CUSTOMER RELATIONSHIPS AND BRANDS

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INTRODUCTION TO CUSTOMER RELATIONSHIPS AND BRANDS

Nearly every entity has intangible assets; several published check lists identify more than 100 different categories, most of which meet the criteria to be considered Intangible Assets and taken into account in applying SFAS 141, 142 and 144.

This Chapter deals with the two most common Intangible Assets owned by nearly every Reporting Unit: (1) customer relationships, and (2) the corporate and brand names that serve to identify the business and distinguish its products and services.

Customer Relationships

Customer relationships may be as simple as an accounts receivables list, or as intricate as a database showing not only names, addresses and phone numbers of past and existing customers, but also containing information on past activities, details of recent transactions, revenue generated in the last twelve months, applicable margins and special charges as well as any order backlogs, referrals and other items.

Brands

Brands are more complex, as they involve a web of product characteristics, formulas, trade names, images & taglines, and, in many cases, specialized distribution systems. Brands and how to value them are discussed in detail later in this chapter.

Valuation Procedures

Both these groups of intangibles are marketing related and normally valued by the Income Approach using a specialized Discounted Cash Flow method; in certain circumstances, the Market and Cost Approaches may also be useful.

The objective with respect to customer relationships, is to determine which customers are profitable and identify the net benefits they contribute to the entity over their varying lifespans.

The process has led to a significant debate among management, valuation analysts, auditors and the SEC staff. Depending on facts and circumstances, customer lists, order backlogs, purchase

contracts and buyer relationships are generally regarded as Intangible Assets under SFAS 141 and SFAS 142, while other items, such as market share, form part of Goodwill. Two key points to consider in valuing such Intangible Assets are: contractual rights and separability, and the contribution of other physical and intangible assets, especially the assembled workforce, which FASB allocates to Goodwill.

TYPES OF CUSTOMER RELATIONSHIPS

While many customer relationships meet either FASB's "contractual-legal" or "separability" criterion, it is often quite difficult to determine the identity of non-contractual relationships. Their ability to satisfy the separability criterion is usually governed by industry or local practices; for instance, banks frequently package customer relationships, such as deposits, mortgages, or credit card receivables, and, subject to state law, exchange or sell them, sometimes as tradable securities.

FASB believes the existence of exchange transactions in the same or similar types of assets serve as evidence of separability. For instance, intangibles associated with a bank's core deposit relationships should be separately recognized, because they are often bought as distinct assets, together with contiguous loans and deposits, by paying a premium over Book Value when purchasing branches.

Core deposits are those by customers who maintain accounts for extended periods; normally, they also avail themselves of more than one product or service. A customer having checking and saving accounts, two car loans, a mortgage and several credit cards would have a number of separate relationships. The car loans, mortgage and credit cards are assets that may be sold to others without affecting the relationships; the others refer to deposits. In contrast, relationships with intermittent customers are rarely exchangeable and therefore are not separable Intangible Assets.

Tests for Value

If someone purchased a doll, he does not have a relationship with its manufacturer; if, however, it is a Barbie doll, whether or not the buyer is a collector and fan club member, their name and address does have value to Mattel in addition to the price of the object, even though the direct relationship is through Toys ‘R’Us.

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In common experience, the following should be excluded from valuable customer relationships:

1. One-time buyers, without a recurring connection
2. Former purchasers, who, for a specific period, have not generated any business; this will vary depending on the nature of the entity
3. Individuals about whom the vendor does not have important data, such as name, address, phone number, purchase history, payment record, etc.

Categories of Customers

Customers can be grouped in several ways; the most common is by frequency of purchase and overall volume. Using these parameters, the Boston Consulting Group divides them into four categories:

FREQUENCY

VOLUME	Low	High
High	Growables 20% - 30%	Loyalists <20%
Low	Also Rans >10%	Satisfactory 40% - 50%

Not all customers are created equal, and the well-established 80:20 rule applies. In general, profits came totally from the Loyalists' group, which has the only customer relationships with value; the Growables and Satisfactory contribute to overhead and keep the business alive, with the Also Rans are likely to reduce earnings.

Customer Loyalty

Loyalty, which is based on many factors, including satisfaction, determines the profitability of an individual or group of customers. Satisfaction is the aggregate of customers' sentiments towards a product or service. Loyalty is the ability to retain buyers in the face of competition; it generates:

- repeat purchases
- higher volumes
- greater participation in a product line
- resistance to competitive pressure.

Loyalty marketing is not a new concept; it goes back, at least on a large scale, to the supermarket green stamps of the 1930s; however, it has now gained greater importance.

Loyal Customers

The major work in this field is "The Loyalty Effect" by Frederick Reichheld, published in 1996. That book's theme is that, although US corporations lose at least half their customers within five years, half their employees within four, and half their investors in one, loyalty is not dead but remains one of the most significant factors to continuing business successfully.

Dr. Reichheld believes that customer loyalty is inextricably linked to employee loyalty, and that improvements in the first often require matched improvements in the second. Consistently high retention rates for customers can create substantial competitive advantages, boost employee morale, improve productivity, enhance growth and even reduce the cost of capital. Conversely, persistent deficiencies (churn) mean that the views of former buyers, that "the firm does not offer good value for money", will eventually become the collective wisdom of the market.

Customers and Profitability

To determine the value of a customer, an entity must look at the benefits, both financial and strategic, that can be generated. They are shown in the table below; allocatable items are those that can be directly linked to an individual or group.

Benefits Generated by Customers

Type	Financial	Strategic
Allocatable	Current activity	Customer satisfaction
	Historic sales	Word-of-mouth advertising
	Referrals	Group affiliation
Non-allocatable	Repeat business	Loyalty
	Growth in sales	Corporate image
	Earning power	Positioning

Based on: J.G. Barnes and J.A. Cumby, "The Cost of Service Quality: extending the boundaries of accounting systems to enhance customer value".

Identifying profitable customers is difficult. Organizations serving "anonymous" buyers, such as many retail stores and entities dealing with consumers of low-price, low-margin goods and services, usually have neither the basis nor reasons to do so. Firms that maintain a customer database, even if only focused on revenues, products bought, returns and credit history, are able to directly determine how much each customer spends, and, by estimating and allocating related costs, contributes to profit.

Referrals

Certain customers are esteemed and regarded valuable by banks because of the position they hold, or their standing in the community. Given that it "looks good to have such people on the books", banks will offer them a higher level of service than is warranted by the size of their accounts.

Level of Service and Costs

As well as banks, manufacturing businesses often rely on referrals. As they grow, managements must tailor the level of service extended to individual or groups of customers to their relative value and avoid any tendency to "give away the shop". In some industries, for instance airlines and travel agencies, detailed customer databases are an integral part of daily operations rather than accounting monitors of receivables and inventories. They can identify customers according to factors such as frequency of purchases, prices paid, and estimates of referral potential; this data may then be used as a basis for different levels of service.

Traditional salesmen think that, if a customer asks for something extra, without charge, satisfying this request will not merely obtain the order and increase profit, but also lead to further business, not only from the customers, but also from his friends and acquaintances who will likely hear about it. This "do whatever it takes" syndrome ignores the costs of supplying such services.

In most entities, essential information on costs has traditionally not been measured or allocated to customers; this is particularly true with staff time. Generally, the belief is that the expenses to measure and allocate such costs would outweigh any benefits. Yet without knowing all service costs and allocating them to individual or groups of customers, excessive resources may be devoted to those from whom an adequate return is unlikely.

	Service Costs	
Type	**Monetary**	**Strategic**
Allocatable	Discounts Samples Remuneration	Employee time
Non-allocatable	Training Recruiting Coaching and feedback by Managers Excessive compensation	Service quality Motivation Aggregation or grief

Based on Barnes and Cumby

Entities must identify the customer relationships that are profitable and should be cultivated as well as those that have a negative impact and few future prospects. This goes totally against the

common view, which judges marketing success by market share gains and relative position. When all the costs set out above are considered, more revenue is not always better:

ATTITUDES OF MANAGEMENT

Every valuation of customer relationships involves an analysis of historic spending patterns and allocatable costs. It includes subjective estimates of the factors listed previously, emphasising referrals, growth in sales and employee time required. Accounting systems generally focus on measuring growth in product line revenue and profitability. An interesting side effect of SFAS 141 and 142 is that the need to measure customer profitability, an essential step in valuing customer relationships, may encourage more customer-focused attitudes by management.

