

Brand Valuation Is the Thing!



By Roger Sinclair

Oprah. A working-class abused black female who became a brand so firmly lodged in the collective consciousness of the Western world that recalling the owner's surname requires a flicker of effort.

—The Independent (UK), 12 March 2002

In addition to learning that Oprah had decided not to come to South Africa this week—because of the image she has of our brand—you probably read this week that Australia is now known as Down Wonder. That is the title given to it by the *Economist* in its lead story about this remarkable country. We may not be very partial to them right now, but over the last twenty years this distant spacious land has become a fantastic success in many areas, in addition to sport.

One area in which they dominate is wine. From beer drinkers and plonk producers, they have become a huge wine success in the world. Their wines now produce in excess of \$1 billion a year in revenues and they are second only to France in the UK—the world's biggest wine importing country in market share. (SA, at 32% p.a. currently has the fastest growth rate, but we have 8% share to the Australian's 16%, so there is a way to go since they are still growing as well.)

What makes their success important for our discussion today is that they led the charge in Europe and now the United States as well, with powerful, well supported brands such as Rosemount, Jacob's Creek, and Brand Australia. Brand Australia, their generic promotion of the country's wines, is given well over £1 million a year; our budget is £0,290 million and dropping with the Rand.

In the early 1990s when the Australians were not so well established, we had a once off opportunity to make a mark. The re-admission of our country was met with enthusiasm. Our wines had been kept off the shelves for many years and there was a very real curiosity to see what was on offer. As the political change unravelled, we became supremely popular and could have sold anything just on the back of our so-called miracle.

But this is what happened.

Most of our wine is grown by independent producers and delivered to the co-op where it is made, bottled, and sold. The co-op manager is often a wine maker from the region who has been elected to the job. That was fine when the KWV did all the selling and marketing at fixed prices. But this is the New World and the New SA.

Suddenly these managers were being forced to do business in a deregulated market and that included negotiating with buyers from the retail trade. Imagine the excitement of the manager of a Boland co-op when he has a visit from a wine buyer from a vast UK supermarket. He tastes the wine and pronounces it to be just what he needs. With 150,000 cases of wine to sell each year, the manager nearly falls over when he is offered a contract to supply, for one year, 75,000 cases at R35 a bottle. He is a hero to his members.

Next year the buyer returns and says the wine was a great success. This year he wants 85,000 cases and will pay R38 a bottle. Now the manager's name is being chiselled into a plaque on the cellar wall of fame. He has created a fantastic flow of future revenues. If only they had known then about branding. If only they had realized that their wine was being shipped in bulk and bottled under strange names and sold at knock down prices to British plonk drinkers.

Which is why the buyer didn't come back the next year. The manager eventually called him to ask what was happening and was told that the buyer was in Chile concluding a deal. He had found a source of better wine at a cheaper price.

That is a true story that happened to more than one of our wine co-ops. It was a harsh lesson from which many have not yet recovered and some never will.

The object of the lesson is that they sold an unbranded, replaceable commodity. The buyer was buying wine, not a brand. It meant little to him where he bought it from and the end user's only loyalty was to the store because they knew that at between £2 and £3 a bottle the store would not let them down, whatever the stuff was called.

They had no brand. There was only short-term value to the commodity they sold.

Contrast this with two new brands selling in the UK: Kumala and Arniston Bay. Perhaps you have never heard of them, but they are two brands that lead the league table of big-selling wines from this country. And each was only launched in recent years. Arniston Bay is owned by Vinfructo, a South African company more associated with Cape Fruit. Kumala is the brainchild of Western Wines, a British company run by an Australian that buys wine from select co-ops.

In just a few years these two innovative companies have built brand equity in that their wines are well distributed and have

developed a loyal following of wine drinkers who know that in these brands they will find consistent quality and a taste they like at affordable prices. As long as the owners maintain the quality of their product and ensure that the consumer remains aware of the availability of their brands, there is no reason why they should not anticipate many years of profits from these entrenched brand assets.

The twenty-first century way of dealing with brand equity—itsself a very late twentieth century concept—is to place a financial value on the brand. Note that I use the term asset to describe what Western Wines and Vinfructo have created. That was deliberate because if you look in the accountant's hand book you will see that they define an asset as "a resource, controlled by the company, arising from past transactions or events, from which future economic benefits are expected to flow to the company and has a cost or value that can be measured reliably."

Apart from the last part of the definition (and we'll deal with that shortly), that is precisely what Kumala and Arniston Bay represent to the shareholder of Western Wines and Vinfructo. It is as though they have bought a building, or a piece of equipment, or a tract of land:

- Each is a resource which, in this context, is taken to mean a stock or reserve upon which one can draw as necessary to meet some need or deficiency.
- They arose from the development of a product, brand name, labelling, promotion, negotiated distribution, and development of consumer demand.
- Because they have each developed some consumer loyalty and therefore can expect increasing levels of repeat purchasing (assuming they continue to support the brand), these resources will generate cash and profits for the shareholders for many years to come.

