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VALUE RELEVANCE OF BRAND STRENGTH

СТОЙНОСТНО ЗНАЧЕНИЕ НА СИЛАТА НА ТЪРГОВСКАТА МАРКА

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Abstract: *Determining the brand value is a complex process dependent on many criteria. Brand value may be defined as an estimate of the value of a specific object in a certain point of time. Depending on the situation and circumstances brands may have a different meaning, i.e. for the evaluation it is possible to be used different definitions (standards) of value. In the following paper the authors suggest as a basis for valuation to be used one of the basic standards of value, namely Market value. For the purposes of this study the authors also suggest two methods based on the Income approaches where royalties are calculated on the basis of sales.*

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INTRODUCTION

During the 90's of the XX-th century the fast and sudden growth of the market value of companies, dealing with acquiring and using knowledge, led to the introduction of a new notion – intellectual capital /IC/ and to the need of its subsequent explanation. Intangible assets have already been recognized as a fundamental and permanent source for acquiring competitive advantages through the use of knowledge and intellectual capacity owned by the given company. At the same time it became clear that the existing definitions of intangible assets and their accounting and value determination don't give a full idea for the possibilities of organizations to create additional value based on management and use of all available intellectual assets. This fact caused various authors' researches and attempts for revaluation of intangible assets role in the economic activity of the organization and led to defining the concept of IC and to formulating methods for its value determination.

Strong brands enhance business performance primarily through their influence on three key stakeholder groups: (current and prospective) customers, employees, and investors. They influence customer choice and create loyalty; attract, retain, and motivate talent; and lower the cost of financing. The influence of brands on current and prospective customers is a particularly significant driver of economic value. By expressing their proposition consistently across all touchpoints, brands help shape perceptions and, therefore, purchase behavior, making products and services less substitutable. In this way, brands create demand, allowing their owners to enjoy higher returns. Strong brands also create continuity of demand into the future, thus making expected returns more likely – or less risky. Brands, therefore, create economic value by generating higher returns and growth, and by mitigating risk.

Determining the brand value is a complex process that depends on many criteria and requires brand identification through the type and nature of the right on it. It may be defined as an assessment of the value of a specific object in a specific moment in time.

In the following paper the authors will adhere to the basic principles and definitions given in the International Valuation Standards (IVS 2013, effective since January 2014).

II. THE BRAND AS AN INTANGIBLE ASSET

In economic aspect, value represents the market overview of the benefit that the owner (or investor) of a specific object has at the time of the valuation. The term "value" is frequently used in economic practice and has many interpretations. Therefore it is commonly used in scientific papers

with a clarifying definition – such as: *book value*; *intrinsic, fundamental value*; *fair market value*; *market value*; *market capitalization of equity*; *investment value*; *liquidation value*.

That diversity is legally regulated in various international and national standards and legal documents, but is far from being exhaustive.

Prof. Shannon Pratt fairly states on this occasion: "Value has no meaning until it is defined. A single value does not exist – an object of property may have different values in different circumstances" (Pratt, 2006).

This is the main reason why the term "value" is always used in a combination with a particular specifying definition.

According to the IVS 210, an intangible asset is a non-monetary asset that manifests itself by its economic properties. It lacks physical substance but it grants rights and economic benefit to its owner.

Intangible assets are divided into:

- ***An identifiable intangible assets*** – patents, licenses, computer programs, product formulas, trademarks, etc.

An intangible asset is identifiable if it either (a) is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so, or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

- ***An undentifialble intangible assets –*** know-how, goodwill, concessions, copyrights, guaranteed market access, special contracts and credits, customer lists, contractual customer relationships, exclusive management, franchising, monopolistic situation, trade secrets, effective and intensive presence online, etc.

Any unidentifiable intangible asset associated with a business or group of assets is generally termed goodwill.