Many organizations are installing Customer Relationship Management ("CRM") systems to improve service and allow better access. While such efforts encourage retention, they do not add to immediate earnings, as profitable customers are not identified.

The objective of these processes is to enhance current and long-term returns from present and future customers: this involves identifying and dealing with also-rans, either by making them profitable or letting them go. However, it is critical to choose the correct level at which to measure profits; for example, several banks have decided that households are more suitable than simply individuals for that purpose.

Identifying Profitable Customers

As a rule, there are two types of profitable customers: "loyalists", who make larger purchases measured by volume, and "must-have-now's", who are prepared to pay more for special services. To identify them, it is helpful to consider certain statistical trends in dominant groups of customers over the past five years:

- Retention Rate: The proportion of a customer group at the beginning of a period (usually a year) that is still buying at the end; this tends to be low in the beginning and rise in later years.
- Churn Rate: The number of customers lost in a period divided by the total of (a) those at the beginning, plus (b) those added; this figure should decline over time.
- Maintenance Rate: Customers retained divided by those lost; this should also rise over time.

The trends in these ratios will give an indication of how successful the entity has been in retaining its customers.

COST ALLOCATION

The process of allocating revenues and costs to large groups of customers depends on available information; ideally, management should:

- define the underlying trends in sales;
- explore the seasonal patterns;
- establish the products/services mix
- calculate the effective gross margins;
- identify cost drivers, such as the numbers of sales calls, orders, shipments, invoices, support requests as well as average receivable balances. These will allow reasonable allocations of sales, operations, delivery, administration, support and interest costs.
- determine appropriate credits for referrals; this is usually a percentage of the related sales for the first three years.

Examples of Good and Bad Customers

Examples of Good and Bad Customers

	Good		Bad	
		$'000		$'000
Sales				
Manufactured	75%	900	60%	1,080
Resale	10%	120	30%	540
Services	15%	180	10%	180
	100%	1,200	100%	1,800
Gross Profit				
Manufactured	33.0%	297	33.0%	356
Resale	25.0%	30	25.0%	135
Services	40.0%	72	40.0%	72
	33.3%	399	31.3%	563
Expenses	**Number**		**Number**	
Sales Visits	4	10	12	30
Orders	50	9	112	20
Shipments	50	18	210	76
Invoices	12	7	210	123
Support Calls	2	2	76	76
		46		324
Interest		2		5
Referrals		(2)		-
Other - Allocated by Sales		235		353
		281		682
Pre-tax Profit (Loss)		118		(118)
Margin		10%		-7%

Careful application of this or similar methodologies over time will allow management to:

1. Strategically discriminate among customers by level of service offered;
2. Become aware when a customer relationship is changing;
3. Highlight customers from whom a positive return is unlikely at the level of service delivered.

Management must accept that some customers are simply not worth keeping, because their requirements divert corporate resources from more lucrative prospects.

Impact of Churn on Fair Value

In industries where customer relationships are a major intangible asset, an increase in the churn rate is likely to have serious effects on the Fair Value of a Reporting Unit. Not only will there be a reduction in Net Income and Cash Flows, but also a decline in expected growth, which may affect the Capitalization Rate.

As an example, a cellular telephone operator had 120,000 subscribers at the beginning of 2003; in Case A it expects to add 38,000 during the year (31.7%, the same rate as 2002), and, at an unchanged 2.2% monthly churn (21.0% a year), lose 33,133, resulting in 124,867 subscribers (a 4.1% gain) at the year end.

In Case B, if the monthly churn rate has risen 30 basis points (100bp = 1%) to 2.5% a month (23.5% annually); at the year-end there would have been only 120,917 subscribers (a 0.8% gain). As shown in the table below, the effects over that period would have been: revenues -1.6%, Net Income -10.0%, and Cash Flows -13.6%.

Even though the average subscribers were not that different (1.6%), investors would have considered the change as a deterioration in the long-term outlook, and, as experience in various fields has shown, increased the Capitalization Rate from 7.9% to 12.2% by not only lowering the anticipated growth from 4.1% to 0.8%, but also requiring a higher basic rate of return.

Case C assumes the monthly churn rate drops rather than rises by 30 basis points to 1.9%; revenues would have been +1.7%, Net Income +10%, and Cash Flows +14%.

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		2002	2003			Change From Case A	
		Actual	Case A	Case B	Case C	Case B	Case C
CUSTOMERS							
Monthly Churn		2.2%	2.2%	2.5%	1.9%	13.6%	-13.6%
Subscribers							
Beginning		115,300	120,000	120,000	120,000		
Additions		36,600	38,000	38,000	38,000		
Losses		(31,900)	(32,391)	(35,958)	(28,720)		
End		120,000	125,609	122,042	129,280		
Growth		4.08%	4.67%	1.70%	7.73%		
Average		117,650	122,804	121,021	124,640	-1.5%	1.5%
Monthly revenue per subscriber		$ 45.05	$ 45.15	$ 45.15	$ 45.15		
INCOME STATEMENTS					$'000		
Revenues		63,602	66,535	65,569	67,530	-1.5%	1.5%
Costs of Service	52.4%	(33,327)	(34,865)	(34,358)	(35,386)		
Gross Profit		30,274	31,671	31,211	32,144	-1.5%	1.5%
Operating Expenses	3%	(22,836)	(23,521)	(23,521)	(23,521)		
Pre-Tax Profit		7,438	8,150	7,690	8,623		
Income Tax	40%	(2,975)	(3,260)	(3,076)	(3,449)		
Net Income		4,463	4,890	4,614	5,174	-5.6%	5.8%
Growth		6.5%	9.6%	3.4%	15.9%		
Margin		7.0%	7.3%	7.0%	7.7%		
CASH FLOWS							
Net Income		4,463	4,890	4,614	5,174		
Depreciation		7,440	7,830	7,830	7,830		
CAPEX		(8,184)	(8,613)	(8,613)	(8,613)		
Working Capital Required		(636)	(665)	(656)	(675)		
Net Cash Flows		3,083	3,442	3,175	3,716	-7.7%	8.0%
FAIR VALUES							
Basic Rate of Return			12.00%	12.00%	12.00%		
Growth			-4.67%	-1.70%	-7.73%		
Capitalization Rate			7.33%	10.30%	4.27%		
Net Income			4,890	4,614	5,174	-5.6%	5.8%
Capitalized Amount			66,746	44,802	121,266		
Fair Values (rounded)			66,700	44,800	121,300	-32.8%	81.9%

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The Fair Values would be allocated as follows:

	$'000		
	2003		
	Case A	Case B	Case C
Net Tangible Assets	35,000	34,500	35,500
Intangible Assets Customer Relationships	27,500	500	33,000
Licenses	1,000	1,000	1,000
Total	63,500	37,000	69,500

The effect of a change in the monthly churn rate of 30 basis points (13.6%) is not symmetrical; an increase reduced the value of the firm's customer relationships by 98% while a similar decrease only raised their value by 20%.

DETERMINING THE LIFETIME VALUE OF A CUSTOMER

Intensive analyses of customer purchasing patterns and the determination of the lifetime value ("LTV") of a significant individual or group of customers has been undertaken by advertising agencies and marketing consultants since the late 1980s. A common format for an LTV uses customer retention, referrals and spending rates as variables to establish a DCF value under the Income Approach.

For any entity, defection tends to be high during the first year. After that initial period, remaining customer loyalty is much higher, as there are increased referrals of friends, relatives and associates to the organization, be it a bank, a brokerage firm, car dealer, or retail store. Usually, customers are also inclined to spend more each year.

In "The Loyalty Effect", Dr. Reichheld suggests adding two other variables: price sensitivity and costs of service. Loyal customers tend not only to make more purchases over time from a satisfactory supplier, but also choose more products with higher average prices, particularly of financial services. Traditionally, costs of service were not included in LTV; for a new customer, they are typically high in the first year.

- Software purchasers call help lines more in the first sixty days after a purchase than over the next six years.
- HMO patients are more inclined to come to a facility to get check-ups, meet doctors and staff, and generally discover what is available in the first few weeks.
- The costs of a bank loan or insurance policy are heavily concentrated in the application and approval processes; after the first year, they are usually very low. Such reductions should be reflected in a customer's LTV.

