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Trademark, Tradename and Brand Valuation

By A. Scott Davidson, CA•IFA, CBV

Trademarks, Tradenames and Brands are vital elements of profitable, growing businesses. Today there is an increasing need to assign values to such assets. Reasons include purchase transaction pricing, financial statement purchase price allocations, annual impairment testing under GAAP and dispute related matters. This article examines practical approaches to the valuation of these assets.

OVERVIEW

When valuing trademarks, tradenames and brands (hereinafter referred to as "TTB") in the context of a going concern, one typically looks to both:

i) Cash flow-based methods (particularly the discounted cash flow ("DCF") technique, which offers the greatest precision); and

ii) market-based comparable measures of value.

Both methods capture commercially-transferable goodwill.

Cost-based measures of value (reproduction and recreation cost) can also provide a "sanity check" and secondary perspectives in a context of a going concern.

CASH FLOW-BASED APPROACHES TO TTB VALUE

Incremental Sustainable Future Cash Flows Drive Value

When valuing IP assets under a cash flow-based approach, one is typically most interested in the incremental cash flow sustainable over future years generated by the business from the deployment of the IP asset. That is to say, incremental cash flow sustainable over future years above and beyond that which might otherwise be generated in the absence of the specific IP.

Authors often refer to earnings and cash flow methods interchangeably. While the principles applicable to both methods are very similar, the cash flow-based methods are more precise.

The value of the incremental economic benefit from the deployment of the IP asset is a function of the following factors amongst others:

i) absolute amount of the cash flow advantage;

ii) duration of the benefit;

iii) growth rates and collateral benefits;

iv) relative risk and appropriate discount rates when converting the future cash flows to a present value capital sum[1].

In short, the value reflects a discounted cash flow methodology based on maintainable incremental cash flows.

Quantifying the Incremental Economic Benefit

Essential to the valuation process is the identification and quantification of the specific annual cash flow increments.

Three ways of quantifying that cash flow are: (a) a direct assessment of the relevant benefits; (b) residual return on assets analysis; and, (c) relief from royalty analysis. These methodologies are discussed below.

(a) Direct Assessment of the Economic Benefit Realized from Deployment of TTB

One can consider and directly quantify a number of types of benefits as discussed below. As these benefits are quantified with direct reference to the TTB's this method can be described as a "bottoms up" approach. The dollar amount of each of the relevant benefits must be quantified on an annual basis over the future benefit – "going forward". Simple math will allow the conversion of the present value of these future benefits to a sales based royalty rate. Common types of benefits are described as follows:

[1] It is beyond the scope of this article to discuss the discount rate at which the identified cash flows should be present valued or capitalized.

"...CAPTURE COMMERCIALLY TRANSFERABLE GOODWILL"

(i) Premium Pricing Advantage

The nature of the TTB may be such that it allows for a premium price to be charged for the subject product. That premium price is the increment in price above and beyond the price that a so-called generic product (but otherwise the same or very similar) commands in the marketplace. For example, a well-known soft drink carrying a mark may be able to be priced at a higher price than an unknown or unbranded drink.

The premium price advantage is quantified simply as the amount of the price per unit increment multiplied by the number of units sold.

(ii) Volume Advantage

The TTB may be such that its use in the marketplace generates incremental unit sales of the subject product. For example, consumers may choose to buy a recognizable soft drink brand carrying a mark in preference to one that is not recognized.

The volume advantage benefit is quantified as the incremental volume attributable to the mark multiplied by the per unit dollar contribution earned on each unit of that volume.

(iii) Economies of Scale or Gross Profit Advantage

With incremental sales volume there are opportunities to realize on economies of scale in the production process. For example, longer production runs can spread fixed costs over a larger base and thereby reduce the per unit allocation of those costs. Similarly, higher volumes can facilitate volume discounts on the purchases of raw materials. These benefits translate into increased gross profits and this benefit may be directly attributable to IP being used.

This benefit is quantified as the incremental gross profit percentage multiplied by the dollar revenues being generated from sales of the product.

