Brand Finance Report

Connecting Brand Value, 'Brand Equity' and Brand Economics

Increasing the Influence of Marketing in Top Management Decision-Making

How do brands add value?

In financial terms a brand represents the pact between a consumer and a supplier, promising a secure flow of future revenues and profits to the supplier. Ultimately, what gives a brand its value is that it is a specifically defensible piece of legal property with an incremental stream of revenue attached to it.

The supplier's earnings are secure because strong brands create both functional and emotional barriers to competition for the consumer's loyalty. On the functional side, brands simplify recognition and selection; they facilitate split-second purchase decisions at point-of-purchase. Brands provide a guarantee of origin and quality; reliable consumer choices can be made in safety. On the emotional side, brands provide reassurance; 'I am a good mother because I use Pampers'. Brands satisfy associative desires; 'I am one of the in-crowd because I wear Versace'. They are aspirational; 'I am an up-and-coming executive because I drive BMW'. Finally, they fulfill self-expressive needs; 'I am manly because I smoke Marlboro.' and so on.

An important additional benefit of strong brands is their ability to transfer established consumer loyalty to new market areas and product categories. In order for brand stretching to be effective, it is necessary that the brand attributes are as appropriate to the new extension area as to the original product or service category. For example, Virgin represents innovative, exciting, youthful, friendly, good value whatever category it is extended into; if the Virgin brand had based its appeal exclusively on functional and rational attributes it would still be stuck in the record retailing category.

That strong 'brand equity' does translate into better financial performance can be seen in the cola market. In blind tests Pepsi Cola consistently outperforms Coca-Cola in terms of consumer taste preference. But when Coke branded packaging is revealed stated preference completely reverses. When otherwise identical cars, made in the same factory, are branded either VW or SEAT the price and residual value profiles differ dramatically. Branding persuades consumers to behave irrationally, adding value to otherwise functionally identical products and services.

Brand Economics

Strong brands with high ‘brand equity’ possess the ability to persuade people to make economic decisions based on emotional rather than rational criteria. They consequently have a profound economic impact and economic value. Brand Finance plc first developed the concept of brand economics in 1999 when it began empirically researching brand related economic phenomena.

Interestingly, it is sometimes argued that branding is a way for companies to ‘rip off ‘ consumers, but the following simple example demonstrates that in a free market brands create a virtuous circle of lower prices, higher profits and higher surplus ‘consumer utility’. Branding consequently has a hugely beneficial effect on individual consumers, individual companies and the economy as a whole.

Brands favorably affect both the revenue and cost curves of a business. ***Figure 1*** shows the average revenue and cost curves of a simple commodity business. ***Figure 2*** demonstrates the absolute amount of profit made in that commodity business at a unit sale price of, say, $150. It will be seen that the average unit cost declines as volume grows; this is because fixed costs are spread over a larger volume of production.