Along with various Income Approach methods, customer relationships can be valued by the Market Approach and the Cost Approach, as described later.

Contributory Assets

A major difficulty in valuing customer relationships is to determine the contributions of all other assets needed to serve them. Examples are, for a bank: branches and staff; for a retailer: location and display space, inventory, experienced employees, convenient financing. Every element will likely include other Intangible Assets, such as brand names and core technologies required by the Reporting Unit to obtain business.

To this purpose, valuation analysts seek to separate the net Cash Flows generated by the relationships from those attributable to the other assets. This can be done by: (a) deducting an imputed return on each class of contributory assets; (b) using a percentage of Cash Flows based on industry experience; or (c) capitalizing the excess earnings achieved from the customer over a "normal" margin.

Defining normal profits is a subjective process. When a Reporting Unit has higher margins than those of Guidelines, the benchmark could be either: (a) the average margin of the Reporting Unit, or (b) that of the Guidelines. In the first case, most customers would be ascribed little value; in the second, the majority would have considerable worth. In our view the latter is the appropriate position.

During this process, it is essential to take into account the Reporting Unit's employees. Although FASB has determined that an assembled workforce is no longer the Intangible Asset it was under APB 16 and 17 but forms part of Goodwill, it undoubtedly contributes significantly to the Fair Value of customer relationships. This is particularly important in service industries.

DCF Methods

A troublesome task in applying a DCF method to customer relationships is to determine their specific Cash Flows, which are not directly reflected on any Financial Statement. One way of doing this is the five-stage process described below. This makes use of marketing as well as financial data; it is imperative that all conclusions are checked for reasonableness.

Stage one projects the average number of customers expected in each fiscal year. As shown in the Retail Chain Example, this involves detailed analyses of past retention and referral rates. It is generally preferable to undertake these analyses only for "good" customers and include the effects of "bad" ones separately.

Stage two estimates future revenues from each retained customer by looking at, for instance, the number of items purchased and their net selling prices; from those, a spending rate is developed.

Applied to the average number of customers, this gives each year's projected revenues from that group. They will normally peak in the third year and then level off.

Stage three determines the costs related to customer acquisition and service as well as the direct costs of fulfilling the order. Acquisition expenses occur only in the first year, reflecting the advertising and marketing necessary to sign up new customers. Direct costs include product development, production, delivery, selling, general and administrative, but not financing costs. Over time, these will decline in relation to sales as the spending rate increases and fixed costs are spread over higher revenues per customer. Service costs, which include all support and warranty work, are much greater for new customers than for existing buyers.

Stage four establishes the contributory Cash Flows for the customers. As all costs are calculated on a cash basis and ignore how the entity is financed, deducting them from revenues gives a form of EBITDA which must be allocated between customer relationships and contributory assets. As discussed previously, three techniques can be used for this; we believe it is preferable to establish rates of return on the Fair Values of all contributory assets; those should be deducted from the EBITDA after direct costs. Acquisition and service expenses differ for new and existing customers, but the benefits of the contributory assets do not. Income tax at the entity's effective rate is deducted to determine the Net Customer Cash Flows.

Stage five determines the present value of the Net Customer Cash Flows over the expected life of the relationship, without a Terminal Value. Divided by the number of original customers, it computes a Fair Value for each. Customer relationships last for varying periods; while five to seven years is the usual average, it may be as short as three years, or, as long as 25 years, for flight training schools serving major airlines.

Retail Chain Example

Our first example is a retail chain. During Year 1, the period of acquisition, the stores are assumed to obtain 10,000 new customers, of which 40% make one or two purchases and then drift away. The remaining 60% are more or less loyal; thereafter, the retention rate jumps to 80% and continues to rise. Also in Year 1, 4% of the customers recommend the store to a friend who becomes a customer. The referral rate subsequently more than doubles. After 5 years, there is an average of 3,588 customers, of which 1,671 (47%) are referrals.

Generally, in Year 1, a customer spends $240.00 on five items averaging $48.00 each. Customers who remain loyal buy more in each subsequent year, reaching $1,000 in Year 6.

As shown in Table 1, applying the five stages with a Discount Rate of 16%, is the Reporting Unit's cost of equity, and a seven year life, results in an LTV of $751,000 for the group of customers, or

$75.06 each; this is over three times the acquisition cost of $23.62. Changing the useful life to 5 years reduces the value of a customer by 37% to $47.42, still twice the acquisition costs.

Customer Life Time Value – Retail Chain

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
CUSTOMERS								
Acquired		10,000						
Retention Rate		60.0%	80.0%	82.0%	84.0%	86.0%	88.0%	88.0%
Retained			6,000	4,800	3,936	3,306	2,843	2,502
Referral Rate		4.0%	8.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Referred			400	480	432	354	298	256
Opening Number		10,000	6,400	5,280	4,368	3,660	3,141	2,758
Closing Number		6,400	5,280	4,368	3,660	3,141	2,758	2,427
Average		8,200	5,840	4,824	4,014	3,401	2,949	2,593
REVENUES								
Items Purchased		5	9	12	13	14	14	15
Increase			70.0%	41.2%	8.3%	3.8%	3.7%	3.6%
Average Price		$ 48.00	$56.00	$60.00	$64.00	$68.00	$72.00	$76.00
Increase			16.7%	7.1%	6.7%	6.3%	5.9%	5.6%
Spending Rate		$ 240	$ 476	$ 720	$ 832	$ 918	$1,008	$1,102
Revenue	**$'000**	1,968	2,780	3,473	3,340	3,122	2,973	2,857
Increase			41.3%	24.9%	-3.8%	-6.5%	-4.8%	-3.9%
COSTS	**$'000**							
Acquisition	12%	(236)						
Direct Margin		40%	42%	44%	44%	44%	44%	44%
Direct		(1,181)	(1,612)	(1,945)	(1,870)	(1,748)	(1,665)	(1,600)
Service New	8%	(800)	(32)	(38)	(35)	(28)	(24)	(20)
Service Existing	0.9%	-	(53)	(43)	(36)	(31)	(27)	(23)
Total		(2,217)	(1,697)	(2,027)	(1,941)	(1,807)	(1,715)	(1,644)
CASH FLOWS	**$'000**							
EBITDA		(249)	1,083	1,446	1,399	1,315	1,258	1,213
For Supporting Assets	60%	(441)	(650)	(868)	(839)	(789)	(755)	(728)
Contribution		(690)	433	579	560	526	503	485
Income Tax	35%	241	(152)	(202)	(196)	(184)	(176)	(170)
Net Customer Cash Flow		(448)	282	376	364	342	327	315
VALUES	**$'000**							
Net Customer Cash Flow		(448)	282	376	364	342	327	315
PV Factor	16%	0.926	0.798	0.688	0.593	0.511	0.441	0.380
Present Value		(415)	225	259	216	175	144	120
Total Present Values		723	Per Customer		$72.26	Acquisition Costs		$23.62

Drug Store Example

Some situations have a very different pattern, for instance, a drug store. Based on prescriptions filled, it has 5,066 identified customers. After analyzing purchasing activity, management determines that, due to moves and deaths, past retention rates have been: Year 1, 85%; Year 2, 75%; Year 3, 50%; Year 4, 25% and Year 5, 10%. This means that even allowing for a 4% referral rate, only one of the original customers remained at the end of Year 7.

