International Valuation Standards Council

PERSPECTIVES PAPER

TIME TO GET TANGIBLE ABOUT INTANGIBLE ASSETS

Part 3: Rethinking Brand Value

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Perspectives Paper

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The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

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The ideas and opinions set out the IVSC's Perspectives Papers do not necessarily reflect the views of the firms represented amongst the author group.

The limitation of the current reporting frameworks to convey value creation and preservation activities is largely because the prevailing value creation strategies that existed when the standards were enacted decades ago, have evolved. As many current business models have evolved over decades, namely, to rely more heavily on intangible assets at the expense of tangible, the standards and the economics have become misaligned. This article series looks to contribute to realigning accounting and reporting standards with the value creation and preservation strategies utilised in modern business models.

In Parts 1 and 2 of our series, we examined the Case for Realigning Reporting Standards with Modern Value Creation and took a deep dive into human capital value creation and measurement. In this paper, Part 3 of our series, we take a deeper dive into brands and reputation value creation.

Brand Insights at a Glance:

- Due to multiple factors brands have become the most critical competitive advantage for many enterprises.
- To assess brand value creation, one must consider the full impact of the brand in its primary market as well as the interrelationship with other assets, especially intangible assets.
- The emergence of ESG suggests that investors require more information on the impact brand has on enterprise value.
- As the role of brand in enterprise value creation evolves, the techniques and assumptions to measure its value may need to change as well.

Introduction

In this paper we will:

- Examine how brands generate value for organizations and the attributes of such value creation,
- Analyze how investors assess the enterprise value creation attributable to brands; and
- Discuss the value measurement techniques and assumptions used to estimate the value of brands.

Of any group of intangible assets, brands likely have the most diverse impact on enterprise value creation. Brands are simultaneously capable of increasing revenues, reducing costs, and lowering risk.

Like most intangible assets, the definition of brand can mean different things to different people. Brands can be thought of narrowly, such as trademarks and trade names. Investors tend to prefer a view that encompasses broader considerations. While such broad considerations may not meet the definition for recognition as an asset for accounting purposes, disclosures as part of financial and sustainability reporting are an achievable goal that is also directly responsive to investor feedback.[i] As such, in the below discussion we focus on a broader definition inclusive of brand.

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How do brands create value?

Central to brand value creation is its enduring ability to generate incremental revenue as compared to unbranded and lesser branded substitute products via enhanced prominence, expectation of superior performance, and trust as perceived by stakeholders. Therefore, incremental revenue from a strong brand can be generated in two ways. Most typical is through the ability to charge a higher price or achieve a consumer preference as compared to a similar unbranded or lesser branded product (i.e., price or market share premium).

[i] CFA Institute Report Highlights Investor Views on Goodwill Accounting and the Importance of a Global Approach

Additionally, strong brands can also be leveraged to enable entrance into new sectors, markets, and geographies (i.e., the scalability of the brand). Scalability may take the form of direct entry into new markets by the enterprise, or through one of numerous forms of licensing. The scalability of a brand, and therefore its potential to create value, is unlike any other intangible asset. For example, even the most valuable technology is limited to finite applications and market segments.

Brand can also create value through cost reduction. The most direct form of cost reduction is the ability of a strong brand to lower the amount of sales and marketing expenses needed to generate a certain amount of revenue.

However, a brand's impact on cost reduction can go much further. As noted in the previous article, a strong brand likely attracts workforce to the enterprise and reduces recruiting and hiring costs. A strong brand can also enable the enterprise to achieve more favorable terms with suppliers, especially as it relates to suppliers of capital (e.g., better access to capital, better terms, and lower cost of capital).

Finally, a strong brand can lower the risk of achieving future cash flows as compared to unbranded or lesser branded enterprises and products. A strong brand achieves the lower risk by enabling an enterprise to create and maintain an effective barrier from competition (i.e., an economic moat).

An economic moat is often an advantage that is difficult to duplicate.

Despite these benefits, there are risks unique to brands, as brands exhibit a non-linear downside risk. The value of a brand can be quickly and permanently impaired despite taking a long time to build. As the value of brands has risen in modern intangible driven economies, so too has investors desire to understand and monitor the risk factors that could lead to such impairments. In this context, we believe there is a strong connection between the relative importance of brand and reputation value creation and the rise of ESG factors which attempt to assess this downside event risk for an enterprise's brand.

Like most intangible assets, it's also critically important for one to consider the relationship with other complimentary assets. As discussed in our previous article on Human Capital, there exist interrelationships with other assets such as technology, human capital, and relationship assets.