Figure 1: Economic model for commodity product

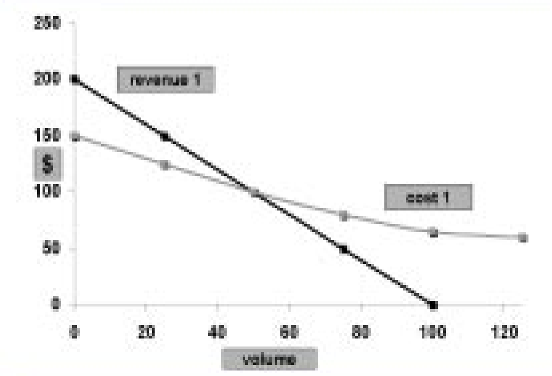


Figure 2: Economic model for commodity product

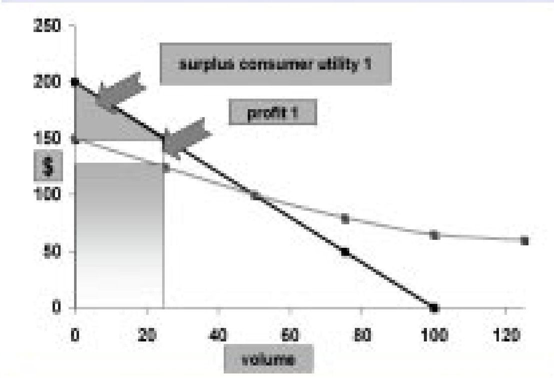


Figure 3: Strong brand equity shifts the demand curve

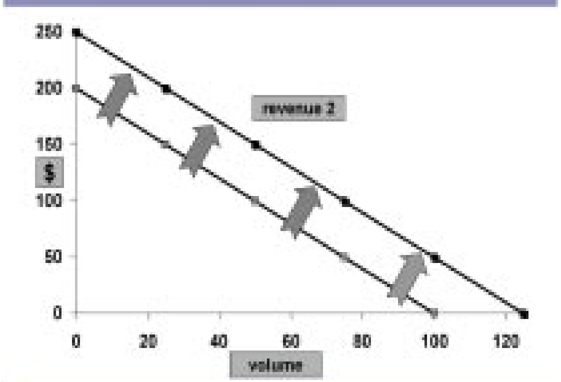
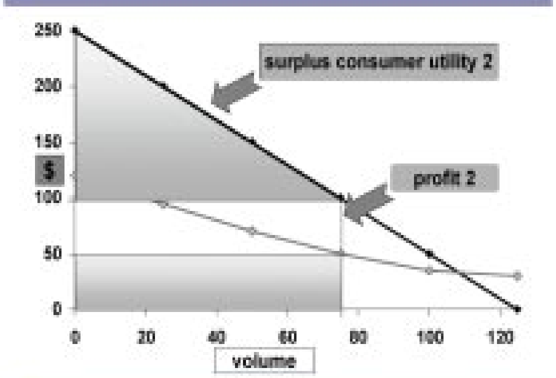


Figure 4: Economic model for power brand



As shown in ***Figure 3,*** if products are well branded, and have acquired strong ‘brand equity’, the demand line moves out to the right, because consumers are quite willing to pay more. There are various effects at work causing this phenomenon; higher trial of the category and the brand, higher repeat rates, lower lapse rates, a willingness to pay a premium etc.

Equally importantly strong ‘brand equity’ drives down the average cost curve. Strong brands are more willingly distributed and stocked by the trade resulting in lower commissions, discounts and stocking fees.

The net result, shown in ***Figure 4,*** is a transformation of the commodity economic model to a branded one, with the revenue curve pushed upwards and the cost curve downwards. Average surplus consumer utility has doubled because preference for the brand expressed in financial terms has increased significantly. Holding the price at $150 provides greater consumer satisfaction or surplus ‘consumer utility’ to all consumers.

Some brand owners would be happy to leave the model at that, satisfied they had achieved higher sales, profits and consumer utility at the original price point. However, a number of interesting strategic options become available under a strongly branded business model.

Brand Economics impact on corporate strategy

In a commodity business an increase in price quite rationally leads to a proportionate decrease in demand, and vice versa. For every unit increase in price there is a unit decrease in volume demanded.

The demand curve in our simplified model is a straight line of this kind.

However, in a branded business, demand varies in irrational ways. As price rises the volume of demand from brand loyal consumers often decreases less than proportionately with the increase in price. As price falls, the volume of demand from loyal consumers may increase more than proportionately because consumers seek to consume or stockpile their favorite brand at what is seen to be a highly favorable price.

In some instances brand demand curves vary in apparently irrational ways. For example, in luxury goods, demand often rises rather than falls as price rises. Some people are prepared to pay a premium for exclusivity.

The shape of a brand's demand curve need to be carefully investigated before deciding on the optimal brand strategy. In the simplified example shown in ***Figure 4,*** demand increases proportionately with price decreases. In the real world this is unlikely to happen for the reasons noted above. If the brand is a strong one, then the demand line often flattens and extends as prices fall. However, the example clearly demonstrates the virtuous circle created by brands like Swatch or McDonalds.
This illustrates that the brand owner is working harder to provide more branded product to more consumers. The brand owner is making more profit but simultaneously creating greater consumer satisfaction and utility. This is why branding in a free enterprise economy is far from being a consumer 'rip-off' If it were, consumers would simply stop buying branded products.

