

Understanding brand equity and brand valuation

Introduction

It is interesting to appreciate brands have always been considered as intangible assets, presumably justified on the basis that brands cannot be seen or touched like a building or plant and machinery. But anyone who has worked in a brand environment will testify there is nothing more tangible than the cash flows generated from the company's brands.

For leading brands these cash flows are resilient, reliable and sustainable and often the sole basis of a businesses existence. Without them there is no real business just people in buildings with not a great deal to do.

Brand valuation in our opinion should not be seen as just a number, the valuation process itself enriches the user with a far more comprehensive understanding of how business generate cash flows through an understanding of their customers, the markets and channels they operate in, the competitive environment, and operational capability to deliver value and growth.

Brand valuation has been in existence for at least 20 years, and has been for a large part of this time misunderstood and too often poorly practiced with the consequence that many in business have been rightly skeptical about the benefits Brand valuation brings.

After all from an ongoing management perspective what is the use of knowing the value of a brand at a point in time if you are not provided with a brand performance tracking process that helps develop growth strategies, performance monitoring and resource allocation decisions to optimize shareholder value.

Critics of brand valuation (and I suppose consequently valuation in general) point out that any discounted future cash flow model is based upon certain key assumptions that make such an exercise very subjective and of little benefit, such as future growth rates, discount rates, profitability etc. But this criticism is pretty pointless as most investment decisions are based upon future cash flow expectations and returns and we have a requirement to continually improve our forecasting capability and understanding.

Besides it should be appreciated that strong brands provide very reliable steady cash flows and I would argue very strongly that you can far more accurately value a brand as opposed to a commercial building (based on future rental expectations).

The development of brand valuation

The problem with brand valuation in the past is that generally brand valuation grew out of business valuation and has been practiced by accounting firms who have first class technical knowledge in terms of justifying a discount rate, appropriate tax rates etc but do not possess the commercial experience or background knowledge to fully appreciate and understand how brands operate from the perspective of consumers and markets and retail distribution in a competitive context. Without this understanding of the real world built into a valuation process any forecasts going forward will be based on guess work without real substance built into the guts of the analysis. And as a direct consequence provide no genuine benefit to business or investors alike.

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Having said that brand valuation methodologies have been developed and improved considerably in recent times, and is now starting to be recognized and used as a leading edge business tool. But only now is Brand Valuation and Intangible Asset valuation being taken seriously mostly due to United States financial reporting standards requiring acquired intangibles which can be separately identified and have separate economic lives to be valued and put on the balance sheet. International accounting standards will require UK (and other countries adopting IAS's) public companies to do the same and this will be effective from January 2005. Additionally these intangibles require annual impairment testing to make sure their values have not diminished. If they diminish in value then a write off to the profit and loss account is required. Not a pleasant circumstance for company directors to explain to their stakeholders. For example in the United States under the new accounting standards AOL Time Warner has written off \$ 54 billion and Worldcom \$ 50 billion dollars.

Even so from the perspective of users of accounts these developments will not provide the full picture yet as only acquired intangibles need to be valued and put on the balance sheet, and only acquired intangibles after the new accounting standards come into force.

All those internally generated brands and brands purchased before the new standards apply, which will be the vast majority will not have to be put on the balance sheet.

But this is a positive development and in due course we should expect to see an interest in putting all internally developed and acquired brands on the balance sheet. Only then can the balance sheet be expected to reflect the real value of the business. This would reveal the real value of the assets under the management of company directors and make interesting reading from the perspective of understanding real returns on assets employed.

Brands drive value

Globalization, technological developments, outsourcing and e-business have forced companies to compete more intensely and brands have become the main way of differentiating products and services, creating and sustaining competitive advantage and maintaining customer loyalty. As such, brands have become the main drivers of value within a company. It is no surprise that branded companies have recently outperformed the major stock market indices. It is imperative therefore to understand what value brands hold and to track where and how they create it. This is recognized by a recent operating and financial review exposure draft issued by the Accounting Standards Board in the UK which requires amongst other things:

- a commentary on items such as "corporate reputation and brand equity".
- a report on how business has sought to maintain and improve future performance, including – "investment in brand equity, through advertising and other marketing activities".

