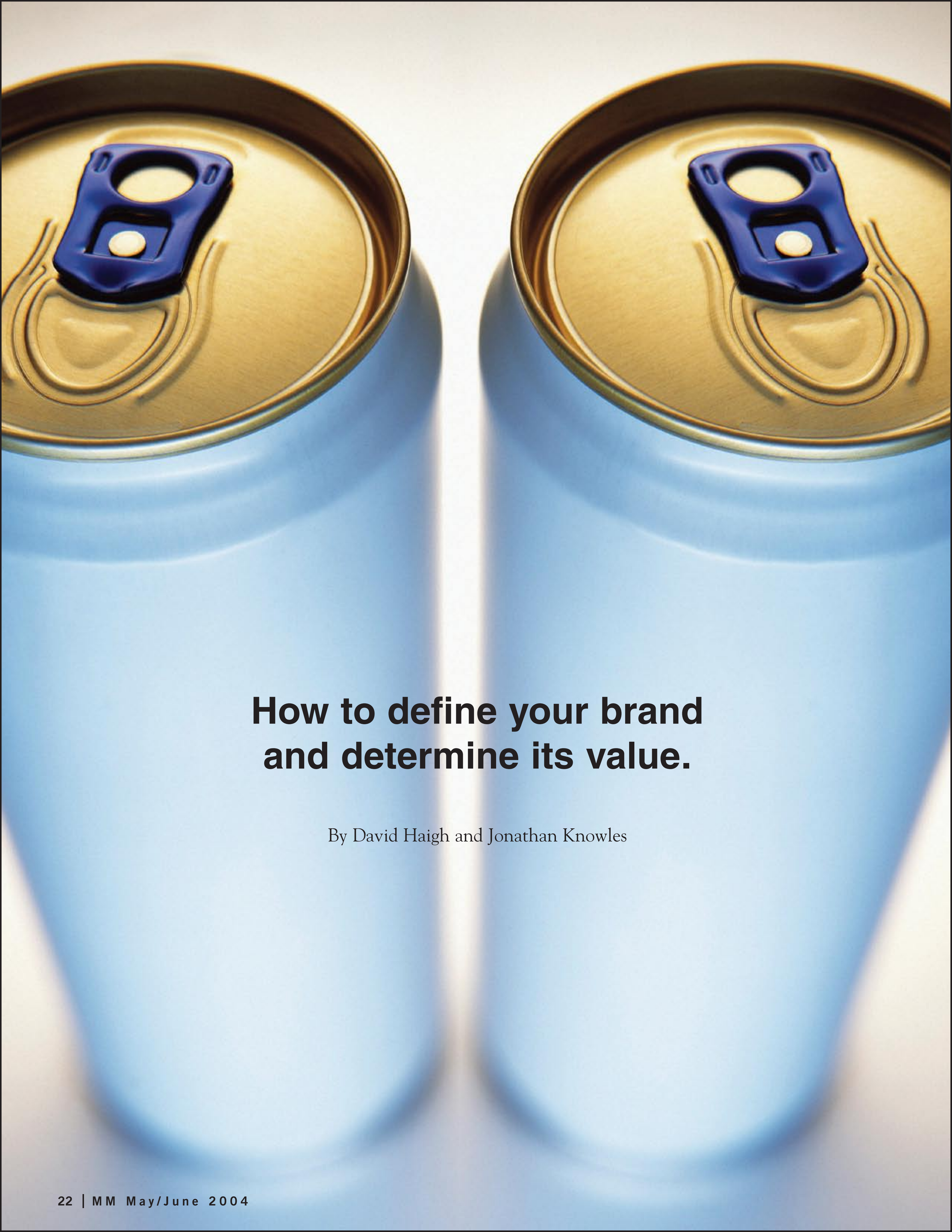


How to define your brand and determine its value.

By David Haigh and Jonathan Knowles

What's in a brand?

How do you define a brand? The word is frequently used, but with a number of different meanings. As brand "guardians," marketers need to be aware that there are at least three different definitions and must understand the circumstances where each definition is relevant.