Therefore, the ability to create value from brand and reputational assets is both a function of the assets' own characteristics, but also the complementary nature of the other intangible assets. For example, strong human capital will likely have a positive synergistic effect with a strong corporate brand. Less valuable human capital may diminish the brand value of an enterprise or increase the risk of impairment. As an illustration, perhaps the greatest risk to banking institutions are cyber security breaches that threaten their brand. As such, the banking industry invests substantially to train their personnel (i.e., enhance Human Capital) on information technology risk to protect the firm's resources and information. The value of brand and human capital are inextricably linked.

Somewhat surprisingly, the empirical evidence from business combinations shows that brands account for relatively less value than other intangible assets.

[ii] JPMorgan Chase & Co. Form 10-I for the fiscal year ended December 32, 2021, p. 145.

As one moves from narrow definitions of brand to more holistic considerations, the shift results in stark differences in the nature and capacity for value creation. Therefore, as the role of brand in enterprise value creation evolves, as explored further below, the techniques to measure its value may need to change as well.

Investor Insights on Brand Value Creation

While the current financial reporting regimes take a narrow view on the recognition and disclosures for brands, investors are clearly desiring more information on broader value creation and risk considerations. To fill this gap between the information reported and the information desired by investors, ESG reporting has begun to collect and synthesize these inputs. However, as noted in the previous article, in its current state ESG lacks standardization, attestation, and harmonization.

Similar to Human Capital, the lack of relevant information has led investors to seek creative solutions to obtain relevant information on brand value creation and risks.

For example, sell side equity research analysts harvest, cleanse, and connect data from various sources for investment insights. These include monitoring social media channels such as Instagram, Google, TikTok, etc. for insights related to brand value including recognition and sentiment.

As one example, UBS has a process to determine absolute performance across various metrics. The metrics are then compared over time and across peer group to determine trends and relative performance. Such absolute and relative performance metrics provide value relevant insights. For example, in a June 2022 report on Nike Inc., UBS notes how Nike's strong brand position can drive sales growth, reduce cost, and reduce risk. See excerpts below:

- **Higher Price** – "The market may not realize Nike's brand image in China is still strong despite last year's boycotts and it is lapping very easy compares. UBS Evidence Lab Pricing data indicates Nike products continue to sell through at high prices with fewer promotions y/y in North America and Europe."
- **Lower Costs**- "UBS Evidence Lab survey and pricing data reveal the Nike brand currently has #1 in mindshare globally and the company has significant room to reduce promotions [and associated expenses]."
- **Lower Risk** – "We believe Nike has the brand strength, strategy, skills, and resources to outperform peers through a potential recession."

Licensing arrangements between third parties can provide additional insights on brand value creation, and the importance of complimentary assets. The first example comes from the apparel industry.

In 2019, Arezzo Indústria e Comércio S.A reached an agreement to become the exclusive distributor of VF Corporation's brand Vans in Brazil under a licensing agreement. The agreement more than doubled Vans gross sales in Brazil from 2019 to 2021. UBS states that the Vans "brand has benefited from Arezzo's local sourcing, eCommerce infrastructure, and its solid relationship with malls, which enabled a faster store expansion." They continue to suggest additional value creation is possible through "licensing of further brands, either from VF Corp or other international brands, which, although may have appeal with customers, historically struggled to operate and scale in Brazil,[vi] partially due to the complexity of its tax system."[iii] In this instance, the complementary assets held by Arezzo were critical to extracting maximum value of the Vans brand. Accordingly, the value creation is split between the two companies.

A second example comes from the toy and entertainment industries. Mattel, Inc. has multiple examples of in-licensing brands from the entertainment industry, and out licensing its own brands to various other industries. BMO Capital Markets and JP Morgan provide insights on the respective cases for value creation. Mattel has licensing agreements with numerous entertainment companies, including Disney, Universal, Nickelodeon and more.

In January 2022, Mattel announced a multi-year global licensing agreement with Disney to produce and sell toys based on Disney Princesses, winning the license back after losing it to Hasbro in 2015. BMO believes "the deal will be accretive by about+12%, give or take a movie year, with further accretion over time given synergies with MAT's doll infrastructure."[iv] In addition to the complimentary assets to design, manufacture, and distribute toys, BMO also notes the complimentary nature of one of MAT's product brands.

For insights on Mattel's out-licensing JP Morgan notes the potential for additional value creation from its owned brands, as it sees a significant opportunity to leverage the strength of its brands to drive additional revenue and profit through licensed partnerships and is actively looking to add new partners, enter new categories, and grow its retail footprint. "The company is collaborating with partners such as L'Oreal, General Mills, Zara, and Nike… Licensing IP is highly accretive for a margin standpoint as MAT receives a royalty with the supermajority flowing through to the bottom line." Much like Disney lacks the complementary assets to manufacture and sell toys,[v] Mattel lacks the complementary assets to manufacture and sell cosmetics, branded food, and clothing. As such, the value creation is split between the licensee and licensor.