IVS 210 provides Commentary on the principle types of intangible assets which describes four principle classes of identifiable intangible assets in order to facilitate the requirement for a clear determination of the evaluated asset. Within each class, assets may be either contractual or non-contractual. These classes are as follows:

- Marketing related;
- Customer or supplier related;
- Technology related;
- Artistic related

Marketing related intangible assets are used primarily in the marketing or promotion of products or services. Examples include trademarks, trade names, unique trade design, internet domain names and non-compete agreements.

Customer or supplier related intangible assets arise from relationships with or knowledge of customers or suppliers. Examples include service or supply agreements, licensing or royalty agreements, order books, employment agreements and customer relationships.

Technology related intangible assets arise from contractual or non-contractual rights to use patented technology, unpatented technology, databases, formulae, designs, software, processes or recipes.

Artistic related intangible assets arise from the right to benefits such as royalties from artistic works such as plays, books, films and music and from non-contractual copyright protection.

Specific intangible assets are defined and described by characteristics such as their ownership, function, market position and image. These characteristics differentiate intangible assets from one another. The differentiating characteristics are illustrated in the following examples:

- confectionery brands may be differentiated through differing taste, source of ingredients and quality;
- computer software products will typically be differentiated by reference to their functional specifications.

Although similar intangible assets within the same class will share some characteristics with one another, they will also have differentiating characteristics that will vary according to the type of intangible asset.

III. MAIN APPROACHES AND METHODS FOR BRAND VALUATION

Brand valuation provides a common language for brand performance around which a company can be galvanized and organized. Responsibility for Brand Strength factors can be allocated to functions, building engagement and a sense of responsibility for the brand across the organization. (Rocha, 2012)

Depending on the situation, the circumstances and the need for determining the brand value, different standards of value may be used. In the following paper the authors suggest as a basis for valuation to be used one of the fundamental standards of value, namely Market value.

Market value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties have each acted knowledgeably, prudently and without compulsion [IVS].

Understanding the nature and attributes of the valued intangible asset and its market nature and characteristics is essential for determining the most appropriate valuation approach.

All methods of valuing intangible assets require an estimate of the remaining useful life. For some assets, this may be a finite period limited by either contract or typical life cycles in the sector. Other assets may effectively have an indefinite life. Estimating the remaining useful life will include consideration of legal, technological, functional and economic factors.

Methods for valuation of intellectual property rights can be broadly categorized into three main methods: cost approach, market approach and income approach, same as the evaluation methods for general other assets. Each one of them applies specific methods, techniques and procedures.

1) The Cost Approach – it is based on the economic principle of substitution. Essentially, the premise is that potential buyers will pay no more for an asset than it would cost them to develop or obtain that same asset or an asset with similar utility in other cases. The Cost Approach seeks to determine the value of intangible assets by aggregating the costs involved in their development. On the face of it, this may seem fairly straightforward. However, there is more involved in the process than simply adding up the receipts for expenditures associated with the intangibles.

There are four distinct Cost Approach methods:

- Reproduction Cost;
- Replacement Cost;
- Creation Cost;
- Recreation Cost.

There are small but significant differences in the definitions of each of these types of costs. These differences are clearly distinguished in specialized literature and in the practice of the most economically developed countries (mainly in the US and Western Europe).

Reproduction Cost measures the level of expenditures necessary to reproduce the exact same asset. It is appropriate in situations such as litigation involving specific patents or when return on investment needs to be measured.

Alternatively, the *Replacement Cost* method measures the expenditures necessary to develop an asset with similar utility and is appropriate in situations such as determining a target price prior to negotiations or calculating a basis for suitable royalty rates or transfer pricing. An important requirement for both methods is that the costs should not be determined in accordance with the historical expenditures that actually took place. Instead, the necessary expenditures and costs to replace or reproduce the asset should be determined as of the valuation date.

The *Creation Cost* estimates the amount that has been invested in creating the brand.