The simplified economic model noted above is the model adopted by Swatch when it revolutionised the wrist watch market and has been adopted by many other enlightened brand owners. By building strong brands they kill several birds with one stone, achieving greater turnover and profit, more competitive pricing to keep out competition and significantly more satisfied, loyal consumers.

Understanding how 'Brand Equity' drives Brand Economics

'Equity' is a financial term that has been adopted by marketing people to reflect the fact that the brands they manage are financial assets, which create significant shareholder value.

It reflects a growing recognition that responsibility for brands must be shared between the finance and marketing functions. The marketing department will always have responsibility for the creative aspects of brand building, maintenance and support. But as brands grow in importance, measuring, monitoring and maximising Brand Economics' effects and returns on brand investment are increasingly a shared responsibility with the finance function.

However, while 'brand equity' is often talked about it is seldom clearly defined. How it works to impact on Brand Economics' not clearly understood. Tim Ambler, of the London Business School, defines 'brand equity' as a marketing asset 'between the ears' of consumers, trade customers, staff and other stakeholders, which stimulates long term demand, cash flow and value. He uses the analogy of a reservoir that needs to be topped up if the outflow of water is to be maintained at a constant or increasing rate.

If the 'brand equity' reservoir is depleted revenues and cash flows may remain strong for a period, but eventually the reservoir empties and cash flows dry up. A great visual analogy, but we need to really understand the flow process.

Paul Feldwick, planning Director of BMP, points out that the term 'brand equity' is often used indiscriminately to describe different points along the stream:

Consumer images, associations and beliefs. These are high up the flow towards the source. A brand may be described as 'young', 'green' or 'exciting'. It is possible to measure and report how such brand images, associations and beliefs vary from consumer group to consumer group, how they change from time to time and how they affect purchase decisions. This provides great diagnostic insight into the consumer segments around which a financial brand valuation is structured.

Consumer brand strength or loyalty. These intermediate outputs may be measured in terms of attitudes or awareness, price elasticity, demand volume, purchase frequency. These measures help forecast future cash flows used in a financial brand valuation.

Financial brand value. Brand valuations are a snapshot of future brand earnings taken at a point in time. They reflect the sustainable outflow and put a firm financial value on it. They depend on an accurate prediction of future brand health because they are based on forecast cash flows generated by the brand. They rely on an accurate estimate of the future flow, which the reservoir has yet to produce. The flow rate may be falling or rising depending on the amount of 'brand equity' left in the reservoir.

Brand Finance definition of 'brand equity'

Brand equity measures 'the propensity of specific audiences to express preferences which are financially favourable to the brand'. Brand equity measurement systems isolate and analyse the attributes that explain changes in this propensity and predict future financial behaviour. Brand Equity helps explain the shape of demand and cost curves in a Brand Economics' study.

Figure 5 illustrates the framework of a typical brand valuation. A market review must first be conducted to understand all the trends driving the size, growth and profitability of the market within which the brand operates. Then a review is conducted to understand competitors and conduct brand strength assessments.
A critical part of this process is understanding how 'brand equity' affects the Brand Economics' and ensuring that the shape of the demand curves in each of the segments is fully understood. Critically the valuation is segmented into discrete pieces to allow an understanding of the brand contribution by segment. This reflects the fact that demand conditions vary significantly from one geographic or consumer segment to another.

So a brand valuation provides a framework for valuing the brand into segments (by geography, product, channel or consumer demographic) which matches with the analysis of 'brand equity' and underlying Brand Economics'.
By understanding 'brand equity' in aggregate and for the individual segments we are able to better diagnose how and where future value can be maximized.

There is no simple measure of 'brand equity'. There are several measures which, taken together, inform management decision-making. What major companies are beginning to realise is that all of the measures available need to be gathered, reviewed and prioritised in a structured brand audit and considered as a whole in the brand evaluation process.