EXECUTIVE briefing Defining what is meant by "brand" is no easy task. The three main definitions examined here offer increasing scopes of what a brand can encompass, including everything from simple logos and trademarks up through the creation of a brand-focused company culture. Knowledge of brands and the key issues involved in brand valuations can help marketers express the importance of brands in generating and sustaining the financial performance of businesses.

1. A logo and associated visual elements. This definition focuses on the legally protectable visual elements used to differentiate and stimulate demand for one company's products and services over another. The main legal elements covered by this definition include trade names, trademarks, and trade symbols.

In order to add value, trademarks and trade symbols need to carry "associated goodwill," which is acquired by providing high-quality products and by giving good service over a long period. For trademarks and trade symbols to go on conveying value to licensees, high-quality products and good service need to remain associated with the trademarks or trade symbols.

2. A larger bundle of trademark and associated intellectual property rights. This wider concept of brand includes marketing intangibles such as domain names, product design rights, trade dress, packaging, and copyrights in associated colors, smells, sounds, descriptors, logotypes, advertising visuals, and written copy.

Many of these legal rights can be registered or protected in different trade classes and territories and, if registered or legally owned, can be traded, transferred, sold, or licensed. When licensing a brand, an agreement on the bundling of these rights is usually included.

Some commentators have interpreted the intellectual property rights included in this definition very widely indeed. In fact, tangible as well as intangible property rights have been referred to as integral components of brands. Some argue that the Mercedes brand would be incomplete if it were separated from the other tangible and intangible assets used to build Mercedes products. We identify four categories of intangible assets that may be required to deliver the subject brand in an appropriate way:

- *Knowledge intangibles.* Among these are patents, software, recipes, specific know-how, product research, and information databases.
- *Business process intangibles.* These include unique ways of organizing the business, including innovative business models, flexible manufacturing techniques, and supply chain configurations.
- *Market position intangibles.* Included here are retail listings and contracts, distribution rights, licenses (such as landing slots), production or import quotas, third-generation telecom, government permits and authorizations, and raw materials sourcing contracts.
- *Brand and relationship intangibles.* These include trade names, trademarks and trade symbols, domain names, design rights, trade dress, packaging, copyrights over associated colors, smells, sounds, descriptors, logotypes, advertising visuals, and written copy. Associated goodwill is also usually included.

Some people argue that a larger bundle of intangibles should be included in the definition of brand because consumer loyalty is created over a long period by many touch points and consumer experiences. This "360-degree" experience may require the presence of any or all of the unique intangibles noted here to maintain brand quality and integrity.

Protagonists of a more holistic definition of brand ask whether the Mercedes brand would command such fierce loyalty and price premium without the benefit of the Daimler Benz design, engineering, and service. They argue that the Zantac brand would be incomplete without the Ranitidine patent. The Guinness brand would not be Guinness without the genuine recipe and production process. This more holistic view is consistent with the opinion that brand is a much broader and deeper experience than either the "logo and associated visual elements" or even the full range of "brand and relationship intangibles" referred to here. This definition will be referred to as "brand" throughout the article.

3. A holistic company or organizational brand. Under the third definition, brand refers to the whole organization within which the specific logo and associated visual elements, the larger bundle of "visual and marketing intangibles," and the associated goodwill are deployed.

A combination of all these legal rights together with the culture, people, and programs of an organization all provide a basis for differentiation and value creation within that organization. Taken as a whole, they represent a specific value proposition and create stronger customer relationships. Their significance has led David Aaker, vice chairman of Prophet brand consultancy and professor emeritus of marketing at the Haas School of Business at University of California at Berkeley, to remark that the CEO is the ultimate brand manager of the organization.

This broadest definition of brand stresses the need for consistent communication with all stakeholder audiences. Rather than just increasing the preference of customers for buying the company's products and services, the brand becomes a tool for affecting the preference of other audiences to do business with the organization. For example, the brand may favorably affect staff, suppliers, business partners, the trade, regulators, and providers of capital. The benefits of a strong organizational brand are increased demand and distribution, but also include lower costs of materials, personnel, debt, and equity.