Customer Life Time Value – Drug Store

Drug Store								
		Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**
CUSTOMERS								
Acquired		5,066						
Retention Rate		85%	75%	50%	25%	10%	10%	10%
Retained			4,306	3,230	1,615	404	40	4
Referral Rate		4%	4%	4%	4%	4%	4%	4%
Referred			203	172	129	65	16	2
Opening		5,066	4,509	3,402	1,744	468	57	6
Closing		4,509	3,402	1,744	468	57	6	1
Average		4,787	3,955	2,573	1,106	262	31	3
REVENU	**$'000**							
Spending Rate		$ 400	$ 412	$ 424	$ 437	$ 450	$ 464	$ 477
Revenue		1,915	1,630	1,091	483	118	14	2
Change			-14.9%	-33.1%	-55.7%	-75.6%	-87.8%	-89.0%
COSTS	**$'000**							
Direct Margin		21.6%	22.0%	22.5%	22.5%	22.5%	22.5%	22.5%
Direct		(1,501)	(1,271)	(845)	(375)	(92)	(11)	(1)
New Serv	8%		(16)	(14)	(10)	(5)	(1)	-
Existing S	1%	(48)	(40)	(26)	(11)	(3)	-	-
Total		(1,549)	(1,327)	(885)	(396)	(99)	(12)	(1)
CASH FI	**$'000**							
EBITDA		366	303	206	87	19	2	-
For Suppo	63%	(230)	(191)	(130)	(55)	(12)	(1)	-
Contribution		135	112	76	32	7	1	-
Income Ta	35%	(47)	(39)	(27)	(11)	(2)	-	-
Net Customer Cash		87	68	46	18	3	-	-
VALUES	**$'000**							
Net Customer Cash		87	68	46	18	3	-	-
PV Factor	16%	0.926	0.798	0.688	0.593	0.511	0.441	0.380
Present Value		81	54	32	11	2	-	-
Total Present Value		179	Per Customer		$ 35.27			

Other Customer Intangible Assets

So far, our discussion of customer relationships has dealt with their profitability and lifetime values. In addition, when an entity is acquired, it will have purchase orders and customer contracts with committed revenues. In our view, the Fair Value of such Intangible Assets is the present value of their contribution; this is revenues less not only direct costs yet to be incurred but also a percentage factor tor equitably allocate the unearned profit between the former owners who obtained the order, and the new one that will create and deliver the goods or services. The Discount Rate should be the acquiring entity's cost of equity.

Improving Customer Loyalty

One way of increasing customers' lifetime values is to increase retention rates. According to Dr. Reichheld, improving those by 5 percentage points results in double figure gains in lifetime profits substantially, the amount depending on the industry. Therefore, management's efforts in this respect should be born in mind by the valuation analyst.

The conventional method is better customer service, which, however, is expensive. Dr. Reichheld believes that higher retention is based not so much on how customers are treated - although this is important - but from recruiting the right customers at the start. According to him, some customers are:

- predictable and loyal, preferring long-term relationships;
- more profitable than others, spending more and needing less service;
- prefer an entity's products and services to those of its competitors.

The valuation analyst should monitor management's efforts to identify and obtain such customers.

Market Approach

The Market Approach is sometimes applied to customer relationships in bulk, such as a newspaper or magazine's subscription list, the clients of a professional services firm, or the customers of a bank branch. For these kinds of relationships enough transactions take place that some can be used as Guidelines to develop a revenue or asset multiple. This is particularly common for: insurance agencies, which trade at multiples of the various types of annual premiums; investment managers, at multiples of assets under administration; medical practices, at multiples of billings, and bank branches, at multiples of Book Value. In all these cases, the entities in a particular State trade at fairly standard multiples.

Cost Approach

This method of valuing customer relationships is commonly applied to professional service firms or retail stores using Replacement Costs of its assets - financial, physical and intangible, including

the Going Concern component. While valuing the financial and physical assets is usually relatively simple, if time consuming (see CHAPTER XIX).

Intangible Assets are not as easy to deal with. Some valuation analysts capitalize excess earnings to give a total for all the Intangible Assets. To the extent the assembled workforce is a contributory asset, it is relatively easy to develop its Replacement Cost, using head hunter fees, salaries and benefits adjusted for the learning curves for the learning curves for the various classes of employees. Let us return to the Drug Store Example:

Drug Store Financials	
INCOME STATEMENT	**$'000**
Revenues	
Prescriptions	2,030
Merchandise	2,105
Total	4,135
Expenses	
Cost of Sales	2,690
Payroll	250
Management (normalized)	120
Operations	545
Depreciation	85
Total	3,690
Pre-tax Profit	445
Income Tax - 35%	(155)
Net Income	290

Drug Store Financials	
BALANCE SHEET - Replacement Cost	**$'000**
Assets	
Cash	40
Receivables	80
Investments	850
Prepaids	80
Total Current	1,050
Property Plant & Equipment - net	350
Total	1,400
Liabilities	
Payables	(200)
Equity	1,200

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Drug Store Financials

ANALYSIS			**$'000**
Purchase Price	15.00%	Net Income return	1,900
Net Financial & Physical Assets			(1,200)
Total Intangibles			700
Return on Net Assets	12.75%	85% of 15%	(153)
Net Income			290
Excess Earnings from all intangibles			137
Effective Intangibles Capitalization Rate			19.6%
Replacement Cost Assembled Workforce)		40% payroll	100
Return (Excess Earnings Workforce)	18.75%	125% of 15%	(19)
Excess Earnings all Intangibles			137
Excess Earnings Other Intangibles			118
Capitalized	22.50%	150% of 15%	526

Drug Store Financials

ALLOCATION OF INTANGIBLES			**$'000**
Location (Medical building)	66.0%	49.6%	347
Customer Relationships	34.0%	25.5%	179
	100.0%		526
Assembled Workforce		14.3%	100
			626
Goodwill		10.6%	74
Total Intangibles		100.0%	700

As mentioned previously, the value of the customer relationships by the DCF method is $178,000, while by the excess earnings method it is $175,000, nearly the same; in practice, if the difference is more than plus or minus 10% from the mean, the valuation analyst should review his assumptions for both methods.

ASSET ACCUMULATION

Another method estimates individually, under the Cost Approach, the Fair Values of each significant asset or group of assets; the most common technique is to charge the net Cash Flows from the customers with appropriate returns on the contributory assets after all deductions; the remainder represents the customers' contributions. Choosing those rates of return is inherently subjective and therefore we do not recommend it.

Reasonableness Tests

All values for Intangible Assets must be subjected to one or more reasonableness tests because of the significant uncertainties in their determination. Not only should all applicable methods be used, not just one, it is often desirable to look at multiple scenarios.

The most important test is to compare the value obtained for an intangible to a benchmark by establishing the value of the total business, either from Guidelines, or by capitalizing earnings. Deducting the financial and physical assets gives an implicit amount for all the Intangible Assets. This is allocated between them, adding the Going Concern Component, which is the assembled workforce and other items required for an operating business that FASB includes in Goodwill.

A second significant test is to match the values of Intangible Assets as multiples of revenue with those disclosed for acquisitions of similar enterprises. A third is to consider the costs and time required to create a comparable intangible; a fourth is to look at the supply and demand of similar assets, if they are available and the costs to acquire them.

Finally, common sense, not to rule out intuition, must always be applied to the results by adjusting the assumptions or the conclusions, based on the valuation analyst's experience and industry knowledge. Remember valuation is still both an art and a science.

Regardless of the techniques used to measure the Intangible Assets, many valuation analysts believe that even when an acquired customer relationship is "at market" and does not generate an excess return, it still has a nominal Fair Value of at least its acquisition cost, due to the relationship being in place and needing only minimal further maintenance marketing costs.

THE IMPORTANCE OF BRANDS

It is generally acknowledged that we live in an era of information overload; this often leads to people having to ignore much of what is bombarded at them to preserve their sanity. Part of this screening process is recognizing respected brand names to facilitate choices.

A brand is a name or symbol, which, with an accompanying bundle of market related intangible assets, has acquired a significance over and above its primary function of identifying the goods or services of one supplier and differentiating them from those of competitors. At the core of a brand are trademark rights that have emotional resonances with buyers; they will usually consist of a name, logo, or combination of both, but can also relate to the appearance or shape of the goods, their packaging, a catch phrase, jingle, even an aroma.

Customer Relationships and Brands

A brand is an important component of nearly every entity's Intangible Assets and, in most cases, may be bought or sold like any other property. Some beer brands, such as Stella Artois (1366), and Löwenbräu (1383), have been in continuous use for over 600 years. The oldest symbol still applied today that identifies a consumer product is the crossed swords of Meissen china, which was founded in 1710 by August the Strong, Elector of Saxony; the symbol was adopted in 1728 and has enjoyed uninterrupted use ever since.

However, most trademarks came into being in the second half of the nineteenth and first half of the twentieth centuries after laws were passed giving their owners proprietary rights. In the United States, the first registered trademark was Averill Paints in 1870. At some time or other, nearly everything has been branded or trademarked, including Heroin, which originally, like Aspirin, was owned by Bayer and marketed as something good for you. When considering an acquisition, potential buyers should carefully value the brands of a Target before offering to buy it or its assets.