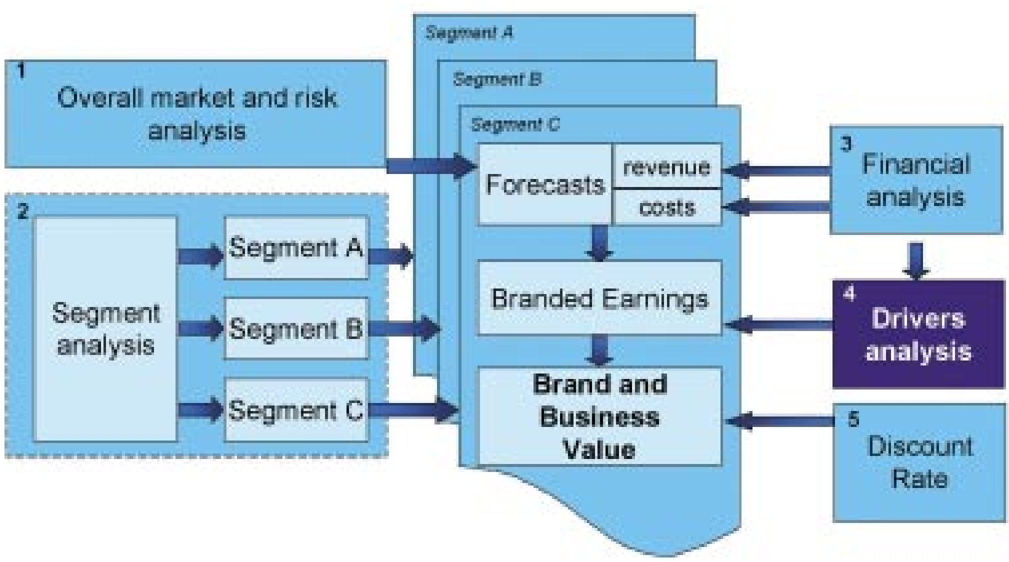
To this end, more and more companies are building brand monitoring and forecasting systems with large volumes of detailed research and financial data incorporating brand equity and brand value measures.

Conclusion

Brands will be major drivers of corporate value in the 21st century. Investors and business leaders have recognised this. Financial managers and planners are increasingly using brand equity tracking models to facilitate business planning. They should go one step further. Investors need and want greater disclosure of brand values and marketing performance. They want to understand the Brand Economics of individual brands to better understand the future performance and value of companies they are investing in.
Financial managers should play a lead role in ensuring that such information is adequately communicated to investors, rather than waiting for statutory disclosure requirements to catch up with reality.

Having detailed information on the brand, not just a brand value in financial terms, including information on perceptual, performance and customer measures can aid the investor relations function. By utilising detailed 'brand equity' and Brand Economics' trackers it is possible to show