In addition, the companies have registered the trademarks for their brands so they have a legal right as well to the name, which cannot be used by any one else and can be defended in court should any competitor cause the brand equity to be diluted in any way.

You already know the answer to the last part because that is the core of what I am here to talk to you about. Yes, it can be measured, and this can be done reliably. The problem right now is the accountant's struggle with the concept of valuing something that is intangible and that relies on estimates of what will happen to that intangible in the future. But as I will show, this is set to change.

Today, brand valuation is the big thing. We have placed values on almost thirty brands in just two years for some of the country's

largest companies—in a range of sectors from FMCG, soft drinks, paints, to industrial equipment, parastatals, banks, insurance companies, and sports clothing. The total value of these brands we have valued is well in excess of R8 billion. The tool we use is the one we developed in the School of Economic and Business Sciences at Wits University over an eight-year period and which we now offer through BrandMetrics. As you will see through the example I am about to show you, it uses accounting and finance concepts which it merges with a measure of the brand in consumer memory.

Why are companies using this new business approach? There are many reasons including, in a few cases, sheer curiosity. But generally there are four main categories:

Accounting. Brands are not permitted on the balance sheet at this time. This stems from an investigation conducted in the late 1980s, commissioned by the UK accounting profession. The commission it set up and which was headed by a marketing academic concluded that brands should not be recognized as assets because, among other reasons, they cannot be separated from the rest of the business. In other words they could not be sold without the buyer having to buy other aspects of the business. They also struggle with the concept of future cash flows because of the assumptions on which these must be based. The way they work remains bedded in the age-old idea of historic cost.

This is set to change—soon. The accountants have recognized in recent years that they will become irrelevant in the modern business environment unless they start measuring more than just the tangible assets that the company historically acquired.

Significantly, at the start of last year they established a permanent organization in London called the International Accounting Standards Board (IASB). Its job is to harmonize world accounting standards, adapting them where necessary and introducing new ones as required. On their list of priorities is the standards that deals with acquired goodwill and also the one that is concerned with intangible assets.

According to Garth Coppin, director of accounting standards at Ernst & Young (quoted in *The Star Business Report* this month) this could occur as soon as 2003 when the IASB brings world accounting standards in line with United States GAAP. When that happens, companies will have to value acquired intangible assets which are normally included in the goodwill item and show them as separate items in the balance sheet.

PricewaterhouseCoopers deputy CEO, Suresh Kana has said, "They (market share and brand management) are crucial when

companies prepare annual reports because they are often the major drivers of value.” (FM, March 8, 2002)

At present there is no formal accounting reason to value brands, but some firms are looking at the future and preparing for the time when this is a requirement. They do not want to have to learn about brand valuation when it is suddenly compulsory to have them conducted. And anyway, there are many other excuses to use this most modern of business ideas.

Taxation. By October 2003 we will have had Capital Gains Tax for two years. Two years is the period of grace given by SARS for owners of assets to establish what they call the base value. Once the asset is sold any gain will be calculated on that base value. Brand owners need to obtain values for assets that could be sold in the future, and that includes brands.

If you’re big enough, there are opportunities for what is called tax structuring—although that term might have lost some sparkle after the SACOB revelations. One scheme involves using a trademark, selling and leasing it back. But I should move off that topic before I become an accomplice. But watch out for some SARS announcements in the not too distant future about intangible assets and some tax relief in that area.

Investment. The investment community is thoroughly aware of brands and the full range of intangible assets. It is their knowledge of the companies they study and in which they invest that has brought about the remarkable world-wide phenomenon of share premiums over Net Asset Value (NAV) in the order of three to four times. This is because they are fully aware that what drives company profits is no longer the factory and machines, it is the quality of management, advanced computer systems, relationships and alliances, and of course the brands that the company owns and the trademarks that protect them.

That is why you will find increasingly in the coming years annual reports that feature brand values. Management is telling the investment community what they are doing to protect their valuable and often famous brands. This is important information and, carefully announced, can impact positively on the share price. Of course the opposite can happen as well, which is why I say carefully.

Marketing. Marketers have historically struggled to communicate with financial management. The language of marketing is neither appreciated nor fully understood around the boardroom table, and sad but true there are too few marketing people around that table to interpret what we mean by modifying attitudes, range and brand extensions, neural networking, peripheral routes to

persuasion, and U&As.