A useful source of information on brands is www.brandchannel.com.

Valuable Brands

The concept of a brand includes not only corporate names such as Microsoft and General Electric, but also those of products like Coca-Cola and Cadillac; they often have an immense value. According to Business Week magazine of August 4, 2003, the world's fifteen most valuable brands, split almost equally between corporate and product names, amounted to $480 billion in early 2003, almost unchanged from 2002, but 13% below 2001.

		Value in US $'billion			
		Early			
Rank	**Brand**	**2003**	**2002**	**2001**	
1	Coca-Cola	70.45	69.64	68.95	Product
2	Microsoft	65.17	64.09	65.07	Corporate
3	IBM	51.77	51.19	52.75	Corporate
4	GE	42.34	41.31	42.40	Corporate
5	Intel	31.11	30.86	34.67	Corporate
6	Nokia	29.44	29.97	35.04	Corporate
7	Disney	28.04	29.26	32.59	Product
8	McDonald's	24.70	26.38	25.29	Product
9	Marlboro	22.18	24.15	22.05	Product
10	Mercedes	21.37	21.01	21.73	Product
11	Toyota	20.78	19.45	18.58	Product
12	Hewlett-Packard	19.86	16.78	17.98	Corporate
13	Citibank	18.57	18.07	19.01	Product
14	Ford	17.07	20.40	30.09	Product
15	American Express	16.83	16.29	16.92	Corporate
Total		479.68	478.85	503.12	

While most of us will rarely have the opportunity to deal with the giants of business, the listing gives a good idea about the impact an established brand name can have; on a smaller scale, where an entity's brand can be its most important single asset.

Importance of Brands

The goal of a brand is to establish an emotional "pact" between vendor and consumer creating an ongoing relationship that ensures continuous demand. This kind of security, which is very unlikely to exist without the brand, is at the heart of brand values and can lead to more stable future earnings.

In the short run, a manufacturer without an established brand may enjoy the same level of sales, economies of scale and perhaps even earnings as a branded producer. We all know the phrase "flavor of the month", but, in the longer term, such an entity is less likely to maintain market share and volume, whereas a supplier with a well-established brand could be confident of continued demand year after year. An authoritative and convincing study relating to brand names by the Boston Consulting Group in the late 1990s found that in 19 out of 22 US product categories, the brand leader in 1925 was still in that position in 1995 - sixty years later; the names were tactfully kept secret.

Brand names lead to the previously discussed, very important, customer loyalty, which is particularly valuable from a marketing perspective. When Coke commissioned market surveys in many parts of the world, they found that great importance was attached to the fact that the familiar coke taste came in the immediately recognizable red can. John Stuart, a former CEO of The Quaker Oats Company, now a division of PepsiCo. stated, when the firm was sold: "If this company were split up, I would give you the property, plant and equipment and I would take the brands and the trademarks and I would fare better than you".

Brand Advantages

A study by Bain & Company of 524 brands in 100 categories from 1997 to 2001 found that, while sales increases for branded products generally averaged 3.2%, in line with GDP, brand "winners," large and small, posted average annual gains of 10.4% in a deflationary environment with customers like Wal-Mart squeezing prices. They were not mainly in high-profile categories like bottled water or frozen entrees; almost two-thirds came from areas like dish detergents, which grew more slowly than average.

New products were important; entities with at least 10% of 2001 sales from products introduced in the previous five years, whether mature firms or new ventures, were 50% more likely to succeed, as were those that increased advertising spending faster than their competitors. Success now seems to depend on old-fashioned product innovation and advertising, even though some managers insist that their category is stale, boring or innovation proof.

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Mature brands can grow through either innovative products or repositioning. For example, Procter & Gamble's "Old Spice" line was more than 50 years old when it introduced a "High Endurance" deodorant in 1994, and "Red Zone" in 1999, as sporty alternatives for younger males. In 2001, these two together accounted for over 75% of Old Spice's deodorant sales and had helped the brand grow by 13% a year in a category that averaged a mere 1% annual gain.

Packaging can also make a difference. Ball Park Franks narrowed its gap with Oscar Mayer's hot dogs by introducing individually wrapped, microwaveable "Singles", which empowered kids to zap a wiener as a quick snack. Well supported the product represented 10% of sales in 1999, its first full year on the market, and by 2001 had grown to 22%. This was an excellent example as to how innovation can offset pricing pressure; the Single is 20% smaller than multi-packaged wieners, yet sells for the same price.

VALUING BRANDS

Valuing brands and trademarks is still a relatively new concept; the formal discipline began in the United Kingdom in the mid 1970s. Since then it has spread around the world with the GAAP of a number of countries, allowing the recording as intangible assets on the Balance Sheet of internally generated as well as purchased brands. Although brands are bought and sold, there is no active market for them and the process is without question a mixture of art and science.

The value of a brand encompasses the economic benefits of all the associated proprietary marketing related intangible assets. Some of them that may be associated with a brand in a sale, license or other transaction are:

- Advertising concepts
- Brand name
- Common-law trademarks
- Contest formats
- Copyrights
- Corporate name and logo
- Formulae
- Graphics
- Jingles
- Label and packaging design
- Marketing strategy
- Packaging
- Product warranties
- Promotion concepts

- Public relations efforts
- Registered trademarks
- Secondary trademarks
- Servicemarks
- Trade dress

Does the Brand have a Value?

A brand must be viewed in the context of these attributes. For example, the MacDonald's trademark and logo are part of a product brand associated with a broad range of marketing concepts for selling hamburgers. These run from simple packaging and container design through consistent trade dress, copyrights, advertising layouts and jingles, to a full range of promotional and premium material. Exterior and interior decor, signage and the famous arch design also form part of the brand, as well as the superior colors and related identification elements.

Four sets of queries determine if a brand has a sustainable and measurable market value.

1. Are the brand's trademarks and related intangibles clearly identifiable? Are all necessary rights owned? Can they be legally transferred without selling the business?
2. Does the trademark clearly differentiate the product or service with which it is associated? How is the brand different: identification, imagery, implied product content, or in some other fashion?
3. Will the trademark or brand be useful to anyone else? Who, except for the current owners or users, will be interested in it? How can they be identified?
4. Does the branded product sell for a premium? Is this sufficient to cover the additional promotional costs? Does it generate enough returns that a third party or licensee would pay to use, rent, lease or buy it?

If the answers are positive, the brand has significant value. As an outstanding example, "Coca Cola" clearly passes all sets of queries:

1. The name and logo "Coca Cola", together with the red labels and the various taglines, such as "the pause that refreshes" are clearly identifiable. The entity, The Coca Cola Company, has registered its trademarks around the world; they may be assigned or licensed anywhere.
2. The name and logo clearly differentiate Coca Cola from similar products, such as "Pepsi Cola" and "Royal Crown Cola".
3. Numerous entities, such as franchisees and licensees, have an obvious desire to use the brand, trademarks, logo and associated marketing intangibles.
4. Many parties are now and have been for years eager to pay substantial fees to use the brand names and trademarks "Coca Cola" and "Coke".

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Different businesses have different expectations in terms of the longevity of their brands and their sustainable profits. To establish this the valuation analyst should look at variables, such as: the breadth of current uses of the trademark, its uniqueness, legal status and protection as well as where it stands in its life cycle; in most cases the life should be considered indeterminate.

Concept of Value

As brands are unique assets, it is difficult to determine a price that a generic purchaser would pay, as its value depends on the buyer. For example, though there might be potential buyers for Coca-Cola, PepsiCo would undoubtedly pay much more than Nestlé, or Procter & Gamble.

Therefore, two concepts are used in valuing brands: "existing use" and "market". Existing use value represents the benefits of the brand to its owner under current business conditions; it does not take into account any "stretch" factors, such as unexecuted plans to extend the brand into new product or service categories, additional geographical markets, different distribution channels, or to license it to other parties. Consequently, it ignores any element of other uses.

Market value represents the price that would be paid in an open, arm's-length transaction by a willing buyer in the same or similar line of business. This is usually a lower amount due to the Discount Rate having to reflect higher risks, although it includes alternative or extended uses and synergies.