(iv) Reduced Costs or Operating Profit Advantage

Additional cost efficiencies in product promotion and administrative and other costs may also be realized because of the incremental volumes being generated. These further cost savings are included in the measure of the economic benefit attributable to the IP being valued.

Chart 1 demonstrates all of these four types of benefits diagrammatically assuming the IP in question was a trademark.

(b) Residual Return on Assets to Capture the Economic Benefit of Deployment of the TTB

Another measure of the economic benefit from the deployment of the TTB is an enhanced return on the assets utilized in the business. This method, based on a residual return on assets analysis, is sometimes also referred to as the excess income method.

Under this methodology, the valuator makes a review of all of the assets, tangible and otherwise, that are deployed by the business in the sale of its products. Having determined appropriate returns that need be earned on all of the tangible and other assets deployed (based on market rates of return), the remaining portion of the total profits generated can be attributed to the TTB. That residual return or excess income is then the measure of the economic benefit of the TTB.

In the context of the branded soft drink carrying a mark, the total profits earned must first be allocated to such assets as the working capital deployed in running the business and the fixed assets used in the production and bottling process. The distribution assets, and likely other assets, would also be entitled to an appropriate return. The residual profits are attributable to the mark/brand.

Chart 2 demonstrates this return analysis diagrammatically.

CHART 1

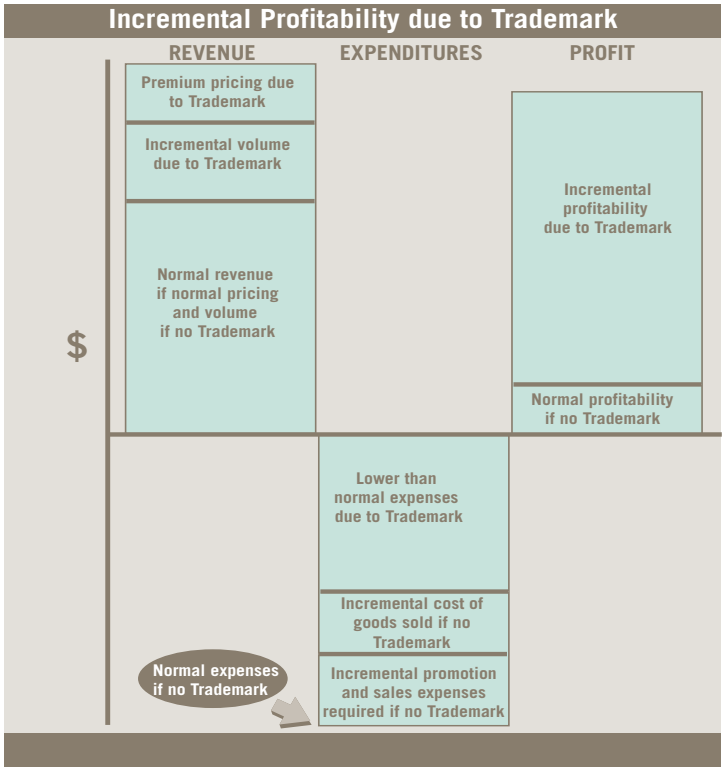
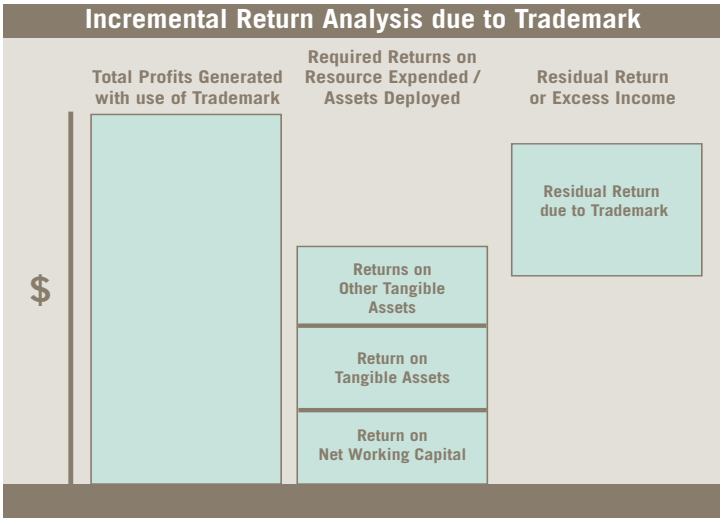


