Balance sheet blues

Current ways of reporting the value of brands provide investors with few insights. It is time to develop new methodologies

By **David Ruder**

Your premium brand had better be delivering something special, or it's not going to get the business.
Warren Buffett

As financial markets grow increasingly complex, many investors have adopted investment strategies that emphasise investments into companies that have strong and reliable brand names. This may mean investing in consumer-oriented companies such as Coca-Cola and Gillette that have premium brands, or it may involve brand-specific investment strategies such as brand lift-outs or franchise securitisations.

Investors like brand names because they can both drive and stabilise revenues and profit margins, because once consumers are loyal to a brand they tend to stay loyal. Cash-flow stability due to brand loyalty can provide great downside risk protection.

Given the importance of brands in the investment process, however, it is of increasing concern that today's generally accepted financial statements and accounting practices are of almost no value to investors looking to assess brand valuation. This needs to change. Not only are investors missing out on important information required for making investment decisions, but also companies are increasingly making financial disclosures under current regulations that do not adequately reflect the value of their brands.

What do investors want to know about brands?

Before getting into the details of why financial statements fail for brand investors, it is instructive to understand at a high level what they are seeking when they are looking at investments involving brands. While there are many factors that influence an investment decision, brand investors care about two things above all else: future revenue and profit forecasts associated with a brand; and brand-specific data that influences those forecasts.

Future forecasts

First and foremost, when making a brand investment, an investor is making a bet on what will happen in the future with respect to revenues and profits associated in the brand. Rather than looking at a brand as an isolated asset, investors inevitably must understand the business dynamics surrounding the brand and the plan for making money. At the end of the day, a brand is only a component of a business and to understand potential returns from an investment an investor needs visibility as to future plans about revenues, and advertising for branded product or services. Visibility can come from management statements about planned investments or advertising behind a brand, reviews of business plans or an understanding of broader market trends.

An investor does not make valuation decisions based on what has happened in the past, because the investment returns will be based on events that occur in the future. While past performance can be an important indication of whether a brand can have value to a business, without forecasts of future financial performance it is almost impossible to make decision to invest in a brand.

Brand-specific data

In order to make the appropriate financial

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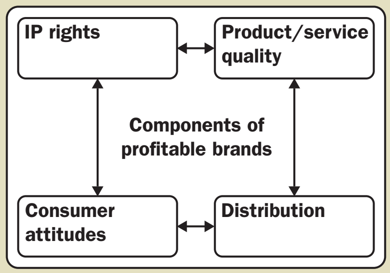
What makes a valuable brand?



A brand is a composition of a variety of rights, relationships and attitudes.

- Which one should be valued most?
- How is the value measured?
- Can elements be separated?
- What is required for a brand to generate revenues and profits?

Valuable brands will have strengths in multiple areas; less valuable brands will be weak in one or more areas.

forecasts for a branded business, an investor needs brand-specific data. This data can involve areas such as consumer awareness ratings, market shares and competitive positioning. These are the types of data that allow an investor to assess whether a brand will drive revenues and operating profits going forward.

Warren Buffet chose to invest in Coca-Cola and Gillette, companies that are in highly competitive markets, but have great brand names because, he decided, the brand names ensure higher margins and market shares. Other brands might be targeted on a particular niche where they have dominance over competitors from a reputation, quality and distribution standpoint. Brand data can give an investor comfort and guidance about the future prospects of a business. Investors that have visibility about brand-specific data use these data to justify the future forecasts described above. Without the data, financial forecasts are more speculative and investment decisions are less certain.

Valuing brands

Note that the valuation of brands as individual assets was not listed as a key investor requirement above. Yes, many investors will insist that they want to have an understanding of brand valuation so that they can protect their downside in case of a liquidation event, or where the brand is collateral for a loan. The problem with brands, however, is that they don't behave in the same way as tangible assets such as inventories and equipment, and they have very different legal properties from patents and other intellectual properties. In fact, brands are so intertwined with businesses that many experts have a hard time even defining what a brand is.

Even among sophisticated marketing professionals there is a general lack of consensus and understanding about the components of a brand. In fact, marketing courses at top MBA programmes will start the classes off with the question: "What is a brand?" The range of answers and interpretations is actually quite broad. Generally when defining the characteristics of a brand, the non-legal, non-financial aspects stand out: impressions, awareness, familiarity, loyalty, distribution, ubiquity.

