THE ECONOMY OF BRANDS

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LIST OF ABBREVIATIONS

ABS	asset-backed security
BAV	brand asset valuator
B2B	business to business
B2C	business to consumer
BC	brand contribution
BC_L	brand contribution of the licensee
BE	brand earnings
BI	brand impact
BLR	brand license revenue
BR	brand royalty
CAPM	capital asset pricing model
CEO	chief executive officer
CFO	chief finance officer
CMO	chief marketing officer
CSR	corporate social responsibility
DCF	discounted cash flow
EBIT	earnings before interest and tax
EBITDA	earnings before interest, tax, depreciation, and amortization
EPS	earnings per share
FAS	Federal Accounting Standard
FRS	Financial Reporting Standard
GDP	gross domestic product
HR	human resources
IAS	International Accounting Standard
IE	intangible earnings
IFRS	International Financial Reporting Standard

IP	intellectual property
ISVC	International Standards Valuation Committee
KPI	key performance indicator
M&A	mergers and acquisitions
NPV	net present value
PPA	purchase price allocation
PR	public relations
R&D	research and development
ROE	return on equity
ROI	return on investment
SEM	structural equation modeling
SPV	special purpose vehicle
WACC	weighted average cost of capital

CONTENTS

LIST OF TABLES AND FIGURES

Tables

Figures

INTRODUCTION

The past 25 years have seen the recognition of intangible assets as the main drivers of business and shareholder value. In many businesses brands now account for the majority of shareholder value. This is not only true for the classic consumer goods businesses such as The Coca-Cola Company or Unilever but also for many B2B businesses selling to a professional audience. It is therefore important to understand how the economy of brands works and how it can be exploited to create sustainable value. The purpose of this book is to develop and enhance the understanding of the brand as an economic asset in order to make better business and investment decisions. It looks at the value creation of the brand from all aspects and provides approaches on how to assess and manage the value of brands. The book is written from a practitioners' perspective and is based on the author's experience in the practical application of brand value in all relevant areas.

Different chapters will consider the economic value of brands from a theoretical and practical point of view. The first chapter deals with the variety of definitions of brands and provides the economic definition of the brand adopted in this book. Chapter 2 looks at the relevance of brands as business assets and their contribution to business and shareholder value. The following chapters 3 to 7 discuss the emergence of the economic understanding of branding and layout in detail the main approaches to valuing brands including, in Chapter 7, a recommended brand valuation approach based on the author's experience and best industry practice. The eighth chapter examines the accounting debate on brands and intangible assets and its relevance for brand value. This is followed by a chapter describing how brands are used in large-scale debt securitizations in different types of financial transactions. Chapter 10 discusses the relevance of brand value in mergers and acquisitions (M&A) and how it can help in optimizing the outcomes. The licensing of brands to third parties as well as internally in the context of transfer pricing is discussed in Chapter 11. In the next chapter the brand value chain is developed and described as a framework for managing the brand's value creation. Chapter 13 discusses brand and marketing

ROI and provides an ROI framework that recognizes the long-term and accumulative value creation of brands. The stock market and investor perspective on brands and share price performance are investigated in Chapter 14. In the final chapter a brand management framework is discussed and developed. The findings and insights of the book are summed up in the Conclusion.

CHAPTER 1

WHAT IS A BRAND?

Understanding and measuring the economic value creation of brands requires a clear understanding and definition of what a brand is. The word brand is derived from the old Norse word "brenna" which means to burn. By burning signs onto cattle skin farmers could demonstrate their ownership. Although the initial purpose of branding was to demonstrate the origin of an animal it quickly grew into a means of differentiation. Over time a farmer would establish a certain reputation for the quality of his cattle expressed by the branded mark on the animal.[1] This enabled buyers to quickly assess the quality of the cattle and the price they were willing to pay for it. The information provided by the brand helped to guide the purchase decision. Facilitating choice is probably the most important purpose of branding in commerce. Understanding how the brand guides customer choice is crucial in defining what a brand is and what economic value it creates.