In this context, some academicians and practitioners use the terms reputation and brand inter-changeably. If there are problems with a company's reputation or brand, damaging effects can arise with any or all of the various stakeholder audiences. As Don Schultz notes in his column on page 10, end consumer measures may be sufficient for the valuation of trademarks and brands, but not branded businesses. We refer to this definition as "branded business."

Financial Impact

There is now widespread acceptance that brands play an important role in generating and sustaining the financial performance of branded businesses. With increasing competition and excess capacity in virtually every industry, strong brands help companies communicate why their products and services are uniquely able to satisfy customer needs.

In an environment where the functional differences between products and services have been narrowed to the point of near invisibility by the adoption of total quality management, brands provide the basis for establishing meaningful differences between competing offers.

For example, the massive improvements in inherent automobile quality over the last decade mean that reliability is no longer a basis for differentiation. (The latest J.D. Power and Associates report shows that average initial quality for U.S.-built autos has improved 24% in the past five years and that the gap between the best and worst performers is down from 212 defects per 100 vehicles in 1998 to 53 in 2003.) Design and customization have become the basis for differentiation, aided by advances in flexible manufacturing.

Competitiveness now depends on being able to satisfy not just the functional requirements of customers, but also their more intangible needs. It means understanding not just what you can do for them, but also what you can mean to them.

Dramatic evidence of this value shift from tangible to intangible assets is provided by the divergence between the net asset value of companies and their market capitalization. The aggregate market-to-book ratio of the S&P 500 rose steadily from an average of around 1.4 at the beginning of the 1980s to around 3.5 in the mid-1990s. It accelerated rapidly in the late 1990s to reach a peak of 7.3 at the height of the dot-com bubble in early 2000 before falling back to 4.7 in February of 2003.

A market-to-book ratio of 4.7 implies that the tangible assets of a business (land, equipment, inventory, net working capital, and so on) account for less than 25% of the value that investors are placing on a company. Intangible assets such as patents, business systems, distribution rights, brands, customer databases, and the quality of a company's management and workforce account for the remaining 75%.

The impact of brands on corporate performance is often more subtle and diffuse than is generally appreciated. As Schultz has noted, it is widely assumed that the only substantive source of brand value is with end users and can essentially be expressed as the premium that these users will pay for the branded product over a generic competitor.

Strong brands help companies communicate why their products and services are uniquely able to satisfy customer needs.

However, we typically seek to understand the value of all brand drivers at work in the branded business model. Many audiences are affected favorably by brand preference changing their behavior toward the branded business. We have found that different audiences are affected by brand equity and that their behaviors affect branded business performance and value in different ways.

The traditional view of customers as the only relevant audience failed to recognize the full value-creating power of brands. This narrow view, combined with conflicting methodologies for researching and analyzing brand equity across all audiences, means that marketers often struggle to make a convincing case for brands at the boardroom level. In response to this dilemma, we have developed a consistent approach across all audiences, capturing data on scorecards for proactive value management. How can such market research metrics be tied to value?