CHART 2



The "Residual Return due to Trademark" box in the third column of Chart 2 is conceptually the same as the "Incremental Profitability due to Trademark" box in the third column of Chart 1. While the two methods are conceptually similar, they will product somewhat different results because they approach value from different perspectives and with different, subjective inputs.

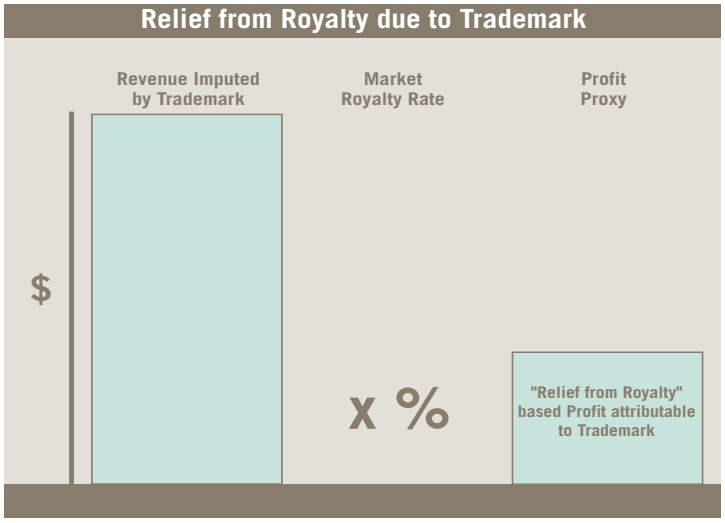
(c) Relief from Royalty Quantification of the Economic Benefit of Deployment of the TTB

The relief from royalty method is another means of measuring the economic benefit that may be attributable to a particular IP asset. It uses a market-based royalty rate as the starting point for quantifying the economic benefit and in this sense is a "top down" method.

Under the relief from royalty method the valuator must determine what arm's length royalty would likely have been charged had the owner of the mark had to licence that asset from a third party. The quantification of the benefit is the product of that royalty rate and the revenues that were generated from sales of the product.

Chart 3 demonstrates the relief from royalty method diagrammatically.

CHART 3



Before settling on value based on the relief from royalty method, careful consideration should be given to the direct method and the residual return method discussed above. Significant differences may be indicative of unusually high or low profitability from the IP or the use of an external market-based royalty rate that is not appropriate or comparable.

While it is beyond the scope of this article to explore how to determine the appropriate royalty percentage or the base against which it ought to be applied, it is often very difficult to generate a market based royalty rate or to find genuinely comparable royalty rates.

Use of Terminal Value in DCF

Under a DCF analysis, in addition to measuring the present value of the annual cash flows over the forecast period, one takes into account the residual or terminal value at the end of the forecast period. A capitalized earnings/cash-flow method is typically used to determine the terminal value.

For example, if at the end of the forecast period the cash flows relevant to the IP were at a stable $3 million per year, the terminal value determined by the capitalized cash-flow method would be the product of $3 million and an appropriate multiple. The present value of this amount at the valuation date would be determined using a discount rate commensurate with the risk associated with realizing the terminal value.

COST MEASURES OF IP ASSET VALUE

The above measures predominate in determining the fair market value of IP. However, it may be appropriate to assess cost of reproduction of the IP asset in some situations, particularly where the dollar magnitudes of the benefits are not susceptible to determination.

Reproduction cost can be assessed with reference to residual development cost and recreation cost.

The residual development cost is the portion of expenditures incurred historically in developing the IP asset that still reside in the asset at the valuation date. In effect, this approach concerns a quantification of the carryover benefit of the historical expenditure that resides in the asset at the valuation date.