What they want to know is how will the vast amount of money that is allocated to the marketing function be spent, and what returns will it generate? Brand valuation can do that because it combines financial data with marketing. It combines concepts such as economic expected life with Brand Knowledge Structure. It uses ideas such as Economic Value Added (EVA) and merges them with market share and category leadership. Hence the tool can be used to estimate return on marketing investment. Some people are looking at using it as well for Payment by Results.

Let’s stick with wine and look at an example.

Say the wine is called Stellenbosch Hills. It was launched five years ago by a company that registered the name and design and is selling half in the South African domestic market and half in the UK. The wine is bought from empowerment independent producers, contract-bottled, and shipped into the trade via agents. The company has no investment in land or vineyards and its only assets are the inventory it has to carry and the net of its accounts receivable and payable.

The brand is performing well and has shown growth of 12% per annum for the last two years.

Turnover	17.6
Less:	
Cost of sales, operating expenses incl. marketing, and overheads.	12.4
Operating profit	5.2
Less:	
Tax at 30%	1.6
Net Operating Profit After Tax	3.6

(all figures in R millions)

The balance sheet shows that the company carries stock valued at R8.0 million, and has a net of accounts payable and receivable of R1.5 million.

Its capital employed is therefore R9.5 million. The weighted average cost of this capital is 15%. Since the cost of capital is equivalent to what the company would earn if it simply sold a commodity with no added value (like the poor old co-op), the difference between the NOPAT and the cost of capital is the special profits the firm earns due to intangibles such as its relationships with retail outlets, contracts signed with grape growers for quality grapes,

a top wine maker on the management team, and of course the rapidly developing fame of the brand.

$$R3.6 \text{ million less } R9.5 \times 15\% = R2.18 \text{ million}$$

Not all of this amount is due to the brand, and we have a way of finding out what this is. The process results in a list of resources that generate the R2.18 million over the cost of capital.

Let's say the list comprises the following:

	a	b	c
Contract for grapes	18	5	9
Tied-in wine maker	12	7	8.4
Established distribution	15	6	9
Control of costs	12	4	4.8
Premium price	25	7	17.5
Brand awareness	<u>18</u>	10	<u>18</u>
	100		66.7%

(a) is the relative importance of each resource; (b) is the influence of Stellenbosch Hills' brand equity on each on a scale of 0 to 10; and (c) is the product of (a) and (b) summed to produce the percentage in the bottom right. 66.7% of the profits shown above can be attributed to brand equity.

$$R2.18 \times 66.7\% = R1.45 \text{ million}$$

Based on historic growth, this is due to continued growing at 12% p.a. for at least the next three years because our wines are now doing well in Europe.

Assets are normally valued by discounting their future cash flows—remember the definition of an asset? Brand valuation uses the same device, because DCF takes account of the time value of money—that is, money earned next year is worth less than money in the hand today. The discount is a rate that you know you will get—without any risk—plus an allowance for the riskiness of the investment. You would demand a higher rate of interest to compensate an investment that you knew to be risky.

Brand valuation does not just project for five or ten years because this would not accurately reflect the normally long-lived nature of brands. We therefore use market research to estimate the strength of the brand in memories of the consumers who use it, and contrast that with the strongest possible brand in the market

which sometimes is the brand we are valuing. When this is not the case, the object brand falls short of the dominant brand by an amount illustrated by the score derived from the market research. We call that Brand Knowledge Structure (BKS). If the dominant brand has a BKS of, say, 46 and the object brand a BKS of 28, the marketing target is to close the gap. It does this by strengthening awareness of the brand and of the attributes that are most vital in determining selection and continued purchase. A strong BKS means that consumers will:

- Buy the brand more regularly,
- Be willing to pay a premium price for it,
- Recommend it to friends, and
- Require less promotional support to retain customers (lower marketing costs).

In the case of Stellenbosch Hills, our valuation process has established that the dominant brand in the category has an expected 28-year life and, as you saw, a BKS of 46. Our brand has a BKS of 28 which translates in the model to an expected life of 16. Those numbers determine the number of years to be discounted.

Based on the data above, the brand value for our brand is R10.5 million. Not bad for a five-year-old wine brand. But it could be worth more. We know that because there is a space between our BKS and that of the market leader. As we move closer to that dominant brand, more people will know of the brand and will feel inclined to try it. Some will join the user group of loyal buyers, and the brand will become more profitable. For example, if the BKS shifts from its current 28 to 35, the years increase from 16 to 19 and the value from R10.5 to R11.7 million.

Since that is an indication of profits still to be earned, the shareholders will be extremely pleased.

These and other adjustments to the input variables allow for a range of "what ifs" to be performed, and for marketing to set these changes as their marketing target. The beauty of this is that in the model these changes end up in a single metric measurement: brand value.

No wonder brand valuation is rapidly becoming The Thing.

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