Royalty rates: the key drivers

Commercial royalty rate analysis

The article considers ways in which royalty rates can be analysed so that decisions based on them can be more informed. First their use in practice and the related context needs to be considered. Next it is necessary to have a good understanding of the sales on which they would be based, and in particular the price point in the supply chain on which royalties are to be based. Then a range of comparable royalty rates can be researched and market research can be used to position within that range. Profitability analysis will then give a view on the reasonableness of the Given the significance of intangible assets to many businesses, and that royalty rates are often key in assessing their value royalty rates will often be key to business value.

Use in practice

Royalty rates are seen in practice in license agreements for intangible assets and valuations of intangible assets. There are many such assets used in business today which are highly valuable, for example patents, copyright and trademarks or brands. In this article we concentrate on consumer brands where there is a wealth of developed research and theory. The same principles of royalty rate analysis also apply to other intangible assets such as B2B brands and copyrights or patents, although there is often a need for a different focus.

There are many ways of valuing brands, but the mainstream method now used in practice is the" relief from royalty method". This estimates the future royalties which would have to be paid to the owner of the brand for its current use. Tax is deducted and a discount rate is used to state future cash flows at to a present value. This is based on the brand in its current use and is based on a saving from owning the brand, or relief from royalties that would be paid to the brand owner.

Royalty rates refer to the percentage amount applied to sales to give royalties attributable to a brand. This is usually a key issue for businesses with significant brands subject to license agreements and/or brand valuations. A royalty rate only has to be wrong by a small percentage for there to be serious consequences. Many brands are heavily exploited on a licensing model, to name but a few as examples: Coca Cola, IBM, Dolby, Nike.

Context

Before any analysis aimed at quantifying a royalty rate it is worth standing back and assessing the background on why it is needed. License agreements are drawn up for many reasons and support different strategies. Licensing might be the core activity of a business, it might be a deliberate exploitation of dormant Intellectual Property, it might be a strategy for markets which cannot be as well developed otherwise or it might be a strategy for non core products (to name but a few strategies). So as an example the royalty rate for Smirnoff within a distribution arrangement for the Japanese vodka market might be say 40%, very different from a royalty rate for the same brand in the US confectionary market (say 5%).

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Within a license agreement the royalty rate may be interlinked with other factors, most notably minimum royalty commitments and decreased royalty rates once certain volumes are reached. Minimum royalties are often a commitment for some form of exclusivity or access to the brand in a market. Decreasing royalty rates could be used to incentivise the licensee to achieve higher volumes as the unit cost of branded products then becomes less.

License agreements usually include a number of other considerations such as:

- Definition of the brand being licensed
- Definition of the sales to which the royalty percentage is to be applied
- A restriction of the use of the brand to specific products, channels and territories
- A specific time period, say 3 years
- Brand use and authorisation procedures. This is to ensure that the use of the brand by the licensee is consistent with that of the brand owner.
- Commitments by licensee to brand marketing. This can also be a percentage of sales or a fixed amount.
- Other legal rights and obligations such as necessary records and returns and access to audit.

These factors will also influence, to a greater or lesser extent, the royalty rate. If a licensee agrees, for example, to contribute to brand marketing then the royalty rate might be reduced to compensate for this.

For brand valuations the context is equally important – the reason for the brand valuation will influence all factors, and can be quite different, as follows:

- Brand planning & strategy
- Brand & market metrics
- Business development and planning
- Financial reporting; and
- Litigation support

Once the context is established, and if the relief from royalty method is the primary valuation method, royalty rates will be extremely important. They are also likely to have some influence over other valuation parameters such as forecast sales growth and the discount rate.
Sales on which royalties are calculated

Royalties are based on sales and so it is helpful to have an understanding of the market, its projected growth, competitor activity and the brand's market share. This will give projected sales of branded products to which the royalty rate can be referenced. We set out below an analysis for a hypothetical menswear brand in Italy, and it can be seen the analysis helps in assessing the branded sales which will ultimately drive the royalties.