In the market practice the Cost Approach for brand valuation is not broadly applied because of its main limitations:

- In the application of this approach the potential future cash flows associated with the brand are not being taken into account. The ownership of the brand is associated with future benefits that may result from it, but Cost Approach does not take this into account and therefore it does not reflect the actual value of the brand;
- When determining the cost of replacement of an existing brand with another one with the same functionality, it is difficult to determine the brand that would meet this requirement. For example, it is difficult to evaluate brands such as Coca-Cola or Marlboro by using this method;
- If the brand value depends actually only on the cost of its creation, higher value might be attributed to brands which were given substantial funds but their development was completed in failure. Such an approach would decrease the actual value of brands that have achieved market success.

The Cost Approach is most useful in cases where there is no economic activity to review, such as early-stage technology that is not yet producing revenue. It also is effective at establishing a maximum price for the asset if the context is a proposed transaction. This situation exists when there are many candidates for substitution available. The main drawback associated with the Cost Approach is that it does not recognize any economic benefits associated with marketplace activity. There is no mechanism to incorporate revenue or profit data, and it therefore ignores important data by which the value of assets is typically measured.

Reliable estimating of the costs that must be made in order to create the intangible asset is a difficult task. Therefore in specialized literature it is assumed that Cost Approach can be applied only to stable branches with long tradition and statistics kept. The majority of cases drawn from the Bulgarian practice do not meet these prerequisites, because many brands are created in situation of dynamically changing conditions of the economy. In situations of rapidly changing market environment the calculation of the costs necessary for creation of similar intangible assets creates a serious difficulty. A significant argument against the application of the Cost Approach is the fact that the cost of creating a brand does not guarantee achieving market success.

2) Market Approach – it is also called Comparative Approach. It is an estimate of value based upon a process of comparing prices in recent sales or deals. The Market Approach investigates value based on the transaction value of assets. Its valuation is priced according to transactions between third parties, so it is characterized by high objectivity, but especially in the case of intellectual property rights, similar transaction examples often do not exist, and its adoption is difficult in many cases. Also, there are generally few examples with intellectual property rights traded separately from the entire business, and assets which generate profits are often traded as one unit, thus one must extract the value pertaining to the intellectual property rights in the asset value of that one unit.

According to Pratt the possibility of applying Sales Comparison Approach is dependent on the following conditions (Pratt, 2006):

- a relevant market has to operate on which buying/selling transactions related to the valuated element of the assets are being carried out;
- there must be a sufficient number of transactions;
- the exact terms of the deal must be well-known in order the comparison to take place;
- the exact moment of the transaction must be known.

In regards to the above mentioned conditions, it must be noted that the most serious limitations in applying the Market Approach for valuation of intangible assets is the small amount of market transactions. Lack of transactions, covering the similar intangible assets, leads to the fact that the Comparative Approach can rarely be applied in the evaluation process in Bulgaria. Additional complications are drawn by the fact that value is subjective category and the same element of the assets can generate various economic benefits to different objects.

In selecting each evaluation approach, one must consider the character and evaluation goals of the property subject to evaluation and do a multifaceted investigation, but in doing economic valuation of intellectual property rights, an evaluation method focused on the profitability of intellectual assets is often appropriate, which is the Income Approach.

3) Income Approach – its main core concept is estimating the future income streams expected from the use of the intellectual property or intangible asset being valued. The future income streams are then discounted via present value calculations to determine their current value. This is one of the most widely used approaches, because the information necessary to determine value using this approach is usually relatively accurate, and often readily available. The parameters used include:

- Future income stream;
- Number of years of the income stream;
- Risk associated with the generation of the income stream

This approach is used directly for determination of the economic value amount. Gordon Smith adopts the Income Approach as the most appropriate way for measuring brand value and recommends its implementation (Smith, 2013). The preference for this approach is based either on its conceptual correctness or on the ability for reliable calculation of the required parameters.

Various methods can be mentioned as a part of the Income Approach for valuation of intellectual and industrial property. They differ in the way of expression of the benefits that arise from the use of the asset. In some methods the benefits are provided in the form of additional cash flows, while others are expressed in the form of additional income, or as potential royalties which the owner of a right could realize if he/she decides to remise the assets to others. Despite their different expression, these benefits most often are subject to discounting.

