drivers of the business and identifies how brand perceptions and preferences affect consumer purchase behaviour and staff and supplier relationships.

As such, it makes a substantive contribution to understanding the sources and scale of a company's competitive position. It quantifies the size of the asset that the brand represents and – perhaps more important yet – identifies ways in which the value can be enhanced.



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Jonathan's expertise in integrating the financial and marketing perspectives on brand is the result of practising brand consulting from both the analytical and creative perspectives. Prior to joining Brand Finance he was senior vice president of BrandEconomics, a brand strategy and valuation business based in New York. His previous role as head of consulting for Wolff Olins, a leading corporate identity and brand consultancy based in London, provided the experience of brand consulting within a highly creative environment and acted as a counterpoint to his analytical training with the value-based strategy consultants Marakon Associates.