The definition of Fair Value, based on a notional sale, implies that market value is the appropriate level, however the underlying rationale of the Price Allocation Process suggests that existing use value is more relevant. We therefore recommend that a valuation analyst applying SFAS 141 should prepare an "existing use" valuation, provided that the amount satisfies Step 1 of the SFAS 144 Impairment Test; SFAS 142 requires "market value". The examples in this Chapter deal with "existing use".

VALUATION METHODS

The following methods have been applied to value brands or trademarks:

Market Approach

- Comparable sales
- Relief from royalties

Cost Approach

- Allocation of goodwill
- Historical cost
- Replacement cost

Income Approach

- Brand contribution
- Economic use

Each of these methods, which are all briefly described below, has specific applications; in our view, the cost approach is least satisfactory and the necessary information for the comparable sale method is rarely available. The two most successful are the relief from royalties and economic use methods, which are discussed in detail in the following sections.

Changes in Value

Just as parcels of real estate change in value over time, so do brand names, trademarks and other Intangible Assets; however, while real estate usually rises, brand values move both ways. Although a brand may endure for many years, its market value may vary significantly with changing conditions.

In the late 1960s and early 1970s, the two most important brand names in American beers were Budweiser and Schlitz. At one time Schlitz was only a few share points behind "Bud"; now it has nearly disappeared. Where it continues to exist, it is a third tier discount brand offered as a loss leader on holiday weekends. Its current value is probably less than 10% of what it was in 1970; management's actions have eroded its relative strengths, dissipated its market share and destroyed its consumer franchise.

In contrast to this example of decline, Marlboro is a brand that has achieved substantial and sustainable gains in value. It has been proven that in an industry under significant legal pressure and in extremely difficult market conditions, a brand can increase its value from two to $22 billion in less than 20 years.

The Market Approach

Comparable Sales

This method uses a revenue multiple from guideline transactions. These are not readily obtainable for brands, as there are very few situations where the brand is sold separately from the underlying business, and sale details are not usually available. By their nature brands are unique, and it may

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therefore be unreliable to apply information from a transaction in one industry to another, as prices vary significantly with the situation, deep pockets, interest and approach of the buyer.

Relief from Royalties

This method is based on the costs, primarily royalties that an entity would be able to avoid by owning the brand. It is based on the principle that the value of any asset is determined by what another party would pay to "rent" it under the particular circumstances. It uses arm's-length licensing transactions for similar types of assets to identify suitable royalty rates. Once a suitable rate is determined, the revenue stream has to be defined and the net present value calculated, determining an appropriate Discount Rate, lifespan and annual growth.

The major difficulty with this method is that there is limited data available on royalty transactions; most such arrangements are highly confidential and rarely publicly disclosed. Although various transaction databases are available, their reported rates may be skewed because the royalties include other forms of intellectual property, such as: patents, copyrights, technologies, and know-how. Frequently the rate will have been arrived at as part of a large, complex transaction and affected by rights of renewal, shared costs, or purchase arrangements. Another problem is finding "comparable" rates is difficult when few brands are similar by nature; however, in spite of its flaws, this method may allow the valuator to reach useful conclusions concerning brand strength.

Cost Approach

Allocation of Goodwill

This method, which was quite common in Purchase Price Allocations under APB 16, provides an approximation for the value of a single brand based on a portion of the goodwill arising on the acquisition of its owner.

For example, Disney in its 1992 acquisition of ABC, the excess of the consideration paid of Book Value was first allocated to the licenses for the owned radio and TV stations based on capitalizing individual Cash Flows. The balance was allocated 30% to the ABC network brand name and 70% to associated intangibles such as programming rights. While this is no longer acceptable under SFAS 141, past trends or multiples of Book Value can provide an effective reasonableness test for other methods.

Historical Cost

This method aggregates all expenditures incurred to bring the brand to its current status; the actual amounts spent should be converted to current dollars, using a factor such as the Producer Price Index. Historical costs included are:

- Advertising
- Allocated overhead

- Application, registration & other fees
- Legal, infringement & litigation
- Market development
- Market research
- Personnel
- Product development
- Promotion
- Selling & commissions

Under most circumstances, this method is not appropriate, as there is no direct relationship between the past financial investment and the Fair Value of the brand.

Expenditures are only one aspect of brand creation. An entity could spend a fortune developing a brand only to discover that its prospects did not live up to expectations; another might spend relatively little, but through good management, timing and luck, the branded product is attractive to customers and of value.

In many cases, establishing the costs to create a brand is virtually impossible. How, for example, can one determine the historical cost of the Coca-Cola brand, which is over 100 years old? Alas, few of us will ever get the chance to value a brand in that league, and brands without the same intensive global penetration present lesser problems.

If the entity has recently launched a new brand or a competitor a similar item, the estimated costs incurred to create it are a starting point, after adjusting for differences in:

- Category size and growth
- Location
- Market position
- Risks
- Underlying net assets

The maximum amount a buyer will pay more for a brand is based on the return he can reasonably expect from utilizing the name; this is not to be based on the sunk costs, but on expected revenues and expenses. Similarly, a seller wants a return on his investment, not merely to recoup all his expenses.

REPLACEMENT COST

This method gives a minimum value for a brand by calculating the estimated total costs that would have to be incurred in order to create from scratch an equivalent package of products, trademarks etc. with similar characteristics, such as market share, growth prospects, awareness levels, and customer loyalty. It also has major practical difficulties; in particular, the cost of replacing a brand depends to a large extent on the actions of competitors during the period and how quickly it can achieve profitability.

A variant of this method is "conversion value"; this is the cost to convert or replace an existing trademark with a new one within the current operations of the entity. If Macy's had to change its name to Brown's, enormous amounts would have to be spent on establishing the new name so as to maintain the same levels of sales and profits. Those include three broad areas of costs: direct expenses, marketing support and "lost" profits.

The directly attributable hard (excluding overhead) additional expenses of the conversion include changes to the physical facilities, exterior signage, uniforms, stationery, designs, listings, logo and all other forms of identification, both internal and external - even the Christmas Parade. For a retail or consumer brand with multiple operations and applications, these would be substantial, but estimable.

In most cases the marketing support for a conversion or replacement is higher than the direct expenses. If Caterpillar had to change its brand name to Butterfly, huge marketing and advertising support would be needed to communicate the change to customers, consumers, suppliers, media, etc. Such costs, however, also can usually be fairly accurately identified. In the case of an industrial product, they could run from as little as 50% of previous annual marketing and advertising expenses to as much as 200%.

A consumer product, for instance a candy bar, would require greater marketing support ranging from 200% to 500% of previous normal expenditures. A good example is the experience of Mars Inc. in converting several candy bar brands in various countries into a single global product under the "Snickers" name; this was well known in the US, one of the world's largest candy markets, but not elsewhere. In the United Kingdom alone, it is estimated that changing the name Marathon to Snickers cost at least $60 million in the first year, five times the previous normal advertising budget; it may have been as high as $90 million. Such additional support, while diminishing over time, usually continues for two to three years before sales revert to previous levels.

The third area of costs is the temporary but inevitable decline in revenues and Cash Flows during the transition; this has occurred in all identified cases, whether for a commercial, industrial or consumer brand; with volumes and profits increased again by the third year.

Income Approach

Applying the Income Approach to a brand has two distinct activities; the first is identifying, separating and quantifying attributable Cash Flows; the second is their capitalization or discounting, as discussed in CHAPTERS X and XI.

BRAND CONTRIBUTION

This method is based on branded products generating greater profits by either having lower costs (rarely) or higher selling prices (commonly); it involves the following six factors:

- Expense reduction data
- Indirectly generated income
- Premium pricing
- Rate of return
- Remaining economic life
- Revenue directly attributable to the brand

Premium Pricing

One common technique is to compare unit revenues of unbranded competing products with those of the brand to establish the premium price. Using this as a baseline, assumptions are made with respect to category growth, market share, inflation, etc., to project super profits to be capitalized or future Cash Flows to be discounted. However, brand profitability more often comes from anticipated higher future volumes than premium prices. This technique therefore ignores a major feature of most brands, security of demand.

Some cosmetics (such as Chanel No. 5), or high fashion brands (Armani) are deliberately priced at substantial premiums; the ability to maintain such levels is a key feature of their strength. On the other hand, many brands aim for additional volume, through ranking first or second in market share rather than obtaining higher prices. Firms such as Procter & Gamble adopt an "Every Day Low Price" policy as a deliberate strategy to reduce price-cutting by retailers and to concentrate competitive activity on the relative strengths of the brands. If prices are equal, then the stronger brands will obtain higher volumes and, if the Operational Gearing is similar, become the most profitable.