Figure 5: Brand Valuation framework

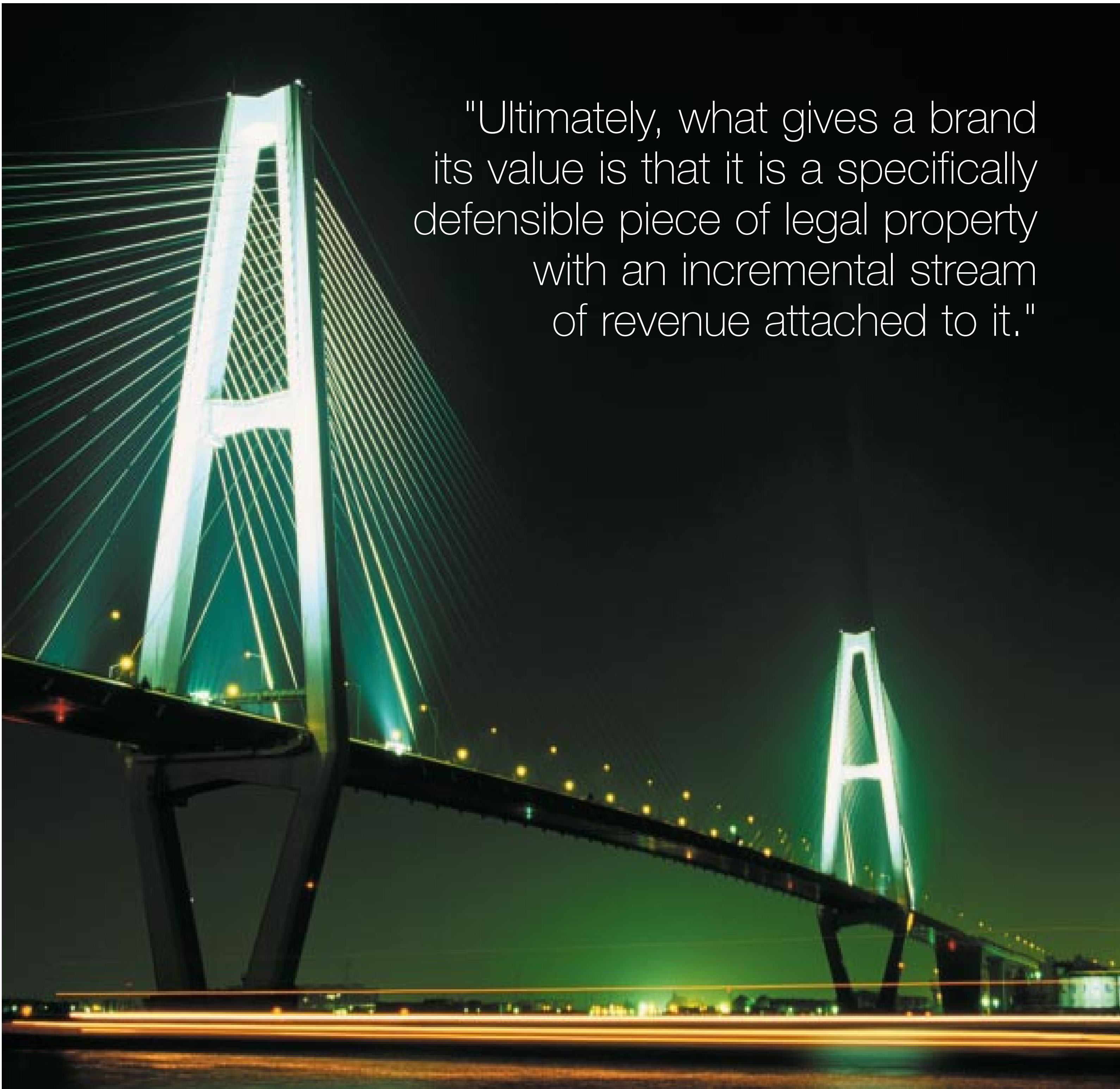


the investment community the contribution of the brand as well as its actual value.

Other key areas in which a greater understanding of ‘brand equity’ and Brand Economics aids company performance includes the setting of marketing budgets, resource allocation, internal communication and brand performance tracking.

Many organisations suffer from a surplus rather than a lack of market and consumer information. Unfortunately, much of this is gathered and stored in isolation. The old functional boundaries of a bygone era still prevent the effective flow and integration of information. Even if brand tracking data makes it onto the Intranet or a shared directory, it tends to remain in ‘research speak’ and tends not to be used by financial and strategic planners.

What marketers and brand owners need to ensure is that adequate data is collected centrally and regularly, that relationships between the data variables are understood, that the financial value of the brand is understood and that it is monitored. It is now best practice to have a ‘brand equity’, Brand Economics‘ and brand value reporting system of this kind and demands for such reporting systems will be further driven by the financial and investment communities in the coming years.



Maximising the full value

For many years corporate financiers have recognised that successful brands provide excellent security against which to borrow and can also attract premium prices when placed on the market. What's new is a growing awareness of the upside potential in under-performing brands. However most owners of such brands do not know how to unlock their full value on a disposal. With this in mind Brand Finance and Cavendish Corporate Finance have been working together to provide a brand realisation service.