Brands can be traced back to ancient civilizations as evidenced by archeological proofs from Etruria, Greece, and Rome. Producers marked their pottery to communicate their origin and quality.[2] Branding became more widespread during the seventeenth and eighteenth centuries for porcelain, furniture, and tapestries. One of the oldest brands, the crossed swords of Meissen porcelain, stems from that period. However, it was the advent of mass produced packaged goods in the late-nineteenth century that made branding commercially important. Through industrialization the production of many household items, such as soap, moved from local production to centralized factories. As the distance between supplier and buyer widened the communication of origin and quality became more important. While mass-manufacturing provided economies of scale and often better product quality the goods needed to be sold to a wider market where customers were only familiar with local suppliers. The mass-manufacturers had to convince consumers, in the local markets, that their products were better than those of local producers. Packaging became the first means of differentiating their goods. It was during this period that brands such as Campbell's, Coca-Cola, and Quaker Oats emerged. In the US market these goods are still called "packaged goods."

In the late 1880s, James Walter Thompson, founder of the advertising company JWT and one of the pioneers of brand advertising, published so-called house advertisements to explain and sell the services of his agency to potential clients. Thompson drew on insights derived from behavioral psychology and advanced market research. His house advertisements were amongst the first systematic descriptions of the use and effect of brand advertising and an early commercial explanation of what is today defined as branding.[3] Consumer goods companies started developing sophisticated communications strategies including brand positioning, tag lines for advertising campaigns, packaging design, mascots, and jingles to build their brands through media communications mainly radio and television. By the 1940s, consumer marketing became more sophisticated as companies began to understand and recognize the social, psychological, and anthropological dimensions of the relationship consumers were developing with their brands. Increasingly brand communications expanded beyond promising quality towards building more complex psychological associations. As the quality of many products became increasingly similar and difficult to differentiate brands had to offer additional, mainly emotional benefits to be distinguishable. Most of these emotional benefits provide means of self-expression and definition. Buying and owning a specific brand communicates specific associations and values internally as well as externally. For example a buyer of a pair of Nike sport shoes communicates to both the outside world and the owner of the brand success, performance, and winning. Both internal and external communications are closely linked with the internal feeding on the external. Alongside the emotional benefits there are also perceptions about tangible or material brand benefits. In most categories consumers can choose from a wide range of options however, they can no longer test and compare the actual material differences of these offers. Some material benefits such as quality are also hard to define as they comprise different aspects such as durability, functionality, timeless design, etc. Often, therefore, consumers have to rely on the brand communications not only for intangible but also tangible benefits.

A brand is very complex object and according to current management theory and practice a brand can be defined in several ways. The narrower view defines the brand in terms of customers and consumers.

The wider view is more holistic and expands the brand across all business activities and beyond that to other entities and organizations such as people and countries. Traditional marketing definitions of brand have focused on its function of identifying and differentiating a company's products and services. The American Marketing Association defines a brand as "a name, term, design, symbol, or any other feature that identifies one seller's good or service as distinct from those of other sellers. The legal term for brand is trademark. A brand may identify one item, a family of items, or all items of that seller. If used for the firm as a whole, the preferred term is trade name."[4] Others have added the importance of the promise the brand makes to the potential buyer. In that context Philip Kottler, an American marketing guru, described a brand as a seller's promise to deliver a specific set of features, benefits, and services.[5] In a similar way, Walter Landor, founder of the equally named branding and design firm, defined the brand as "a promise. By identifying and authenticating a product or service it delivers a pact of satisfaction and quality."[6] Beyond the sheer promise, the experience of the brand is equally important. This leads to the more holistic view on branding according to which the brand is the result of all impressions and experiences the brand delivers. Ultimately, the brand is in the heads of the potential customers. David Aaker, marketing professor and creator of the term brand equity, sees the brand as "a set of assets (or liabilities) linked to the brand's name and symbol that adds to (or subtracts from) the value provided by a product or service."[7]

In financial terms, the brand constitutes an intangible asset that provides its owners with an identifiable and ownable cash flow over the time of its useful economic life. This can span more then 100 years as evidenced by brands such as Coca-Cola, Nokia, and Goldman Sachs. The brand is an economic asset that creates cash flows on a stand-alone basis (e.g. licensing) or integrated with other tangible and intangible assets. The cash flow impact is the main reason why businesses engage in building and maintaining their brand assets. The mental impact of branding is only economically relevant if it results in a positive financial return for the user or owner of the brand that outstrips the investments into the brand. The impact of brands on shareholder value is substantial and can amount up to 80 percent of shareholder value.