Consider some of the key elements that go into a brand:

- Intellectual property rights – many intellectual property practitioners and analysts, too, often think that once they have defined the trademark, they have defined the brand. A company may have a trademark and that trademark may have value. However, a trademark alone does not allow a business to make money. A trademark is only a right to use a name over a particular class of goods and services; though, obviously, the broader the protection, the more valuable the trademark. Also copyrights, design patents and other IP rights can enhance the value of a brand. However, anybody can file a trademark application and get the right to use a name, and IP rights are not always difficult to establish. So, even though IP rights have been established, this does not mean that a brand has been created.
- Consumer awareness and attitudes – brands have major influences on the buying decisions of consumers. Coca-Cola and Gillette have huge advantages in their businesses over store brands and new start-ups because of the long and extensive marketing campaigns, and positive consumer experiences, that have been built up for years. If consumers do not know of a brand, then the ability of the brand to influence the purchase decision is marginal. If consumers have a negative view of a brand, then the brand actually deters purchase. Advertising, logos, visibility on shelf space, word of mouth, product quality and other factors play a major role in determining whether a brand evolves positive or negative consumer attitudes.
- Distribution – there are many brands that have positive name awareness and trademark protection, but for whatever reason have limited or even no distribution. If a product is not on shelf at a store, then no matter how strong the name, that brand will not be driving

revenues. Some brands actually are relatively weak compared to competitive brands in terms of name awareness, but are associated with excellent distribution relationships that allow for huge volumes of products or services to be sold. Distribution is a major factor in the strength of a brand, as at the end of the day loyalty is created through consumer experience with a product or service, not advertising.
- Product or service quality – getting to Warren Buffet's point in the quote at the beginning of this article, ultimately the product or service behind the brand is why consumers will part with their cash. Without a quality product, consumer attitudes can decline. With quality, consumers will have positive experiences. This is not to say that quality trumps all, as there are many quality products with weak brands that are unsuccessful.

Investors invest in businesses that generate cash flows; and because brands are so intertwined with other business components, analysing a brand as a discrete asset, separate from a business, is a strange exercise. After all, what good is one component of a brand if another is absent? If a brand is well known, but consumers can't buy the product, revenues cannot be generated. If a product is on shelf, but a brand is unknown relative to its peers, its margins will be thin.

Any trademark lawyer engaged in a transactional practice already knows this concept. For a trademark to be properly assigned from one company to another, it must be assigned with some sort of business value, which lawyers generally describe as associated goodwill. A trademark that is assigned without any associated business can nullify the underlying trademark rights because under the principles of trademark law, a trademark is an indication of source and to sell a brand without the goodwill means that the name no longer has any association with source. Similarly, for investors, valuing a brand without understanding the underlying associated business is just not possible.

Current brand financial reporting practices

How well are the above needs of brand investors met by current financial reporting and accounting practices? Not well at all. The financial data available to investors from GAAP accounting statements just is not sufficient to get a clear understanding about brands.

Case study: Fortune Brands Inc

To illustrate this, consider Fortune Brands Inc, a US$12 billion market capitalisation firm located outside of Chicago. Fortune Brands owns many major brands in three operating segments. Key brands in the portfolio include:
- Home and hardware – Moen, Masterbrand, Master Lock
- Spirits and wine – Jim Beam, Makers Mark, Clos Du Bois
- Golf – Titleist, Footjoy, Cobra

In 2006, Fortune Brands had US$8.7 billion in revenues, of which 54% was from the home and hardware segment, 31% from spirits and wine and 15% from golf. Fortune Brands is an interesting story. It was originally known as American Brands and was the owner of The American Tobacco Company. Fortune Brands sold off the tobacco company and, through a series of acquisitions and divestitures, it assembled the brand portfolio identified above.

The acquisition activity of the company has resulted in a great deal of goodwill on the balance sheet (see box on page 66).

According to the latest 10-Q of Fortune Brands, approximately US$8.45 billion of the company's total assets (about 56%) are intangible assets that are valued on the balance sheet after acquisitions. Theoretically, many of the individual brands are valued on the balance sheet in this goodwill number. How should an investor seek to understand this information?

Understanding goodwill

Many financial analysts are trained to look for goodwill on a balance sheet as the representation of a company's intellectual property portfolio. The belief is that goodwill represents all of the intangibles of a business, such as the brands, patents, business contracts and reputation, and if you want to understand the value of a company's brands all you need to do is understand goodwill. Unfortunately this is not the case.

First, goodwill is created and valued on a balance sheet only after an acquisition, so it ignores organically created intellectual property. For example, if Fortune Brands were to acquire a golf business (Golf A) with US$20 million of hard assets next year for US$100 million, US$80 million of goodwill would show up on the balance sheet under Golf A. However, if the company were to create its own new golf brand simultaneously from scratch (Golf B), spend US$100 million advertising the brand and grow a profitable business around the brand, the value of Golf B would be absent from the balance sheet. In both cases Fortune Brands spends US$100 million for a brand, but only in the case of Golf A will an asset show up on the balance sheet. So although Fortune Brands lists US$8 billion worth of goodwill on its balance sheet, one cannot be sure which of its brands are included in that number.