Valuation Variables

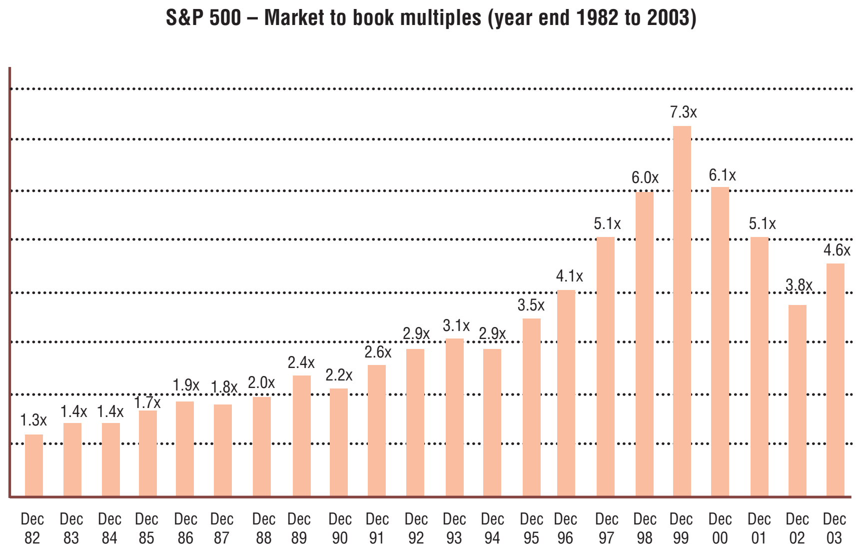
Valuation is a function of three primary variables—profitability, growth, and risk. Investors care about the level of free cash flow of a company (profitability), the prospects for increasing cash flow (growth), and the volatility of these cash flows (risk).

A number of studies have analyzed the relationship between brand health and superior profitability. One of the most notable was conducted by David Aaker and Robert Jacobsen in a 1994 *Journal of Marketing Research* article, "The Financial Information Content of Perceived Quality." The study showed the close relationship between changes in brand equity (as measured by Total Research's EquiTrend methodology) and changes in ROI for a sample of 34 companies.

Subsequent studies produced less convincing results, largely because they failed to use the appropriate marketing metrics to correlate to financial performance. Typically the studies have attempted to understand the relationship between brand awareness and superior stock performance. Unfortunately, awareness is more often a lagging indicator of performance rather than a leading indicator, and, as previously noted, valuation is based on future cash flows. In seeking to explain future cash flows, we need a marketing metric that measures a brand's potential, not just its presence.

Exhibit 1

U.S market to book ratios



Two recent pieces of research have provided powerful evidence for the impact of brands on shareholder value. The first is an as yet unpublished study by Susan Fournier of the Tuck School at Dartmouth and the University of South Carolina's Tom Madden and Frank Fehle titled "Brands Matter—An Empirical Investigation of Brand Building and the Creation of Shareholder Value." (A copy is available at www.ssrn.com.) Their research demonstrates that, during the period from August 1994 through December 2000, a portfolio of 111 highly branded companies produced a monthly return that was 0.57% above the total market average, and at a beta of 0.85. This provides powerful evidence of the impact of brands on increasing the earnings of companies and lowering the volatility of those earnings.

The second is work by the company BrandEconomics LLC, which has combined the BrandAsset® Valuator (BAV) brand health database (developed and maintained by the Corporate Research Group at Young & Rubicam Inc.) with the Economic Value Added (EVA®) database developed and maintained by Stern Stewart & Co. Their approach was to analyze whether differences in the valuation multiples of companies of apparently similar profitability and prospects could be explained by differences in their brand health.

The work demonstrates that profitability alone (measured in terms of returns above the cost of capital) typically explains some 50% of the variance in the observed valuation multiples of companies. Adding a brand health variable (measured in terms of relevant differentiation) typically raised the explanatory power to between 70% and 80% of the observed variance. This indicates that brand health is a powerful proxy for growth and risk.

The aforementioned studies provide robust evidence for the macroeconomic significance of brands. The Aaker/ Jacobsen and Fournier/Madden/Fehle research both indicate that brands play a meaningful role in supporting superior levels of profitability, with the Fournier/Madden/Fehle research also demonstrating the impact of brands in reducing earnings volatility. By controlling for profitability, the BrandEconomics research identifies that brand health acts as a powerful proxy for growth and risk.

These studies validate what marketers have known for years but have found difficult to express in financial terms—namely that brands create preference (the basis for profitability), permission (the basis for growth), and loyalty (the basis for reduced risk).

Value Creation

If the macroeconomic evidence for the impact of brands is strong, we still need to understand the microeconomic mechanisms by which that value is generated. In our experience, it is important to understand the impact of a brand on four major audiences (consumers, suppliers, staff, and investors/financiers) in order to quantify the scale of its financial significance.