With the Income Approach, an asset is worth the present value of the future economic benefits (income or net cash flow) that will accrue to its owner. It requires a projection of future income, an estimate of the likely duration of the income stream, and an estimate of the risk associated with generating the projected income stream. The projection of future income incorporates expected sales of products or services that feature the intangible assets. Of course, an accurate forecast of revenue depends on understanding the competitive and economic environment in place during the appropriate timeframe for the valuation. The length of the forecast is dependent on an accurate estimate of the asset's remaining useful life. This will incorporate factors such as potential obsolescence, historical usage, and expiration of the period of transaction.

The discount rate used in the present value calculations must incorporate the many risks associated with the generation of the future income. These include the overall market risk, specific industry risk, and risks associated with the assets and operation being analyzed. Although it may seem less precise than the cost approach due to the inclusion of multiple estimates, the information needed to make these estimates can be accurately developed and verified. Given sufficient data availability, an additional benefit of this approach is that it provides the ability to perform sensitivity analyses by adjusting the value parameters, which allows management to better understand the importance of the various factors driving value in their particular situation.

For the purposes of the current study two Income based methods will be offered. Their common thing is that the calculation of royalties is based on sales revenue.

- ***Relief from Royalty Method*** – This useful method is positioned as a simple method which considers practical application aspects and is applied to valuation of brands and trademarks. The basic way of thinking of the Method is, for example in the case of patent rights, if one assumes use of the patent rights subject to valuation is being licensed from a third party, and compare to similar license contracts to estimate the royalty which the owner would pay to that third party. Specifically, based on the company's business plan and sales plan, investigate the value of the patent rights by calculating an estimate of "royalties" (license fees) which would have to be paid if the patents required for manufacturing that product were not held, then calculating the present value of those amounts during the period subject to evaluation.

Also, if economic value of a brand or trademark is calculated by the Relief from Royalty Method, by the same way of thinking, calculate an estimate of royalties (license fees) which would have to be paid if the trademark/brand were not held, and discount to the present those amounts. Based on past results, investigate the value of trademarks by calculating an estimate of "royalties (license fees) which would have to be paid if the trademarks required for supplying the service using trademarks were not held, and discount to the present those amounts.

Steps in the Royalty Relief brand valuation process:

- ✓ Obtain brand specific financial and revenue data.
- ✓ Model the market to identify market demand and the position of individual brands in the context of market competitors.
- ✓ Establish the notional royalty rate for each brand
- ✓ Calculate the notional future royalty income stream for each brand.
- ✓ Calculate discount rate specific to each brand, taking account of its size, international presence, reputation, and Brand Rating
- ✓ Discount future royalty stream to a net present value (NPV).

Here the authors adopt the assumption that the featured characteristics of the license that is used to transfer rights to use the brand on a hypothetical buyer) can be classified as follows:

- according to the form of legal protection – patent;
- according to the subject of intellectual property – a trademark license;
- according to the volume of licensee rights – exclusive;
- according to the volume of provided rights – unlimited in time;
- according to the parties' consent – voluntary.

- **Excess-earnings Method**: this brand valuation methodology calculates the earnings above the profits required to attract an investor – which uses the estimated rate of return based on the current value of the assets employed. These excess earnings are assumed to be attributable to the intellectual property or brand.

The method is based on the understanding that the brand value is a part of the excessive profit cost. The authors adopt the following assumptions and limiting conditions:

- ✓ Brands will benefit from their owners independently (without other services or products) on Bulgarian market for selling all kinds of goods for which brands have legal protection under their Registration Act;
- ✓ Brands must have a patronizing term up to 10 years with the possibility for repeated extension;
- ✓ Revenue forecasts should be based on a business plan for anticipated income from the realization of goods with the specific brand for which brands have legal protection;
- ✓ The profit margin from operations will be calculated as a weighted average value of the results of the analysis made in retrospect on "common operating income" and "total cost of operations", as the burden of the past years results is reported in direct proportion of the proximity of the year to the date of the valuation;
- ✓ Forecasts are presented for five-year-period assuming that their patronizing term will be extended and the financial results for the post-forecast period will remain unchanged.