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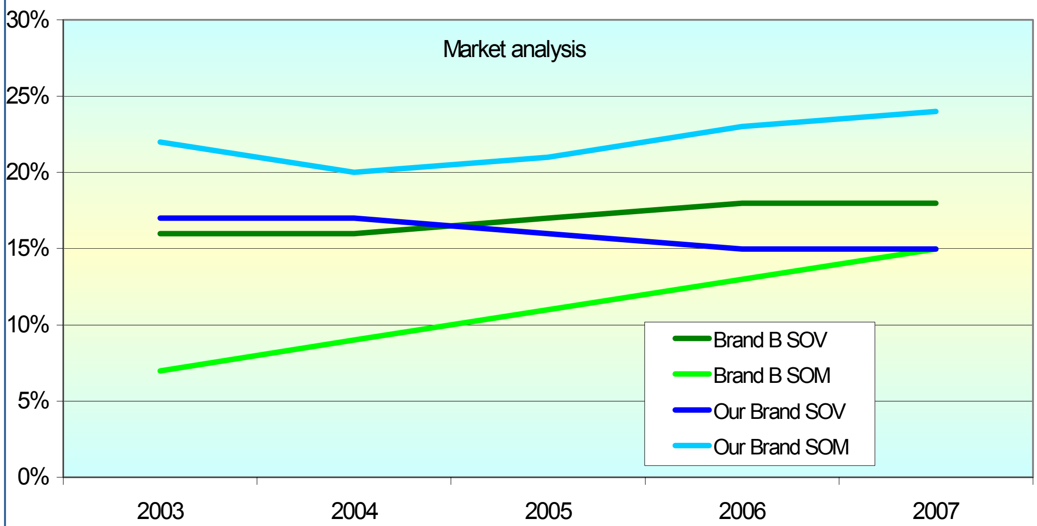
Market Analysis - Menswear						
Italy	Actual	Actual	Estimate	Forecast	Forecast	Forecast
	2002	**2003**	**2004**	**2005**	**2006**	**2007**
Overall Economic Indicators						
Population 000's	58,138	58,005	58,109	58,338	58,569	58,800
Private consumption per head (US$)	14,300	14,600	14,900	15,200	15,506	15,818
Specific Apparel Indicators						
All clothing, sales value (US$ million)	28,267	28,782	29,283	29,727	30,177	30,635
Clothing sales per head	486.20	496.20	503.93	509.56	515.24	520.99
Clothing sales as a % of private consumption	3.40%	3.40%	3.38%	3.35%	3.32%	3.29%
Specific Market segment data - Menswear						
Market Value US$ million	5,615	5,807	6,039	6,261	6,491	6,729
Competitor A share of voice	9%	9%	9%	9%	9%	9%
Competitor A market share	10%	11%	13%	11%	11%	11%
Competitor B share of voice	15%	16%	16%	17%	18%	18%
Competitor B market share	6%	7%	9%	11%	13%	15%
Our Brand share of voice	15%	17%	17%	16%	15%	15%
Brand market share %	23%	22%	20%	21%	23%	24%
Brand sales	1,291	1,277	1,208	1,315	1,493	1,615

Such an analysis brings greater understanding of the sales carrying the brand. Key figures can also be charted for an easier comprehension of trends, and anomalies. The chart below indicates that Brand B has gained market share rapidly and its share of voice now exceeds that for our Brand. Given that share of voice and share of market are generally thought to converge in the long term this highlights an issue of how realistic the forecast growth in market share is, on which a royalty rate can be calculated.



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Price points and supply chain

Even if a brand drives value at retail level, market dynamics may not allow for royalties to be charged on retail prices.. They may, for example, be paid by the manufacturer to the brand owner, and the royalty rate will then be based on the manufacturer's price point rather than the retail price point. So a higher royalty rate will be needed to give the same royalties This could mean that a royalty rate of 17% on the manufacture price point is equivalent to a royalty of 5% on the retail price point, as illustrated on the diagram below.

