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KEY POINTS IN THE VALUATION OF BRANDS

by Bruno Husson, Associate, and Henri Philippe, Vice-President of Accuracy

To appraise brands, there are two approaches – intrinsic and analogical – which cover the two categories of methods implemented to appraise companies. Alongside these valuation approaches, there are also references that can provide an initial estimate.
This article aims to present a non-exhaustive but sufficiently complete critical overview to provide a perspective on the various references and methods available.

1. Valuation references

There are two references that provide an initial approach to the value of a brand: (i) the establishment cost reference, (ii) the net worth reference. The main interest in these two references lies in their simplicity.

1.1. Establishment cost reference

Principle

The brand's value is measured by the sum of the costs incurred to create it or by the estimation of costs that would be necessary to recreate an equivalent brand.

Difficulties

- Difficult to implement for the oldest brands.
- Difficult to take into account the brand's changes over time, its changes in positioning, its successes, its failures...
-…as well as the current positioning of the brand, its particular features in a specific market context.

Conclusion

This reference is only relevant for brands recently established or those that target a limited market. By default, this involves a reference when the information necessary for the implementation of other approaches is unavailable or unreliable.

1.2. Net worth reference

Principle

The brand's value is similar to the company's goodwill. This goodwill reflects the existence of an economic rent, resulting from the difference between the actual profitability of the company on the invested capital and the profitability demanded by investors as compensation for the risk (traditionally measured by the cost of capital).

Difficulties

- Estimating the fraction of goodwill attributable to the brand, as other intangible assets such as know-how, patents, and market share generally originate from goodwill.

Conclusion

Easy to implement in the case of listed companies, this method makes sense only if the brand is the company's main source of economic rent. In other cases, there is an extensive definition of the brand that includes (or ignores) the value of other intangible assets.
In the case of well-established brands, however, this method makes it possible to perform a consistency check with the values obtained by other methods.

2. Analogical approach

In terms of financial valuation, the analogical approach works through comparison based on target prices observed on comparable assets with the appraised asset, whether these assets are listed on a stock exchange or they were recently traded over the counter.

2.1. Comparables method

Principle

The brand's value is obtained through comparison with equivalent brands that were the subject of a recent transaction. As with the analogical approaches used to appraise businesses, an implicit multiple is taken away from the transaction price and used to value the brand. For example, brand X, which generates €5 M in revenue, was sold for €10 M; it was therefore sold for a price equivalent to two times its revenue.

Difficulties

- Precisely isolating the fraction of the transaction price attributable to the brand.
- Comparing two brands.
- Getting reliable, relevant information about the identified transactions.
- Choosing an appropriate valuation multiple.

Conclusion

Difficult to implement, without information or a relevant analogy, this method offers an order of magnitude based on market data, making it possible to confirm or not the estimates obtained by other methods.

2.2. Relief-from-royalty method

Principle

Since the brand is not being used to produce and sell, the brand holder can simply license it and obtain a flow of royalties. The value of a brand corresponds to the discounted sum of royalties after deduction of all expenses necessary to maintain the brand.

Difficulties

- Determining an appropriate royalty rate for a given brand on the basis of a panel. In fact, it is not unusual to encounter ranges of rates of around 2% to 10% of revenue, i.e. estimates ranging up to fivefold.
- Estimating the projected sales from a detailed analysis of the brand's various markets.
- Determining an appropriate discount rate.

Conclusion

Used regularly, this method is very sensitive to the estimates of its fundamental parameters: royalty rates, revenue, and discount rates.

In addition, it undervalues the brand. If a company pays a royalty to use the brand over a fixed term, it is considered to have an economic interest in it! A significant portion of the value created by the brand therefore corresponds to the valuation of the brand by the licensee, a value that does not follow this method.

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KEY POINTS IN THE VALUATION OF BRANDS *(continuation and ending)*

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2. Intrinsic approach

The intrinsic approach of valuation considers the appraised asset in isolation. The primary method here is the discounted cash flow (DCF) method, which has become indispensable in business valuation: the market value of a business is assessed from the cash flows that its portfolio of activities will generate in the future. This value differs from book value if and only if the expected return on the committed capital is greater than the profitability demanded by the financial backers (cost of capital). For a brand, the same principles apply.

2.1. Price premium method

Principle

The brand's value is measured by the difference between the value of two companies making similar products, one with a brand and the other without. This difference in value results from price differences between the two companies. These differences are the source of a cash flow surplus obtained by the company holding a brand compared to the company without one.
Specifically, it involves calculating the difference in price paid by consumers between products with and without a brand ("price premium"), estimating how this difference will change over time, applying it to the volume of business involved, and lastly, deducting the costs associated with maintaining the brand. The resulting flow is discounted at an appropriate rate. The same approach applies if the brand generates additional volume ("volume premium") and not a price change or if the brand generates both a difference in price and volume.

Difficulties

- Identifying an unbranded company operating in a comparable sector.
- Estimating the premium paid by the consumer for a branded product.
- Assessing the sustainability of this premium.

Conclusion

The cases where this approach can be easily implemented are rare. This is the case for certain common consumer goods for which there are actually products with and without a brand. Yet, even in these cases, the existence of specific attributes (packaging, etc.) can justify a price differential that is not inherent in or attributable to the brand.

2.2. Excess profit method

Principle

The excess profit method is the direct application of the "abbreviated goodwill income method", commonly used before the advent of the DCF method. In this context, the brand's value is the current value of the excess profits that it allows to be generated. For a given year, the excess profit is calculated by deducting from the forecast revenue all operational costs as well as a notional charge representing the profitability required by the company's financial backers, i.e. an amount equal to the cost of capital multiplied by the capital invested.

Difficulties

- Measuring the excess profitability and its change over time.
- Determining the fraction of excess profit attributable to the brand (the balance being attributable to the income resulting from goodwill, know-how, market share, etc.).

Conclusion

The excess profit method is currently encountering paradoxical success in the work of brand valuation. Paradoxical because, like in business valuation, the DCF method seems to have permanently replaced the abbreviated goodwill income method; with regard to brand valuation, the excess profit method differs from the premium method only in presentation and in no way in the merits and therefore the results obtained.
In the premium method, the difficulty lies in the identification of excess flows through comparison between companies with and without a brand. In the excess profit method, this difficulty is replaced by the determination of the profitability required by the financial backers in the absence of a brand.

3. Conclusion: Why make it simple when it should be complicated?

In business valuation, the simplicity and swiftness of the market comparisons method (analogical approach) is frequently pitted against the complexity and difficulty of the DCF method (intrinsic approach). And ultimately, it is not uncommon to observe that the estimate provided by the first method differs from the second method’s estimate by only 20% or 30%. Does the desire to avoid an estimation error of this size justify the additional investment?
In terms of brand valuation, the issues related to the selection of methods are very similar: the application of a percentage or a royalty rate to the volume of business generated by the brand (analogical approach) is faster and less demanding than the implementation of the premium method (intrinsic approach). However, insofar as the brand generates an additional flow, the risk of error is necessarily greater, as the estimates provided by the two approaches can easily show a gap of up to threefold. Only the sophistication and the iterative approach brought about by structured methods can make it possible to appreciate the consistency of the estimates obtained thanks to “magic” formulas.

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