[iv] 27 JAN 22 — SSR: BMO Capital Markets: BMO Research Today - January 27, 2022

[v] 16 JUN 22 — SSR: JPMorgan: Toy Time : Sector/Company Deep Dive (HAS, MAT, FNKO)

Value Measurement

While the analyst insights above help to show the importance of brands in corporate value creation, it does highlight some potential inconsistencies between market economics and the assumptions utilized in common value measurement methods.

Given the value creation characteristics discussed above, value measurement methods typically rely on the income approach. However, consideration of the investment to develop and maintain a brand, particularly in a brand's infancy, should not be overlooked.

The most common method to value brands is the Relief from Royalty Method, a form of the Income Approach. The Method estimates the cash flows the user would have to make to the owner of the asset in return for the rights to use that asset. The primary assumption in the application of the Relief from Royalty Method is the royalty rate (typically expressed as a percent of revenue) that would be paid for use of the brand. Royalty rates observed in licensing transactions between third parties are typically used as the primary evidence for determining the royalty rates used in the Relief from Royalty Method.

As seen in the examples discussed above, brand owner's out-license in markets in which they don't have the complimentary assets to extract the full value of the brand. It is more advantageous for the brand owner to license to an entity which can extract the brands full value with in-place complementary assets and split the resulting value creation. The implication is that the royalty rates observed in market licensing transactions may only reflect a portion of the brand's value creation capacity, the portion that accrues to the licensor in the form of a royalty.

Therefore, relying on royalty rates observed in licensing transactions between third parties implicitly assumes a brand would not be deployed with the complimentary assets to create its maximum value and therefore may not be valued at its highest and best use.

This conclusion highlights the limitations of leveraging observed royalty rates when one considers the requirements for many standards of value. For example, Fair Value as defined by the FASB and IASB requires the use of market participant assumptions. However, the observed licensing transactions are between parties that are not market participants in the same market (i.e., geography, product, segment). In other words, license transactions occur because the two parties are not in the same market.

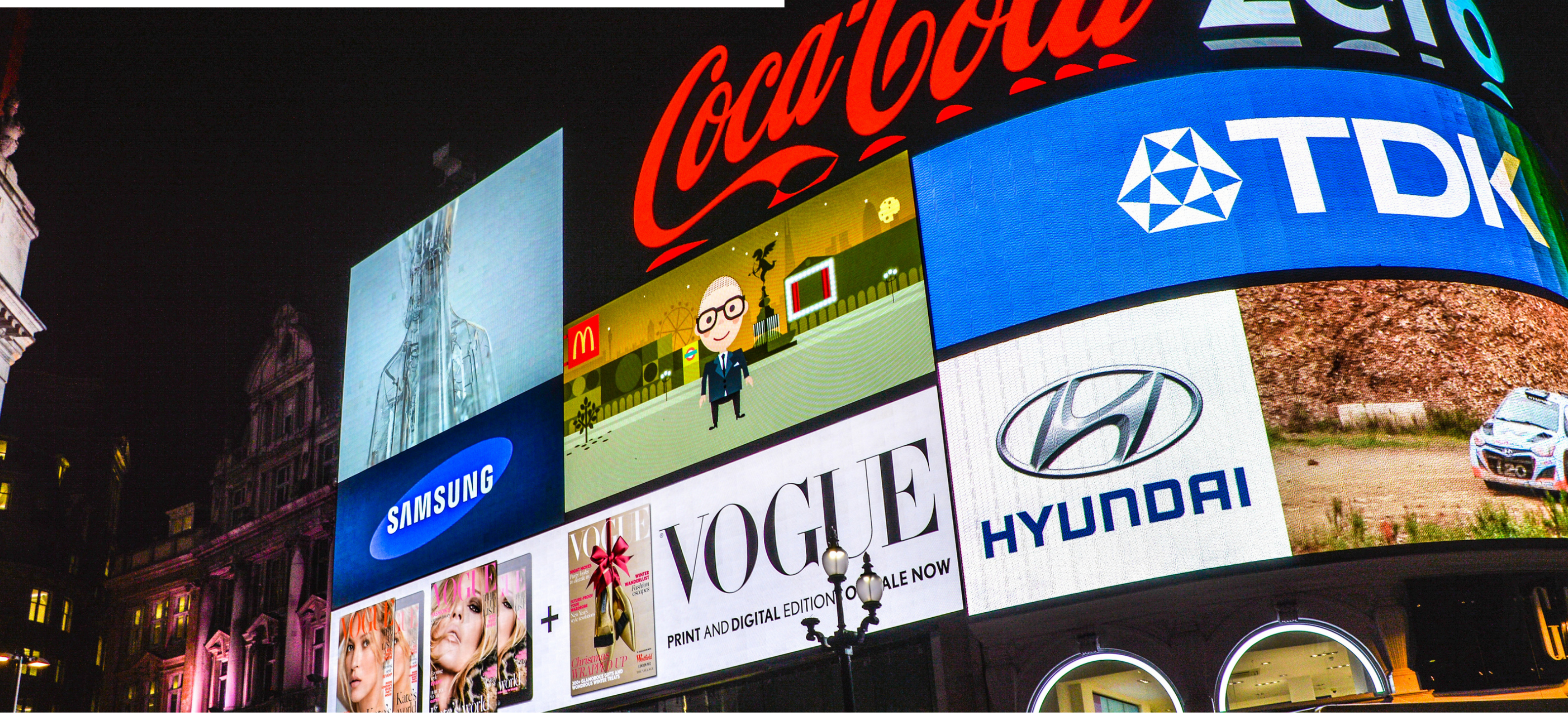
Yet, it's common to leverage these agreements without consideration of whether the terms would be different if the parties operated in the same market. The result may be a mismatch of inputs to the Relief from Royalty Method, in which revenue forecasts for the primary market are utilized but are coupled with a royalty rate derived from a transaction outside of the brand's primary market.