Supply chain	Raw material	Manufacture	Distribution	Retail
Price point	$10	$30	$60	$100
Royalty	$5	$5	$5	$5
Equivalent royalty rate	50%	17%	8%	5%

Range of comparable royalty rates

For any royalty rate analysis it is useful to find out comparable royalty rates – any analysis is easier when relevant benchmarks in the market can be referred to. Comparable royalty rates can be obtained from a variety of sources, including:

- Analysis of existing available agreements. This can sometimes be, for example, a supply agreement for a range of goods including the use of the brand. Such agreements can be analysed to give brand royalties
- Searching on the SEC database, which contains a number of disclosed license agreements
- Research or enquiry in the industry or comparable industries
- Buying information from licensing database holders
- Analysis of business acquisitions or share prices

Brand Strength Analysis

The next stage is to assess how a brand can be positioned in such a range. There are many ways in which this can be done but a simple and practical approach can be to use a Brand Strength Analysis. This takes a number of key value drivers for a brand, based on market research, and scores the brand against those drivers relative to the competitive set. This then gives a score against a minimum and a maximum possible and is used to position the brand in the royalty rate range. An example of this is shown below:

Illustrative Brand Strength Analysis

Factor		Score					
		0	1	2	3	4	5
Market Factors							
1	Economic growth		1				
2	Substitution				3		
3	Strength of competition			2			
Brand Factors							
4	Brand perception						5
5	Loyalty					4	
6	History, heritage, longevity					4	
7	Price premium					4	
8	Share of market					4	
9	Potential for line extensions					4	
10	Share of voice			2			
			1	4	3	20	5
		TOTAL SCORE					33

Scoring : Each factor is scored on a scale of 0-5, with 5 being highest.
Scores are relative to the defined competitive set

Royalty rate range	1.0%	7.0%
Derived royalty rate		5.0%

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VIEWPOINT

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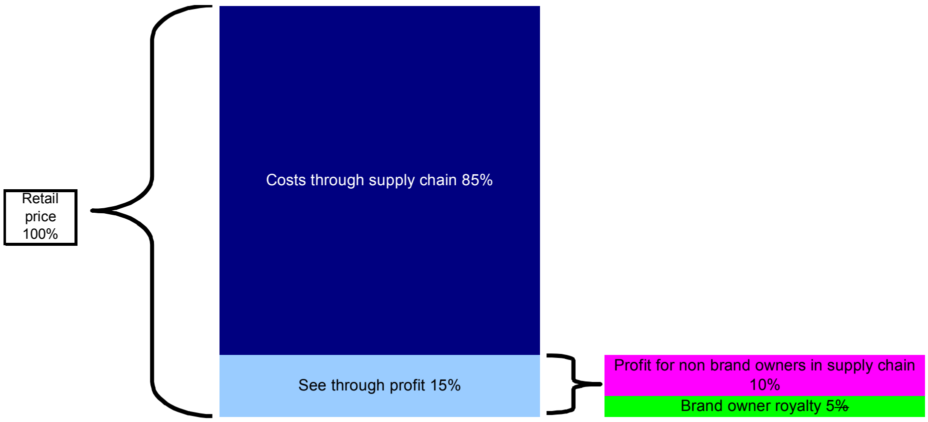
Profitability

Royalties are a way of showing value brought to a business by a brand, and determining compensation to the brand owner. Such value will often be based on the profitability of the business, together with other factors such as the strength of the brand. An analysis of this profitability can be done on a see through basis through some or all of the supply chain. The resulting see through profit can be attributed to various business functions, but one will be the brand. In the long term royalties relating to this part of the supply chain will be a proportion only of the see through profit. For commercial arrangements to be successful on a long term basis the value brought by the brand will need to be shared by all concerned in bringing it to market.

This sharing of see through profit can be illustrated as follows:



Significance

Royalty rates are typically small percentages, but they are applied to sales figures, meaning that royalty values are often significant. They drive brand values which are in themselves often highly significant (the Malibu spirit brand was bought by Allied Domecq in May 2002 for £560 million – this transaction was mostly attributed to brand value). Given this significance they warrant in depth analysis – so that significant decisions are made on an informed basis.

The royalty rate analysis illustrated in this article has been 5%. When applied to the forecast sales (in the illustration of brand sales in menswear in Italy) this gives significant annual forecast income of £80 million in 2007, and when capitalised as a brand value using a relief from royalty methodology it can amount to £760 million: Significant by any standards.