Below David Haigh, CEO of Brand Finance comments on the current market for brand realisations and outlines the key steps in a brand audit and valuation exercise.

Marketing people have always known that genuinely strong brands add value to the business proposition by increasing revenues and reducing operating and financing costs. The main change in the market over the last few years has been the increasing recognition that there is potentially considerable value in brands, which are tired, distressed or generally under-performing.

'Brand Guardians' like the Saatchis, (through SAATCHiNVEST), have identified the opportunity and are increasingly willing to step in when current owners are either unable or unwilling to unlock a brand's true potential.

The SAATCHiNVEST vehicle is not the first of its kind. In the 1980s Sir Paul Judge, then strategy director at Cadburys, bought a parcel of non-core brands out of Cadburys to form Premier Brands and five years ago John Murphy, the founder of Interbrand, led a small consortium to buy Plymouth Gin out of Allied Domecq. Cavendish subsequently acted for John Murphy on the sale of Plymouth to Vin & Sprit AB of Sweden at a considerable profit.
Now, however, most of the large conglomerates like Unilever, Diageo and Arcadia are reviewing their brand portfolios and spinning off those which do not fit. This has created an active and willing market, with competition hotting up between private equity players, mini-conglomerates and individual 'angels'.

The difficulty is that most investors and bankers have little idea what makes a brand that is likely to deliver the expected benefits, and therefore which under performing brands are dogs waiting to expire and which are the downtrodden stars.

We have noticed that it is often the smaller PLC's and the private equity houses, who do not necessarily have the requisite in-house brand management resources, who are failing to secure best value on the disposal of such brands.

In the majority of cases all that they need is a rigorous appraisal of the underlying potential of a brand and practical advice on how to realise its potential. Essentially, can the brand be strengthened, is it worth the effort, and, if so, how? What is its value and, if it is best to sell the brand, how can it be presented to the market in such a way as to maximise value?

We have labelled this a "Brand Due Diligence Review".

Typically the following five key steps would be included in such a review:

1 Legal review and risk analysis
Involves understanding the nature of the franchise:

- Are trademarks registered in all territories and business classes?
- Are trademarks properly protected?
- Are trademark rights sold, shared or licensed?

# of under-performing brands

- Are sales being lost through parallel trading or counterfeiting?

2 Market review and risk analysis
Involves understanding the risk profile of the industry:
- Is the industry in a growth or decline phase?
- Is the industry stable or particularly vulnerable to social, economic, political, technological or environmental factors?
- How are developments in e-commerce and the internet affecting the distribution channels in the industry?

3 Competitor review and risk analysis
Involves understanding the competitor landscape:
- Who is the market leader and what is its strategy - is it integrating up/down/across?
- Which of the other businesses are considered market challengers/followers/niche players and
- what appears to be their marketing strategy?
- What are the barriers to entry in the market?

4 Brand image review and risk analysis
- Is the brand well managed?
- Customer target profile
- Pricing strategy
- Adequate marketing support
- Responding to changing environment
- Is there protection against reputation damage?
- Product malfunction
- Personnel error
- Ethical or environmental problems

5 Branded business review and risk analysis
- Is there any sustainable competitive advantage?
- Product innovation
- Manufacturing capability
- Distribution/channel structure
- Quality of service/people
- Lowest cost/price
- Customer loyalty/inertia
- Intangible differentiation

The resultant report from such a review would include a branded business valuation, and commentary on what drives demand and loyalty and a detailed appraisal of various alternative growth and value realisation options.

The Brand Finance and Cavendish view is that, with the right preparation and presentation there is no reason why the existing owners cannot extract considerable additional value from their brands. Often the value is hidden away, but why leave all of it for the next man?

Brand Finance and Cavendish successfully completed their first joint mandate in summer 2003 with the successful sale of BCP, the UK's leading airport car park reservations businesses. In this exercise a brand due diligence review was carried out, which helped to highlight the strength of the brand and its potential. This ammunition was then used effectively by Cavendish to secure a very full price for the business.

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