This method is also flawed in that a number of brands, such as Mars candy bars, have no generic equivalent. This is partly due to Mars bar having always been priced at levels at which other manufacturers, due to lower volumes, cannot make a meaningful return. In addition to those normally associated with using Financial Projections, another difficulty with this method is that it

is only based on market information and revenue and does not consider the impact of the extra marketing costs of the brand.

Application

In applying a brand contribution method:

a) operating Cash Flows must be separated from those due to financial, physical and other intangible assets;
b) overheads must be fairly allocated;
c) all costs incurred specifically to sustain the brand, such as advertising and marketing, must be included;
d) tax should be deducted at the marginal corporate rate.

Example

		$
Unit Operating Profit of Branded Product		77.25
Less:		
(a) Unit Profit of comparable unbranded line		(46.80)
(b) Marketing costs for Brand support		(15.40)
(c) Profits attributable to contributory assets	30%	(4.52)
Unit Profit from Brand		10.53
Multiply by units sold		1,622,000
		$'000
Total Profits from Brand ($'000)		17,080
Income Tax	35%	(5,980)
Net Income from Brand		11,100
Cost of Equity		12%
Less: Growth Rate		-4%
Capitalization Rate		8%
Value of Brand Rounded		140,000

ECONOMIC USE

The economic use method is a version of the brand contribution method that builds on the concept of economic value generated for its current owner by the brand in its existing use. It develops a value by identifying sustainable future Cash Flows from the brand and obtaining a net present value using a Discount Rate that reflects the risks of their not being realized.

Similar to the "economic value generated" method for valuing an entity, it focuses on the economic profits expected in the future as a result of owning the brand rather than the business. The main

premise is that no value is added until an appropriate return has been earned on all other assets employed. It reflects the reason owners create brands: to secure future demand and, consequently, Cash Flows.

Appropriate Methods

While all of the methods set out above may be applied to determine the existing use value of a brand, each has its shortcomings. The two most common methods are the relief from royalties and economic use methods. The next sections discuss them in detail.

APPLICATION OF RELIEF FROM ROYALTIES METHOD

If the information is available, a valuation analyst should use the relief from royalty method, which is a market driven DCF technique, even if only to obtain a supporting value.

Elements of the Process

Obtaining a market based Fair Value for a brand or trademark has seven elements:

1. Identify royalty rates on comparable licensing transactions; these will likely fall into a broad range.
2. Analyze the brand's strengths in relation to similar trademarks and competitors.
3. Determine the brand's extension and expansion possibilities.
4. Use the strengths analyses and expansion potential to select a specific royalty for the brand from the range of rates.
5. Estimate the remaining useful life; if it is indefinite, we use 25 years; if a brand is not very strong, the life may drop to ten or fifteen years, even as low as five or six.
6. Project an expected annual growth rate for the remaining life. This usually will have two phases: management's expectations for the first few years and an industry rate thereafter.
7. Deduct taxes at the marginal rate.
8. Select a suitable discount rate, usually the firm's cost of equity adjusted for risk.

Comparable Transactions

The first step is difficult, but important: to identify transactions for other trademarks and brands with similar strengths and market conditions comparable to that being valued. Useful data may come from public and private data bases as well as trade or industry associations and market research. Items that may be helpful include: sales of various brands; licensing rates for similar trademarks in either domestic or foreign markets; management or contract fees charged for the use of similar names; advertising expenditures to support comparable brands; and finally, information reported to their shareholders by public companies which have purchased brands and trademarks.

Weston Anson of Trademark & Licensing Associates Inc., a San Diego consulting firm, aptly described the process as "science mixed with alchemy". No two brands are fully comparable, although some may be closer than others, but there are a few basic rules:

1. Stick to similar industries or product backgrounds.
2. Use rates for marketing intangibles; those for technology-oriented items, such as patents, are useless for this purpose.
3. Make sure the rates are current; those of five years ago reflect the economic situation then.
4. Accept geographic differences; a global brand can only be compared with others of the same ilk; regional rates in Europe may not apply in the U.S.
5. Be aware of criteria such as: length of the agreement, exclusivity, end product use, promotional uses, marketing support and retail channels.

As many points of comparability as possible should be established when developing a range of royalty rates for a given trademark or brand from other transactions; this is likely to be broad, as shown in the following table, which summarizes licensing transactions in the Food/Hospitality industries.

Licensor	Product/Service	Royalty Rate
Food Conglomerate	Frozen & Dairy	1.5 to 5.0%
Multinational Company	Meat & Dairy	1.1 to 4.7%
Fast Food Chain	Promotional	5.0 to 7.0%
Hotel Chain	Hospitality Services	1.0 to 3.0%

Such a broad range of royalties (1.0% to 7.0%) is not useful on its own and, for a West Coast ice cream brand might be trimmed to between 1.5% to 5.0%, the "frozen & dairy" range; The key factor is where within the range the particular brand might fall; this is dependent on its relative strengths.

Relative Strengths of a Brand

Every brand has some unique selling characteristics, which are difficult to quantify; it is therefore essential to rank it against the same four sets of criteria, as set out in the table below.

Factor	Competition	Market	Time	Geography	Total
Time in market/life cycle position	3	2	3A	2B	10
Breadth of use/distribution	5	3	3C	2B	13
Product uniqueness	2	2	4D	2B	10
Sales growth	3	5	4D	5E	17
Margins	3	5	4C	3	15
Protection/legal status	5	5	3F	5G	18
Market position/competitive edge	4	5H	5C	5	19
Market share	4H	5H	5C	2B	16
Barriers to entry	34	3	4C	2C	13
Advertising/brand awareness	5	4	5	2B	16
	38	39	40	30	147

Notes: Each factor is ranked from 1 (low) to 5 (high).
The overall strength is 147/200, or 73.5%.

A – Improving
B – Only West Coast
C – Increasing
D – Accelerating
E – Adding Mountain States this year
F – No change
G – National
H – Ranked Number 2

The specific strength score determines the brand's relative position in the range of comparable royalty rates, with a score of 50 or under representing the low end. We normally allocate the established royalty range in a linear fashion by the strength of the brand from 50 to 100. In this case the royalty is between 1.5% to 5.0%, so that each percentage point of strength over 50 represents a 0.07% royalty above 1.5%. Therefore the brand's strength of 73.5% equals a royalty of 3.1%. This is then used to establish the Cash Flows attributable to the brand, which are discounted to determine its value. Such market-based value should be supported by other methods.

Example

To demonstrate the process, we have applied the previously developed assumptions for each element in the process to give an overall value for the West Coast ice cream brand.

Element	Assumption
Comparable royalty rates	1.5% to 4.5%
Relative strength	73.5%
Most likely royalty	3.1% (3.0% to 3.2%)
Extension potential	Good, now only West Coast
Remaining Life	15 years
Growth rate	
Years 1 to 3	5.0% (extension)
Years 4 & 5	3.5% (management)
Thereafter	2.0% (industry)
Tax Rate	35.0%
Discount Rate	12.0%

Customer Relationships and Brands

With current revenues of $216,432,000, the net royalty for the first year would be $4,579,000; this gives a value for the brand of between $29.2 million and $31.1 million, with the most likely amount of $30.1 million.

APPLICATION OF ECONOMIC USE METHODS

The most commonly adopted economic use method is that developed in London by Interbrand, a subsidiary of Omnicom, one of the world's largest advertising companies. It is based on the premise that well managed brands affect consumers' behaviour and deliver economic benefits. The important question is how much more valuable the entity is because it owns a particular brand. Its Fair Value is not only a financial measure that reflects potential earnings, but also a marketing measure that represent their established volumes and growth prospects. In addition to the Interbrand method, Brand Finance PLC, also of London, has developed a similar but slightly different version of the method that is also generally used; our description integrates both versions.