In its broadest definition, the brand can be defined as a conveyor of information. Contents and reception of this information define the scope and impact of the brand. As this book deals with the economic impact of brands it uses brand in the context of economically relevant transactions such as the sale and purchase of products and services. The information brands convey can be functional and emotional. Functional information ranges from factual elements such as origin, price, product features, and technical specifications to more general and less clearly defined elements such as functionality of product features, quality, consistency, and reliability. While the former can be tested and verified to some degree the latter are entirely subject to perception and judgment. Emotional information comprises, as the term suggests, all kind of emotions, feelings, moods, and attitudes. While functional information can in theory be factually verified emotional information is intangible and subjective. There are, however, many market research methods that can verify the emotional information. All brands have a combination of both elements although in very different proportions. Some brands focus mainly on the functional delivery others on emotional aspects. The functional aspects are important as in many cases they cannot be verified or tested by the audience to which they are communicated. Consumers buying a television will in most cases not be able to properly assess the technical quality of the product. Most flat panel TVs look very similar with little physical difference. Without a brand attached to them, choosing a television would be very difficult as consumers would be faced with a large number of flat boxes in black or silver. In addition to functional features, brands can communicate emotional aspects. Consumer electronics brands such as Sony and Samsung communicate prestige, status, and style in addition to their technical aspects. In cases of B2B and product-led brands, for example in technology, the functional information is always important and can at the extreme dominate the communication. In cases of famous iconic brands such as Coca-Cola, Marlboro and Nike the information is almost totally emotional with little or no functional contents.

The contents of the information can vary according to the audience the brand is addressing. Historically, brands were focused on consumers and customers in the context of the potential or actual purchase of goods and services. This is still the main task of brands and is at the core of brand management. However, with the recognition of the importance of corporate branding in the 1980s, the role of the brand has been extended to other internal and external audiences such as employees, suppliers, investors, regulators, and the general public thus blurring the differentiation between brand and corporate reputation.

While customers are still the main focus of branding activities worldwide the term brand has been expanded across a wide range of commercial activities and stakeholders. Countries, as well as individuals, can be brands. Most organizations have started embracing the concept of brand across stakeholders including customers, employees, investors, public institutions, public opinion, and suppliers. According to this wider interpretation of branding, the information it communicates facilitates a wide range of transactions: selling goods and services to consumers and customers; attracting and retaining employees; influencing capital markets; dealing with public institutions; and special interest groups.

There are several key components that constitute a brand. The most visible aspects are the trademarks and designs. They comprise brand names, logos, packaging designs, color schemes, shapes, and smells. These elements can be legally protected to provide their exclusive use. Most brands are based on a combination of several trademarks. In the case of Coca-Cola these are the Coca-Cola name, the signature style of the name, the dynamic ribbon under the name, the waisted bottle shape, the combination of colors, and many of the company's slogans, the most famous being "It's the real thing." Increasingly, companies have extended their trademark protection to jingles, smells, and shapes. In 1994, Harley-Davidson Inc. filed the engine "roar" exhaust sound of its v-twin motorcycle engines as a trademark but withdrew it a couple of years later due to strong opposition from competitors which made a successful application highly unlikely. Nevertheless, the Harley example demonstrates how complex and sophisticated the legal protection of brands has become. The exclusive ownership and control of the overall mix of the different brand elements is crucial as it allows their owners to identify and distinguish their products and services. Identification and differentiation are the most basic commercial functions of brands. They establish a clear link between a product or service and its provider. Once the origin of a product and service can be identified other functions follow.

Patents for technologies and formulas can also form part of the brand. Most pharmaceutical brands are linked to patents. The secret formula for the Coca-Cola syrup is also a core brand element. The Microsoft brand is linked to several patents and technologies.

Due to the importance of the legal protection of their brands to their business, brand-owning companies fiercely protect their trademarks around the world. Most companies have trademark experts in their legal department and employ IP lawyers to protect their brands and initiate legal actions against the slightest possible infringement.

Lindt & Sprüngli, the Swiss chocolate makers, have for many years been entrenched in a legal battle to prevent a German chocolate manufacturer from selling gold-wrapped chocolate bunnies in order to protect their famous golden chocolate bunnies.[8] The World Customs Organization estimates that counterfeit goods account for between 5 to 7 percent of global merchandise trade, amounting to US$450 billion.[9] China alone is estimated to be contributing to almost two-thirds of all the fake and pirated goods worldwide. LVMH, the French luxury group, spends more than US$16 million annually on legal investigations and procedures against counterfeiting.[10]

All these legal rights are important as they represent the "tangible" and most visible elements of the brand that trigger its specific associations and values that materialize in cash flows generated from customers' purchases of the brand.