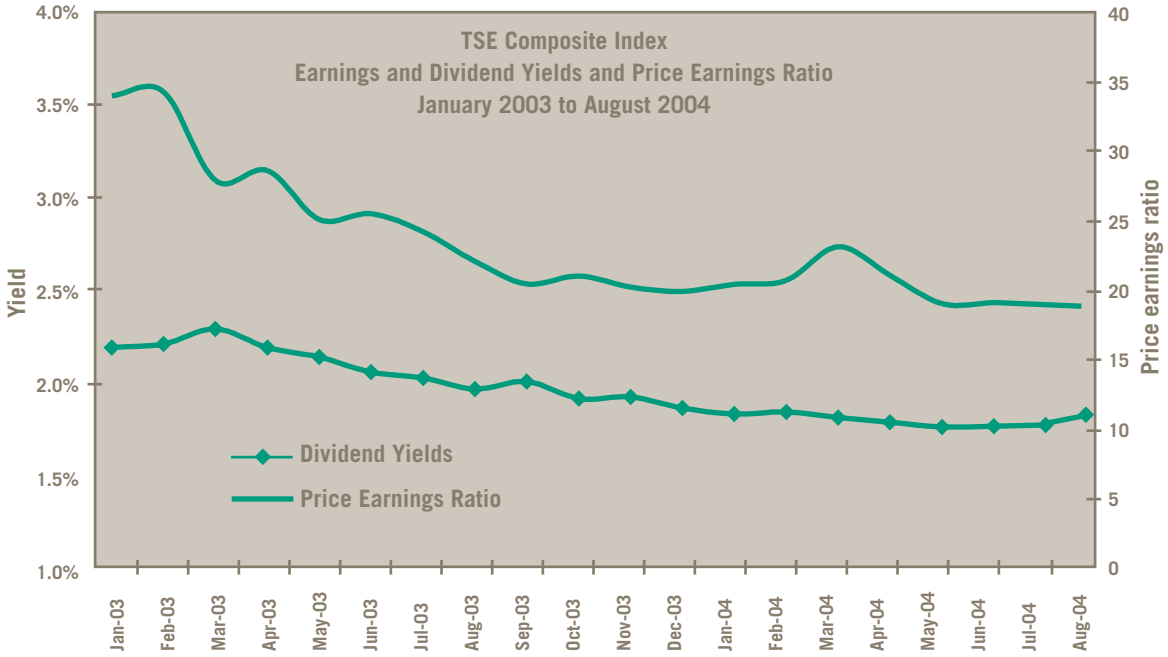
Another way of conceptualizing the carryover benefit is in terms of the extent to which the past spend directed at the IP has not "depreciated" as at the valuation date. For example, in the context of advertising spend directed at the development of a trademark, it is often considered that the value of that advertising "depreciates" over an economic life ranging perhaps as high as five years.