A key parameter in the above described methods is the amount of the license rate (royalties). This rate is often expressed as a percentage of product sales income under a given brand. Calculating the amount of royalties as a percentage of revenues is based on the so-called standard royalty rates determined on the basis of the analysis of licensing deals made in world practice for the given branch. RoyaltyStat® is the most reliable source of royalty rates derived from licensing agreements, adjusted accordingly for taking into account of factors that influence its value in a hypothetical licensing deal. For Bulgaria this source records 58 license contracts so far compared to the US market where there are 4732 contracts. In order to determine the range of the royalty value, the authors offer a modified version of T. Forbes's Model for valuation of brand strength (Brand Strength Analysis). Ten crucial for the brand strength factors are taken into consideration. Three of them characterize the market and seven factors are related to the brand itself. Of each factor is assigned a value from 0 to 5. The greater the brand strength according to the given factor, the greater value it has. The maximum possible number of points is 50.

Brand Strength measures the ability of the brand to create loyalty and, therefore, to keep generating demand and profit into the future. The main factors on which the ***Brand Strength Analysis***

is based are:

a) *expansion rate of the sector* – the more rapid expansion, the higher the valuation;

b) *possibility for substitution* of products/services within the sector with new products/services – the greater possibility, the lower valuation;

c) *competition intensity in the sector* – the larger competition intensity, the lower the valuation;

d) *brand image* – the greater brand image (quality, associations), the higher the valuation;

e) *customer brand loyalty* – the greater number of loyal customers, the higher the valuation;

f) *market life duration* of the brand – the longer it is, the more higher the valuation is;

g) *price premium* – the higher prices it can achieve regarding competition, the higher the valuation;

h) *brand market interaction* – the greater interaction, the higher the valuation;

i) *potential for transferring the brand on new products/services* – the more larger it is, the higher the valuation;

j) *brand trend* – the more innovations are introduced by the brand in the market, the higher the valuation .

Table 1 shows an example for valuation of Brand Strength Analysis.

Table 1. Brand Strength Analysis for Determining the Royalty Value

MARKET FACTORS	0	1	2	3	4	5
Expansion Rate of the Sector				3		
Substitution Possibilities					4	
Competition Intensity						
BRAND FACTORS	0	1	2	3	4	5
Brand Image				3		
Customer Brand Loyalty			2			
Market Life Duration	0					
Price Premium			2			
Market Share				3		
Potential for Brand Expansion						
Brand Trend			2			
Total:	0	2	6	9	4	0
Total Points:	**21**					

The final result obtained by the Brand Strength Analysis allows the license fee to be positioned at the appropriate place within the acceptable limits of hesitation. If the brand analyzed by that table has received 21 points out of 50, the value of the license fee is in the range 21/50. For describing the limits of the interval within the licensing fees may be located (e.g. from 1% to 10% of revenues, according to Forbes) the following conditions are necessary to be taken into consideration:

a) technological cycle stage (production of materials, semi-finished products, finished products, wholesale, retail – the more prolonged the stage, the less maximum value of the license fee;

b) branch type;

c) branch profitability;

d) volume of rights provided;

e) area of operation of the license agreement;

f) license type – patented, exclusive, unlimited;
g) worth degree – low, medium or high;
h) need for additional capital investments including additional researches;
i) expected revenue volume.

CONCLUSION

The methods for valuation of intellectual resources held by organizations under the form of intangible assets allow their contribution in creating economic benefit to be analyzed by appraising their impact on economic performance in creating value for those companies.

There are many approaches and methods that can be used for economic analysis and brand valuation. When considering the fundamental similarities and differences among the procedures it can be established that they are logically grouped into three general categories of valuation analysis called: Cost, Market and Income Approach.

The Income Approach is widely used in valuation of intangible assets and intellectual property (Iliev, 2011). The basis of the preference for the Income Approach is the requirement for fair calculation of required parameters used in the valuation methodology.

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