A Rationale and Proposed Set of Principles for Brand Valuation

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Leading the Marketing Community

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Why value brands?

Brands are cash generating units*

they generate future economic benefits

which contribute to enterprise value

Marketing activities must add Economic value

* A cash generating unit is the smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows of other assets (single brands) or groups of assets (portfolios of brands)

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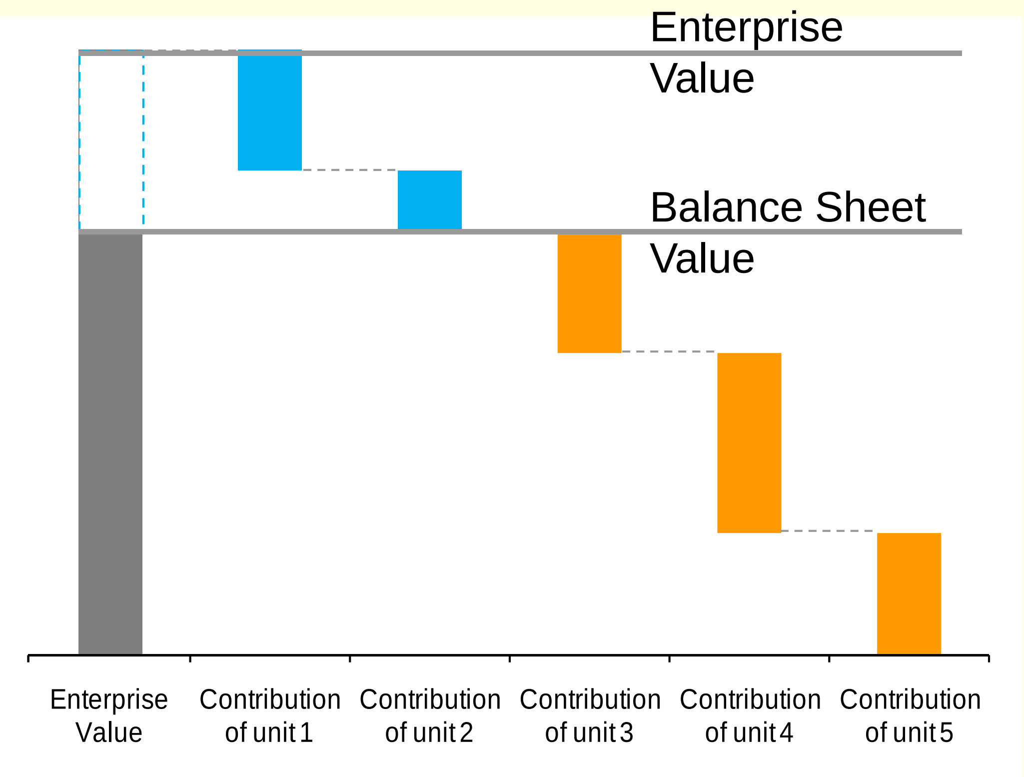
The Enterprise is a cash generating unit… as are many of its components

Enterprise value is made up of cash generating units, that collectively contribute to the total enterprise worth. They can be tangible e.g. machinery, buildings and vehicle fleets, or intangible, e.g. brands (corporate or portfolio brands), internet domain names, and IP

On December 31, 2010, Coca-Cola's market value was $151 billion, while its book value was a mere $31 billion



Marketers manage cash generating units

- They don’t see it that way
- Others do …
  - Investors
  - Analysts
  - Accountants
- Accountants have standards that guide them in valuing intangible assets (including brands).
- Marketers do not – hence this project

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Brand valuation is *not* serving the role it should

- **The current public face of brand valuation is divergent and inconsistent:**
  - **Users must be assured that the number is valid and credible**
  - **The approach must be useful for financial modeling and planning, reporting to the finance function and as a financial tool for justifying investment**

- **Marketers must converge with the financial function:**
  - ***Language***
  - ***Methods of reporting***
  - ***Approach to valuation***

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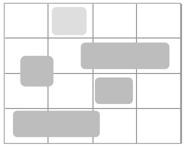
Marketers should embrace brand valuation; it allows their actions to be evaluated in the context of their contribution to driving shareholder value

Brand valuation can be used for many reasons, but the ability to judge marketing actions based on their potential to drive economic value is powerful & marketers cannot afford not to be a part of the conversation in deciding how it is done

Marketing effectiveness

Investment justification



Portfolio optimization

Communication tool

Positioning strategy

Asset management

Investor relations

Valuations for financial use are *not* conducted by brand valuators

- **Despite the relevance of brand valuation to marketers, valuations are rarely conducted by the marketing based firms**

- **Banks, IP specialists and accounting firms are normally commissioned to do the valuation work and they use a method with no marketing input whatsoever**

- **Bank / Accounting Valuations**
  - Accountants tend to use an approach that estimates the value of the “relief from royalty” that a brand owner would otherwise pay
  - This method uses a Discounted Cash Flow approach to a fraction of sales over a 5 year projection, plus the value of a perpetuity benefit

- However:
  - Typically the greater portion of the estimated value comes from the perpetuity (up to 70%)
  - The royalty rate is a subjective estimate
  - The calculations use no customer oriented research metrics whatsoever

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What is this project?