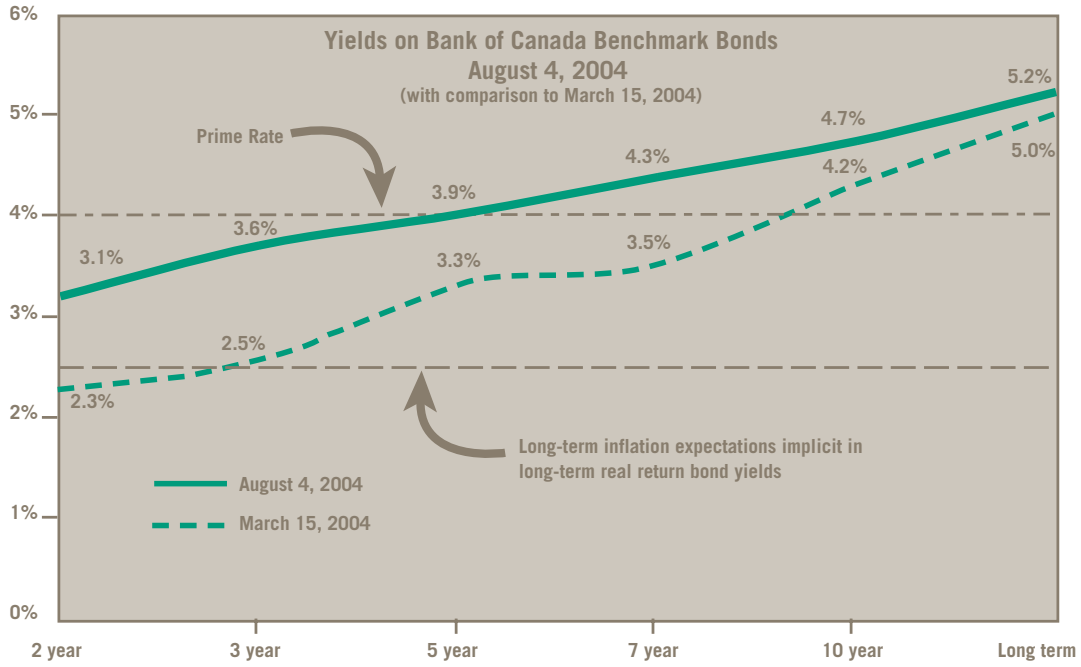
The relevant expenditures can be of many types including, for example, costs of concept development, consulting, legal, consumer testing, design, advertising, traffic building cost, start up losses and lesser profits during "runway or buildup period".

Recreation cost is dollar value of the efforts and expenditures necessary to recreate the IP asset. Recreation cost is based on a multiple of annual ongoing (or sustaining or "retention") spend. In the context of a TTB, the value will be a multiple of the annual "retention" spend (advertising and other ongoing expenditures) that would otherwise be directed to the preservation (but not growth) of the TTB.

While the context of the IP valuation will often dictate the primary valuation method, careful consideration should be given to at least one or two alternative methodologies to ensure a well balanced and market based result. Reconciliation between different methodologies will also ensure not only greater insight into the result but will often surface input errors.

Some Benchmarks Relevant to Value today





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VALUE+ADDED™ ABSTRACTS
September 2004

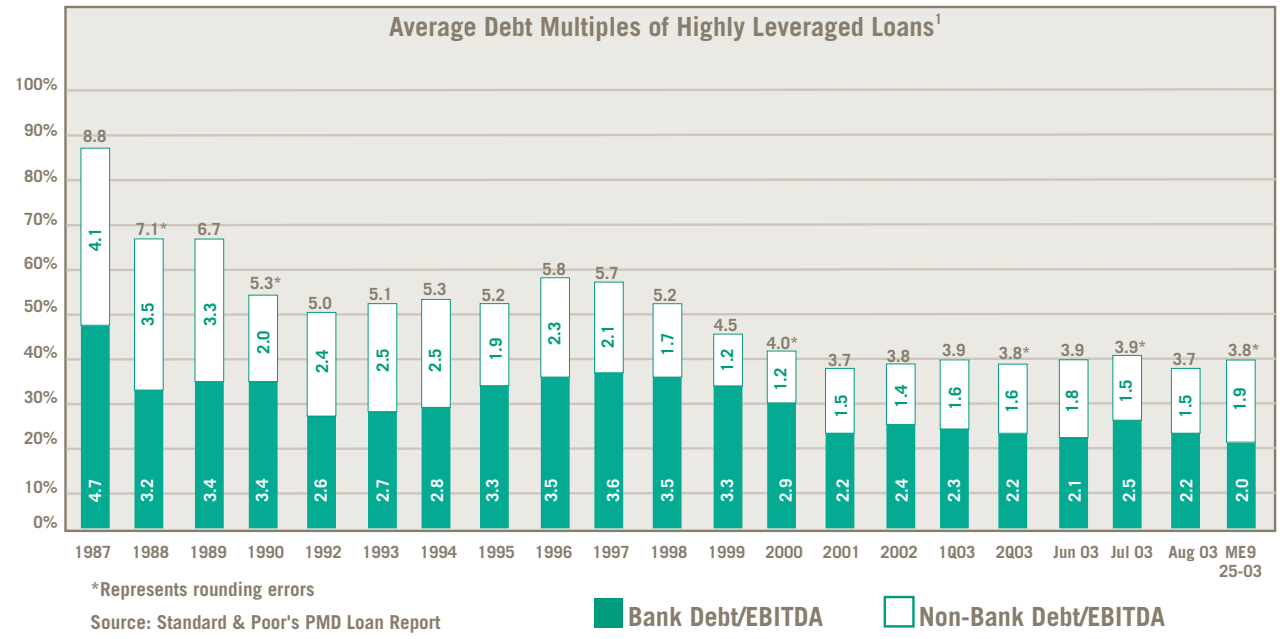
Financing Mid-Market Companies Going Private