A meaningful concept of brand which is adopted throughout this book defines the brands as an intangible asset that creates and secures identifiable cash flows by combining symbols, associations, and perception in a unique manner that motivate consumers to choose and purchase a company's goods and services in preference to its competitors. The associations and perceptions are the result of a company's actions and communications as an entity. The brand evolves out of the expectations it generates and experiences it delivers. Both factors are closely intertwined. Brand communications and experiences can be systematically managed to maximize a company's cash flow generation.

CHAPTER 2

THE VALUE OF BRANDS

The value of brands materializes in several ways. The most direct and obvious is the sale of products and services to consumers. The combination of the price paid for a product plus the quantity and frequency of purchase creates the sales revenues for a business. This is converted into profits and ultimately shareholder value. The share price of a company is driven by investor's expectations about the future ability of the business to attract customer revenue and extract profits from these. The value of brands also materializes in mergers and acquisitions, the subsequent balance sheet recognition, licensing, and other financial transactions such as securitizations.

BRANDS AS INTANGIBLE ASSETS

Intangible assets have become the key driver of shareholder value. Over the past 25 years the average price-to-tangible book value of the S&P 500 (a value-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States) has been about 3.9 meaning that investors valued the companies included in the S&P 500 close to four times their tangible net assets (see Figure 2.1). In this context it is important to note that the S&P 500 index includes a wide range of B2B businesses as well as companies from the energy, resources, and manufacturing industries that have traditionally been more physical asset heavy. The time period also includes several business cycles and stock market bull and bear phases. The average price to tangible book value of the S&P 500 rose steadily from an average of around 1.4 at the beginning of the 1980s to around 3.1 in the mid-1990s. It accelerated rapidly in the late 1990s to exceed 7.0 during the dotcom bubble before falling back to 2.7 during the 2008/9 stock market crash. The long-term price to tangible book value of 3.9 indicates that the tangible assets of a business (land, equipment, inventory, net working capital,

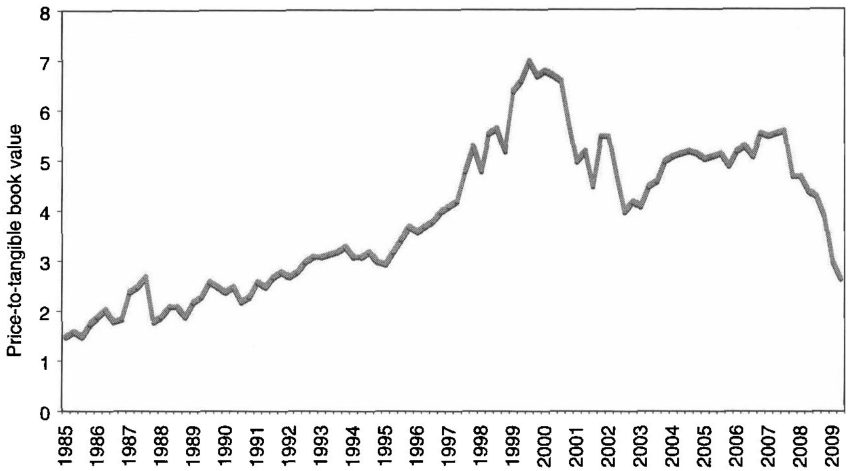

FIGURE 2.1 **S&P 500 price to tangible book value**
Source: Bloomberg, 2009.

etc.) account for about a quarter of the value that investors are placing on a company. The remaining three-quarters are accounted for by intangible assets such as patents, business systems, distribution rights, brands, customer databases, and the quality of a company's management and workforce. Although book and market value are only partially comparable, as most accounting items are cost based and the share price represents investors' expectations of the future cash flows of a business, the price to tangible book value provides a sufficiently clear indication that investors see the majority of value in a company's intangible assets.

Among all intangible assets the brand is unique with respect to its durability and holistic nature. Brands can maintain their leading position over long periods of time. Some of the worlds leading brands such as Coca-Cola, Gillette, and Goldman Sachs are over 100 years old. Most brands outlive all other business assets. Brands are also more holistic than other assets as they are the combined result of all customer experiences and communications. Ultimately, brands represent the relationship between a company and its customers who generate its revenues through buying its products and services. This is supported by the fact that consumer and brand related spending accounted in 2008 for 72 percent of US gross domestic product.[1] That means that nearly two-thirds of the GDP of the world's largest economy are tied to brands and their value generation.