Elements of an Economic Use Brand Valuation

Determining the Fair Value of a brand by an economic use method requires the following five analyses:

- Legal - confirms ownership of the brand, trademark, logo and all other related rights.
- Market - investigates customer attitudes and competitive conditions in the various market segments served.
- Competitive - assesses the strengths and weaknesses of the brand against its competitors to obtain a measure; Interbrand calls this the "Brand Strength Score", while Brand Finance refers to it as "brand beta".
- Drivers - measures the role the brand plays in driving demand and therefore the proportion of the excess earnings from all intangibles that are attributable to it. This is called the "Role of Branding Index" by Interbrand and "Brand Value Added - BVA" by Brand Finance.
- Financial - identifies both business earnings and those from intangibles for each distinct segment.

Segmentation

In applying an economic use method to a brand, one critical task is to determine the necessary segmentation of sales and earnings; this is usually by Reporting Unit, but sometimes may be done more satisfactorily on a worldwide basis such as gross profits or profit contribution after marketability costs. The brand's total value would then be allocated to the Reporting Units on a reasonable basis. Once this is determined, the required internal financial and marketing data must be obtained as well as external information with respect to market and competitive trends.

Effective segmentation of a brand's sales requires:

- Geographic, product or customer grouping to be homogeneous
- Competitors in each segment to be clearly defined
- Available market research data for each segment
- Satisfactory volume and sales data by segment for competitive brands.

It cannot be stressed too strongly that a successful brand valuation requires careful selection and planning of the relevant segmentation and obtaining of suitable data.

Brand Financial Projections

Once the segmentation is complete, the appropriate brand sales and profits are identified. These must relate solely to the brand and not include other branded, unbranded or private label goods manufactured in the same plant. Then a five-year projection of revenues and EBITs is prepared; the valuation analyst should discuss the results with management for reasonableness, not only looking at existing budgets and financial plans, but also determining that sufficient financial and physical assets will be available.

Extensive due diligence is necessary for each market in which the brand operates to ensure the projections take into account all factors likely to affect demand; these may be micro-economic, technological, structural, legislative, cultural or competitive. In addition, the trends in both volume and sales for the market as a whole as well as the brand must be considered. The entity's marketing staff should be able to supply competitor analyses, corporate strategies and market research.

Management's views of the factors that have in the past affected the performance of the brand in each market must be considered. This may involve statistical analyses of past activity to show the relationships between advertising, marketing, and promotional expenditures on volume, pricing and sales. One must also understand the relative effect on sales of different advertising media. It is often desirable to have management prepare three sets of projections: best, worst and most likely, and apply appropriate probability factors.

While the revenue projections are the most important, the valuation analyst should fully understand the bases on which fixed and variable costs have been projected, and that their allocation between each geographic, product or customer segment is suitable. They should relate only to the projected brand revenues and include a portion of central corporate overhead.

Charge for Capital

Until the expected return is obtained from the other operating assets of the business, the brand and related intangibles do not add any value. Therefore it is necessary to make a deduction for the contributions of the net financial and physical assets; these include the distribution system, manufacturing plant and inventory. After deducting this charge for contributory assets, the residual

is the "Earnings from Intangibles". This technique is similar to the concept of Economic Value Generated.

Calculate Brand Earnings

The next step is to establish the portion of the Earnings from Intangibles that relates to the brand. This is the heart of a brand valuation, as it determines the amounts that will be discounted each year. Different businesses rely in varying degrees on brands to stimulate demand and support prices. The contribution of the brand may be estimated by identifying what drives demand in each specific market. A form of trade-off analysis based on market research typically achieves this. The result is a percentage, which is applied to determine Brand Earnings.

In some businesses, such as perfumes or packaged foods, Brand Earnings are almost the same as Earnings from Intangibles, as they have few other significant related Intangible Assets. In more technically complex fields, the ability to earn more than a base return on financial and physical assets is partly a function of the brands, but also of other intangibles, such as patents, technologies, know-how, distribution agreements, etc.

The key drivers of demand should be identified from existing qualitative and quantitative market research and discussions with management. Research with broad customer samples gives a useful barometer of the relative importance of the different factors, which drive demand, and also supplies robust justification for the brand's contribution.

The role that brands play will vary greatly, depending on:

- the degree to which price affects sales
- consumer perceptions as to value added by the name
- customers' knowledge of the product from experience
- degree of interchangeability with competitors.

ROLE OF BRANDING INDEX

Interbrand has developed a process for estimating the degree to which the brand drives the success of the business and what would be lost if the brand was no longer owned. This "Role of Branding Index" produces a systematic supportable conclusion, which is determined as follows:

1. Identify the main drivers of demand for the segment in terms of what prompts the purchase of the brand rather than a competitive product.
2. Apply a weight to the importance of each driver relative to competitors.
3. For every driver, consider how much of the business's effectiveness would be reduced without the brand. This may depend on customer perception as well as reality.
4. Evaluate the overall weighted role of a brand for each driver.

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5. Combine the impact of all drivers to form an Index for each Reporting Unit.

Example

A hypothetical Index calculation:

Driver	**Weight**	**Dependence on Brand %**	**Index**
Pricing	40	25	10
Product quality	25	60	15
Availability	15	5	1
Customer service	10	10	1
Awareness/familiarity	5	100	5
Innovation	3	60	2
Breadth of product range	2	30	1
Total	100		35

In this case, 35% of the Earnings from Intangibles relate to the brand.

CONTRIBUTION INDEX

Another way of accomplishing this is the Contribution Index of Brand Finance, which uses trade-off analyses at various levels to identify the importance of each factor to the purchase decision. The following example, based on available market research, indicates the contribution of various factors to mutual fund purchase decisions in 1999:

Factor	**Index**	**Contribution %**
Investment performance	100	22.7
Product range	60	13.6
Expense ratio	55	12.5
Brand name	50	11.4
Sales force	45	10.2
Customer service	40	9.1
Administrative	0	6.8
Advice/education	30	6.8
Online access	20	4.6
Investment process	10	2.3
Total	440	100.0

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Each factor is graded from 1 to 100; Investment Performance is responsible for 22.7% (100/440) of the EVG and the brand for 11.4%.

This is an empirically supportable means of attributing income to the brand. It also tracks changes in the importance of different drivers on the factors affecting demand change between markets; as well as valuations, it can be used for planning advertising and marketing spending.

Brand Earnings for each Reporting Unit are obtained by applying the Role of Branding or Contribution Index to its Earnings from Intangibles. As Discount Rates are normally developed for after-tax Cash Flows, tax at the entity's marginal rate should be deducted before discounting.

Example

To return to our West Coast ice cream manufacturer, the table below shows the process of determining the Fair Value of the brand, using the assumptions developed above.

West Coast Ice Cream Brand Valuation							**$'000**
		Year 0	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Revenue		216,432	227,254	238,616	246,968	255,612	260,724
Growth		5%	5%	5%	4%	4%	2%
Costs							
Fixed	2.0%	61,250	62,475	63,725	64,999	66,299	67,625
Variable	46.7%	101,074	106,127	111,434	115,334	119,371	121,758
Marketing		32,465	46,206	48,451	45,893	44,291	40,559
Total Costs		194,789	214,808	223,609	226,226	229,961	229,942
Operating Profit		21,643	12,445	15,007	20,742	25,651	30,782
Margin		10.0%	5.5%	6.3%	8.4%	10.0%	11.8%
Contributory Assets		183,101	195,919	201,869	211,963	219,382	227,060
Charge	7.5%	(13,733)	(14,694)	(15,140)	(15,897)	(16,454)	(17,030)
Earnings from Intangibles		7,910	(2,249)	(133)	4,845	9,197	13,752
Brand Earnings	60.0%	4,746	(1,349)	(80)	2,907	5,518	8,251
Income Tax	37.2%	(1,766)	502	30	(1,081)	(2,053)	(3,070)
Net Brand Earnings		2,981	(847)	(50)	1,825	3,466	5,182
Present Value Factor	11%	0.9479	0.8539	0.7693	0.6931	0.6244	0.5625
Present Value		2,825	(724)	(39)	1,265	2,164	2,915
Present Value of Cash Flows		8,407					
Terminal Value		26,499					
Fair Value		34,906					

Note: The Terminal amount is the present value of the Year 5 Net Brand Earnings capitalized at the Discount Rate

The Fair Value of $34,906,000 determined by this method is 15% more than the number developed from the Relief-from-Royalties method of $30,100,000. However, the difference is within the normal plus or minus 10% acceptable variance and their mean of $32,400,000 (rounded) is a supportable Fair Value.