Lacher, Rick A., "Panel: Financing Sources for Going Private Transactions", 2003 Public-to-Private Seminar, Strategic Research Institute, November 19, 2003, The Fairmont Hotel, Dallas, Texas

The following excerpts are the very best we have seen in many years concerning the financing of mid-market companies going-private.

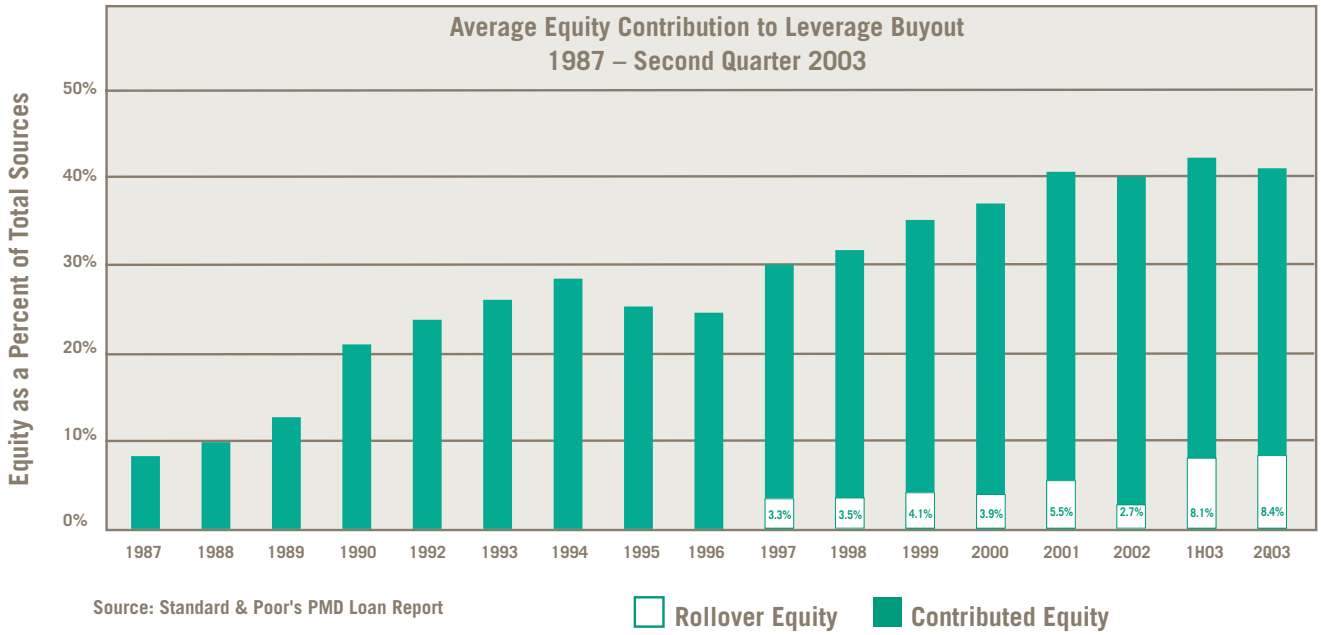
1. Debt to EBITDA Multiples at Historical Lows – Three to Four Times

Recent total pro forma debt to EBITDA for transactions under $100,000,000 has exceeded four times in only approximately 19% of M&A transactions.



2. Average Equity Contribution At Historical High

For mid market transactions, equity required is at all time high levels.