For each of these audiences, we analyze the extent and the nature of the awareness and image profile that the brand enjoys and capture the impact of these on the subsequent behavior of that audience.

As Exhibit 1 illustrates, the impact of brand shows up in different areas. With consumers, the impact of brand health drives both profitability and growth. With suppliers and staff, the impact of brands is evident in lower costs. With investors and financiers, the benefit of strong brands is seen in lower funding costs.

On the demand side, consumers are willing to pay higher prices, give a higher share of their requirements, repeat purchase, and purchase more cross-sold products. Trusted brands also grow markets. Brands grow market share, increase prices, increase loyalty, and extend the footprint through brand extension.

Brands also affect the cost side of the economic model. Trade buyers stock well-branded products more readily and charge less for doing so. Staff members stay with strongly branded employers and are more motivated. Most important, brands reduce the cost of capital by influencing investors' and bankers' perceptions of the prospects for the business.

Why Value Brands?

There are two critical questions to answer in brand valuation. The first is, "Exactly what is being valued?" Determine if you are seeking to value the trademarks, the brand, or the branded business. The second important question to ask is, "What is the purpose of the valuation?" An important distinction must be made between technical and commercial valuations.

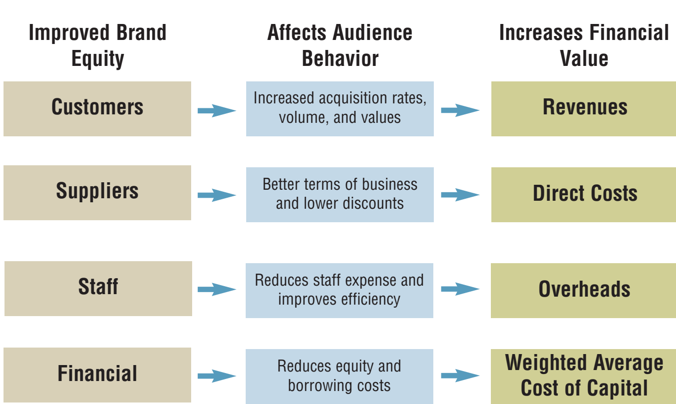
Technical valuations are conducted for balance sheet reporting, tax planning, litigation, securitization, licensing, mergers and acquisitions, and investor relations. These focus on giving a point-in-time valuation. They generally relate to a valuation of the trademarks or of the brand as defined previously.

Commercial valuations are needed for brand architecture, portfolio management, market strategy, budget allocation, and brand scorecards. Such valuations are based on a dynamic model of the branded business and how important a role the brand has in influencing key variables in the model.

Whether the ultimate purpose is technical or commercial, the starting point for every valuation is a branded business valuation. The model provides a discounted cash flow analysis of future earnings for that branded business discount at the appropriate cost of capital. The value of the branded business is made up of a number of tangible and intangible assets. Trademarks are simply one of these and brands are a more comprehensive bundle of trademark and related intangibles.

Exhibit 2

Brand health affects financial value



Steps in an Economic Use Valuation

1. **Model the market.** This identifies market demand and the position of individual brands in the context of all other market competitors. Usually the valuation model is segmented to reflect the relevant competitive framework within which the brand operates.

2. **Forecast economic value added.** This identifies total branded business earnings.

3. **Estimate brand value added.** Use business drivers research to determine what proportion of total branded business earnings may be attributed specifically to the brand.

4. **Benchmark brand risk rates.** This assesses the security of the brand franchise with both trade customers and end consumers and therefore secures future brand earnings. The resulting discount rate is used in the discounted cash flow calculation.

In the case of a pharmaceutical brand like Viagra, value is partly trademark- or brand-related, but is also largely attributable to the patent and other marketing intangibles. We need to decide what are the intangible assets creating the value, and usually there are a variety of these. It could be landing slots for an airline. It could be distribution rights, patents, or recipes.