The difference between observed royalty rates from secondary markets and the royalty rate that captures the full value creation in the primary market value chain will depend on multiple factors. For example, the more removed the secondary market from the primary market, the greater the value share will shift to the licensee (e.g., lower royalty rate). The more closely aligned the primary and secondly markets, the more likely the licensor is to have many of the contributory assets and thus would be unwilling to license the brand but for a greater share of the economic profit (e.g., higher royalty rate).

The absolute difference is also impacted by the amount of profit available in that market. As such, the difference would be lower in industries in which company brands are not the primary driver of value creation, such as business to business industries as well as low margin industries. Alternatively, this difference may be vast in highly branded industries with high margins. We look at an example of the latter in the below.

A review of EBITDA margins for a set of publicly traded branded food companies shows an average LTM EBITDA margin of 22%. However, the largest publicly traded private label food manufacturer has consistently earned an average EBITDA margin of 9% for the last four years. The difference in EBITDA margins is 13%, which implies the extent of excess profitability of branded products to unbranded products.[vi]

However, third party licensing data in this industry via a search of ktMINE shows an average royalty rate of 4%. Comparing the excess profitability of 13% in the industry to the average royalty rate of 4%, suggests that reliance on licensing transactions may not capture the full value creation in instances where brand is the primary asset driving incremental returns. The reason is that the license arrangement may only capture a portion of the value creation capacity of the brand.[1] This proposition is further supported by data from purchase price allocations, which show that brands on average are only valued at 3% of the total deal consideration.[vii]



[vi] Source S&P Capital IQ

[vii] 2019 and 2020 Purchase Price Allocation Study (hl.com), page 21

[1] It's common to compare the royalty rate of royalty bearing assets to a rule-of-thumb of 25% to 33% of operating profit. This practice acknowledges that a majority of value is attributed to another asset, yet brands are often the differentiated asset which is primarily driving excess returns.

An obvious alternative in such instances would be to leverage the Multi Period Excess Earnings Method (MPEEM). Alternatively, to continue use of the Relief from Royalty Method, some have started to more fully recognize the value of brands in certain instances by estimating a synthetic or simulated royalty that equates to the excess earnings generated by the business. The synthetic royalty rate derivation follows a similar process as the MPEEM, by subtracting charges from operating profit for contributory assets such as working capital, tangible assets, human capital, IP, and customer assets. Instead of asset charges, functional returns may also be used. In instances in which the brand is a key intangible asset for the enterprise, the calculated synthetic royalty would typically be higher than the observed royalties from licensing transactions. The advantages of the synthetic royalty approach are that it can better account for the full value of the brand that is not observed in licensing transactions, while still leveraging the preferred method for valuing brands.

Conclusions and Next Steps

We believe the above insights can help spur additional dialogue, help inform standard setters and similar stakeholders in order to drive value relevant policies, and ultimately improve value measurement considerations. Brands are more important and require more thoughtful consideration on the way in which they create value, and which methods and assumptions are most appropriate to inform value conclusions.

In our next article we will explore technology assets. The IVSC would be interested to hear your feedback on the subject discussed in this paper.

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