3. Private Equity Return Expectations Today are in the Range of 20% to 30%

Private Equity Firms are looking for downside protection however, given the abundance of cash and serious competition for investment targets, private equity return expectations today are in the range of 25% to 35% as opposed to the 30% to 35% common in the late '90s.

There is a continuing fight to quality and commensurate lowering of interest costs across all levels of debt.

At 40% equity capitalization with no assumed multiple expansion, EBITDA must triple in five years to generate a 30% IRR.

4. Traditional Subordinated Debt Returns are Approaching 16% to 18% and More Aggressive Mezzanine Debt in the Range of 17% to 25%

Conditions are better than at anytime in the past ten years for the raising of mezzanine capital. Traditional subordinated debt returns are approaching 16% to 18%, down from 22% to 25% in late 2001 and early 2002. Many investors no longer require warrant positions and will consider "straight rate" returns. Stability of cash flow however is critical. More aggressive mezzanine debt and asset based loans might target IRR's in the range of 17% to 25% depending on their proximity to an equity equivalent.

5. Summary of Financing Alternatives

KEY CONSIDERATIONS	SENIOR BANK DEBT (ASSET-BASED)	SENIOR BANK DEBT (CASH FLOW)	SENIOR NOTES	SCIL[1]	SUBORDINATED NOTES	CONVERTIBLE DEBT	PRIVATE EQUITY
Cost of Funds	LIBOR + (250 – 350)	LIBOR + (275 – 375)	T + (175 – 225)	12 – 14%	17 – 21%	20 – 25%	25 – 35%
Dilution	None	None	None	None	Limited	Meaningful	Substantial
Leveragability (Multiple of EBITDA)	Asset Value Approach	2.25 – 275x	2.5 – 3.5x	Asset Value Approach	3.5 – 4.0x	3.5 – 4.0x	N.M.
Maturity	4 – 6 years	4 – 6 years	5 – 12 years	6 – 8 years	7 – 10 years	7 – 10 years	N.M.
Covenant Flexibility	Flexibile	Restrictive	Restrictive	Flexible	Flexible	Minimal	N/A
Interest Rate Risk	Yes	Yes	No	Limited	None	None	None
Collateral	Yes	Yes	No	Yes	No	No	No
Prepayment Penalty	Minimal	Minimal	Make-Whole	Yes	Yes	Minimal	N/A
Timing	10 – 14 weeks	10 – 14 weeks	10 – 14 weeks	10 – 14 weeks	14 – 18 weeks	16 – 20 weeks	18 – 22 weeks
Investors	Banks. Commercial Finance Companies	Banks	Insurance Companies	Banks, Special Situation Funds	Insurance Companies, Funds	Funds	Funds

1 Second collateralized institutional loans.

6. Private Financing Markets – Cash-Flow Oriented Lenders versus Asset-Based Lenders

Cash-Flow

Maximum debt capacity for cash flow borrower is a function of maximum conservative EBITDA multiple – currently in the range of three having steadily fallen from six in 1998. Volatility creates potential problems for borrowers and cyclical industries generally restrictive financial covenants and maturities four to six years for cash flow based loans.

Asset

Asset rich companies can borrow in excess of typical debt to cash flow multiples.

Asset-based lenders focus on appraised net orderly liquidation values ("NOLV").

For less than investment grade borrowers, loans frequently secured by all assets and stock of borrower.

ASSET TYPE	RANGE OF LEVERAGE	VALUATION BASIS
Accounts receivable	70% to 85%	GAAP
Inventory	40% to 70%	GAAP – lower of cost or market
Fixed assets	70% to 90%	NOLV
Real property	60% to 80%	FMV
Intangibles	25% to 50%	NOLV

Asset-based loans will take first priority security in all the borrowers' assets.

Maximum debt is a function of NOLV and determined by applying advance rate formulas to the borrower's asset values in the range noted below. (Canadian percentages are likely 10 to 15 percentage points lower.)

Mr. Lacher is the Managing Director and head of Houlihan Lokey Howard & Zukin's Dallas office.