- It prepares the way for a single set of brand valuation standards
- The three assumptions and twelve basic principles are soundly grounded
- If the standards follow these principles, any subsequent valuation method can be tested against them providing assurances of validity and credibility
- But .. first: A proviso

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By definition, measuring intangibles requires some degree of judgment on the part of the valuator

- The need for judgment is acknowledged in accounting & financial reporting standards (CFA Comprehensive Business Reporting Model 2007 & IASB, 2010:OB11)
- Accounting & financial standards ensure that reporting subjective judgments is as transparent as possible by enforcing disclosure where estimates, assumptions and judgments are used – the same principle should be applied to brand valuation

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Sources used to ground these principles

The Conceptual Framework for Financial Reporting

IFRS 3 Business Combinations (Brands are Assets)	IAS 38 Intangible Assets (Brands are not Assets)	IAS 36 Impairment of Assets (Intangibles lose value over time)

IFRS 13 (Topic 830) Fair Value Measurement

Brealey, Myers & Allen (2008) Principle of Corporate Finance

Wiley's Guide to Fair Value under IFRS

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NB. These standards are those set by the International Accounting Standards Board (IASB). The IASB works closely with the Financial Accounting Standards Board (FASB) to harmonize standards world-wide.

Three Assumptions

Assumptions that underpin the principles

Three General Assumptions

The Indefinite Life Assumption (GA # 1) Brands are long-lived; they do not depreciate; and only sometimes have finite lives
The Valuation Approach Assumption (GA # 2) The income method is the appropriate approach; not cost nor market. Brands generate future economic benefits - indefinitely
The Corporate Brand Assumption (GA # 3) Brand, as cash generating units, accumulate to contribute to enterprise value; investors place additional value on companies to account for the power of the corporate brand

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The Principles

Basic Principles #1 & #2

How did they calculate this value?
<u>The disclosure principle (BP # 1)</u> For a valuation to be valid and credible the method by which the valuation was calculated must be fully disclosed including all assumptions and calculations

How are the brand advantages identified?
<u>The Economic base principle (BP # 2)</u> The basis of a brand valuation should be the calculation of economic profit which separates the brand from the non-branded version

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Basic Principles #3 & #4

How is the brand portion of economic profit extracted?
<u>The brand contribution principle (BP # 3)</u> The valuation method shall have a component that works out the proportion of economic profit attributable to the brand

If brands are long-lived, how is this accommodated?
<u>The expected economic life principle (BP # 4)</u> The valuation method shall attempt to model the complete expected economic life of the brand

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Basic Principles #5 & #6

What part does the consumer play in brand valuation?
<u>The brand strength principle (BP # 5)</u> The valuation method must have a component in the model that uses brand strength as a driver of value*

Aren't assets affected by uncontrollable forces?
<u>The environmental influences principle (BP # 6)</u> There must be a component that incorporates an evaluation of the relevant environmental factors that are outside the control of the marketer

* Brand strength, measured by reliable and valid market research (see MASB MMAP standards), is a crucial input to any valid valuation.

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Basic Principles #7 & #8

How should the discount rate be calculated?
<u>The discount rate principle (BP # 7)</u> The discount rate used for both the economic profit and DCF should be the Weighted Average Cost of Capital (WACC)

Risk is fundamental to DCF; where is it applied?
<u>The risk principle (BP # 8)</u> Risk specific to the brand that might impose a negative impact on the future economic benefits should be taken account of in the cash flows and not the discount rate. It should be probability weighted

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Basic Principles #9 & #10

What happens with ambitious growth rates?
The growth rate principle (BP # 9) The short term growth rate should only exceed the average for the three previous years if there is credible justification to do so. Longer growth rates should use the sum of consensus GDP and inflation

We don't always have impartial, fact based data.
The source of data principle (BP # 10) When possible data used should be from observable sources. Disclosure deals with data from unobservable sources

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Basic Principles #11 & #12

Can I track trends with a brand valuation?
<u>The consistency of time principle (BP # 11)</u> Valuation techniques and source data should be applied consistently so that valuations may be reliably replicated over time

I can't afford to value every brand in every sector?
<u>The multiple markets and segments principle (BP # 12)</u> Use an 80:20 Pareto Principle to arrive at a valuation for multiple markets and market sectors

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In summary

- Brands are assuming greater importance as assets
- Marketers are ***not*** being asked to value them for non-marketing purposes
- This is diverting funds and credibility to other business functions
- Marketers must embrace brand valuation and a set of standards that make brand values credible and valid in the boardroom and useful for marketing planning and measurement
- The MASB brand valuation principles and MMAP standards are designed to achieve just that.

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Thank-you!