Brand valuation is starting to be recognized as a primary tool in the business model bringing together brand metrics, market analysis and finance to improve and inform Management decisions and maximize shareholder value. In so much it aids in the following:

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- Marketing investment, budget and resource allocation decisions.
- Highlighting brands as drivers of value, income, profitability and long term growth. Amongst other things this enables a company to develop / rationalize an existing portfolio to maximize returns.
- Continuous brand equity and value tracking enables brand performance by line of business, geography or channel to be monitored and reported in an understandable financial value. This also enables different brand strategies and marketing investment as well as the performance of different marketing teams across an organization to be monitored and altered as necessary.
- By application of a dynamic brand equity performance model specific consumer metrics can be applied to determine the viability of a brand to attract new users through brand extension activities, highlighting relative risks and rewards across a portfolio of brands and markets.
- By using a financial model using predictive research the brand's impact on volume and price can be used to identify if new product development through brand extensions or stretch is viable.

Intangible Business, a leading specialist brand valuation consultancy in the UK, has evolved the Relief from Royalty methodology thereby eliminating many of its shortcomings to provide a far more complete and reliable valuation methodology for both one off brand valuations and for use by management as a performance measure that quantifies and appreciates the connection between brand equity and brand performance delivery.

Brand premium approach: This makes the Relief from Royalty methodology more rigorous by analyzing existing comparable commercial arrangements within the company and sector they are valuing and corroborating such analysis with available external comparables and the understanding of commercial affordability to reach an appropriate royalty rate. The financial analysis can assess the earnings between different points in the value chain i.e. the brand owning entity, the distributor and retailer separating the earnings applicable to the brand. Cross checks are also made with external sources. In the diagram below this process is referred to as Brand Premium Analysis.

The wealth of information that many companies hold internally on consumer insight along side a detailed market analysis is the first stage of this valuation methodology.

Intangible Business, through a combination of real hands on knowledge and expertise in brand management, markets, finance and corporate development has combined their extensive knowledge in this area and adapted their individual offerings to develop a consumer driven brand equity performance model that reflects not only the current value of the brand but also its potential to grow.



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Intangible Business has developed and implemented a brand valuation methodology and process that competitively benchmarks brand profitability (the premium a brand derives) and brand equity to understand the relationship between the drivers of brand equity and financial performance.

The process is logical and practical and has been systemized into existing business processes.

Leading edge brand companies who want the latest business tools to stay ahead of the game in terms of managing and optimizing resources for growth now have an opportunity to significantly improve their business model and to use this process to galvanize all the different disciplines in the business through the brands that they operate and own.

All disciplines and operatives in the business should add value and understand how they add value to the brands they operate, whether they are in sales and distribution, marketing, manufacturing or finance and there is no better way to demonstrate their contribution than through a brand value tracking model.

For example in our experience we have seen how a gradually declining mature brand has actually increased its brand value over time through driving costs down through the supply chain thereby increasing margins that have more than offset volume losses.

Marketing and sales did their bit too by maintaining premium pricing positions and continuing to invest in the brands major markets. The supply chain operatives should have the opportunity to understand and be aware of their contribution to the business in this way. It is motivational and ensures cohesive effort directed to one purpose.

Summary

Brand valuation in this form brings together market analysis, brand metrics and financial performance in a meaningful and pragmatic structure allowing leading edge brand companies the opportunity to significantly improve their business model.

Marketers understand brand equity metrics and market performance measures of the brands under their stewardship in a competitive context, and will have access to volume, net turnover, gross margin and brand contribution financials. But what they do not have are the tools to measure and understand the impact of marketing investment on the long term equity and future earning potential of their brands.

Understanding the linkage between brand equity and brand performance delivery focusing on a brands ability to attract new users and retain the loyalty of existing customers is critical for improved strategic investment decisions.

Management decisions will be significantly better informed and the until now separate disciplines of Marketing and Finance will be truly brought together in a combined commercial understanding that puts Brands legitimately at the top of the Board agenda.