There are a number of recognized methods for valuing trademarks or brands as defined here. We can look at historic costs—what did it cost to create? In the case of a brand, one can look at what it cost to design, register, and promote the trademarks and associated rights. Alternatively, one can address what they might cost to replace. Both of these methods are subjective but we are asked to value this way because courts may want to know what a brand might cost to create.

It is also possible to consider market value, though frequently there is no market value for intangibles, particularly trademarks and brands. Generally speaking, the most productive approach is to adopt the economic use valuation method. There are a number of different economic use valuation techniques.

First there are the price premium or gross margin approaches that consider price premiums or superior margins vs. a generic business as the metric for quantifying the value that the brand contributes. However, the rise of private label means that it is often hard to identify a generic against which the price or margin differential should be measured.

Economic substitution analysis is another approach—if we didn't have that trademark or brand, what would the financial performance of the branded business be? How would the volumes, values, and costs change? The problem with this approach is that it relies on subjective judgments as to what the alternative substitute might be.

The difficulties associated with these two approaches mean that the two most insightful approaches for valuing trademarks or brands are economic use valuation methods using either an earnings split or royalty relief approach. In the former case, we attribute earnings above a break-even economic return to the intangible capital. These excess earnings are split between the various classes of intangible assets, one of which is the trademark or brand.

In the latter case, we imagine that the business does not own its trademarks but licenses them from another business at a market rate. The royalty rate is usually expressed as a percentage of sales. This is the most frequently used method of valuation because it is highly regarded by tax authorities and courts, largely because there are a lot of comparable licensing agreements in the public domain. It's relatively easy to calculate a specific percentage (for example, 2%) that might be paid to the trademark or brand owner.

Having determined the slice of earnings attributable to the trademark or brand, now and for each year in the forecast period, we discount them back to a net present value—the trademark or brand value.

The impact of brands on corporate performance is often more subtle and diffuse than is generally appreciated.

It is clear that if we value intangible assets separately, without reference to one another, the sum of intangible assets may possibly be greater than the value of the branded business. This is, of course, impossible. The answer is to reconcile all asset values back to the branded business valuation we initially calculated. We must then consider the value of each intangible asset in the context of the others.

It is necessary to apply a similar approach to each of the major intangible assets. It is a classic post-purchase allocation approach with a parallel royalty relief or earnings split analysis for each different intangible asset. The earnings split approach is typically based on some form of market research drivers of demand analysis.

Conceptually, it is quite easy to see that in a software business it is the software that is driving the value. In a technical business, value is often largely patent value. In a highly fashionable business, such as apparel or perfume, a very large proportion of surplus value over tangible value is attributable to trademarks or brands. Market research and associated analysis are used to determine the split. Reconciliation is therefore crucial.

The Branded Business

The foregoing review of brand valuation methods started with a branded business valuation and then considered various approaches to valuing the specific intangible assets owned by those businesses—specifically the trademarks.

The more narrowly focused valuation approaches are generally the ones suited to technical valuations, such as balance sheet reporting and tax. However, for commercial and brand management purposes, it's more useful to know the value of the branded business as a whole and what the demand and cost drivers are that determine and change that value. Managers with responsibility for business and brand development are primarily interested in knowing the principal value drivers of the business and how brand perceptions and preferences affect consumer purchase behavior and staff and supplier relationships.

It should be born in mind that the branded business value is the intrinsic value of the business worked out from first principles. It is not market value. The market value of equity and debt could be a long way above or below the intrinsic value and there may be hidden value.

We have often valued branded businesses and looked at the sources of value to discover that intrinsic value is much higher than market value. We are frequently called upon, in mergers and acquisitions and in investor relations, to communicate this hidden brand value.

Similarly, within a branded business where it is broken down into product, channel, geographic, or customer segments, we frequently find that one segment is value-creating and another is value-destroying. Segmental value analysis identifies how to manage value-destroying brands or segments to build overall portfolio value. ■

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