Second, even if 100% of the brands owned by Fortune Brands were acquired, the calculation and composition of goodwill on a balance sheet would be very difficult to understand. How companies attribute value to specific assets after a purchase is a highly subjective exercise that involves a number of assumptions and variables. Consider the statement of Fortune Brands from its most recent 10-K with respect to its goodwill valuation practices:

> "*Our predominant method of approximating fair value in determining whether an impairment exists is to use cash flow projections. We measure impairment based on discounted expected future cash flows attributable to the tradename compared to the carrying value of that tradename. When separate cash flow information is not available, we use the relief-from-royalty approach. Fair value is represented by the present value of hypothetical royalty income over the remaining useful life. Where information is not available to determine an appropriate royalty rate, we utilize a profit split methodology, which is a customary valuation practice, to establish a reasonable royalty rate. Profit split analyses allocate economic income (EBITDA less returns on working capital and fixed assets employed) between a tradename and residual assets of the economic unit in determination of the expected profit margin associated with commercialization of the tradename. Additionally, independent valuation experts are used for periodic review and testing of management's assumptions relative to all significant trade valuations and lives, and for independent research on market and competitive dynamics.*"

For all of the assets included in goodwill, Fortune Brands performs a complex valuation exercise that, as stated, is very hypothetical. The components of goodwill are not disclosed; neither are various valuation and projection methodologies involved. For any analyst to understand the composition of Fortune Brands' goodwill, that analyst would need to have full access to the internal valuation workings of the company and access to independent valuation experts. Importantly, all of the valuation exercises are tests to determine whether goodwill should be adjusted downward or impaired. There are no requirements to increase the valuation of a brand should the company find that its valuation results are higher than the carrying cost on the books.

Finally, it is not clear that this analysis even makes sense in the first place given the discussion of investor needs described above. As stated previously, in real life a brand would not be sold as an isolated asset separate from the cash-flow generating business components to which it is attached. If Fortune Brands were to sell the Jim Beam brand, for example, what would the transaction look like? For sure, the company would sell trademark rights and associated goodwill to satisfy the legal requirements for assigning a trademark. Beyond the trademark rights, the buyer of the brand would want a variety of things associated with the Jim Beam brand, such as product formulas, marketing plans and strategies. Are those portions of the Jim Beam brand valued on the balance sheet? Additionally, the asset purchase agreement might include various side agreements

Fortune Brands balance sheet (in $millions)

	30 Jun 2007	31 Dec 2006
Assets		
Current assets		
Cash and cash equivalents	150.8	182.7
Accounts receivable, net	1,316.2	1,165.3
Inventories		
Manturing spirits and wine	1,228.7	1,186.0
Other raw materials, supplies and work in progress	437.3	452.4
Finished products	564.5	548.6
	2,230.5	2,187.0
Other current assets	444.7	395.1
Total current assets	4,142.2	3,930.1
Property plant and equipment, net	1,949.1	1,948.5
Goodwill resulting from business acquisitions	4,350.9	4,345.6
Other intangible assets resulting from business acquisitions, net	4,109.9	4,096.9
Investments in unconsolidated subsidaries	183.1	179.0
Other assets	273.0	167.3
Total assets	**15,008.2**	**14,667.4**

relating to post-sale competition and indemnification provisions. No matter what the case, when the deal is done, it is almost a certainty that in the valuation of the brand, the FAS 142 valuation analyses of the Jim Beam brand are likely to have little bearing on the negotiation of the purchase price for the brand.

Solution: new metrics required

If companies want investors really to understand and value their brands, they cannot rely on their financial statements and assume investors are going to figure it out. The more that companies report brand-specific data, the better investors can understand the brands and develop valuation models of their own. This data would ideally include for any brand:

- Revenue size.
- Gross margins.
- Operating margins.
- Associated licensing revenues.
- Royalty rates.
- Target market.
- Name awareness in target market.
- Market share in target market.
- Market growth.
- Other data that may be relevant to a specific industry or sector.

Of course, providing all of this data may be cumbersome and potentially risky if it gives competitors insights into how to compete with the brands.

Fortune Brands does provide some extra-financial data about its brands. In its annual report there is great data about the brands that it wants investors to understand. Fortune Brands also publishes a fact sheet that is designed to give investors even more data about its brands. For instance, it lists its 25 largest brands (Moen had 2006 sales of US$1.05 billion, followed by Titleist at US$750 million). The fact sheet features a host of brand-specific metrics that provide colour on many of the brands owned by the company, including market share rankings, market trends and operating margins. For understanding and evaluating brand strength, the fact sheet is infinitely more valuable than the company's accounting statements.

New reporting standards

If one of the goals of the accounting system is to give investors clarity about a company's assets, the current system is not working. Ideally, companies would report the type of data described above in a standardised and consistent way. Rather than trying to understand an accounting system that does not work, investors should have access to data that actually matters. Ideally, companies would report data in a consistent way, where data is reported with agreed-upon methodologies, and this would allow investors more efficiently to evaluate and understand the value of a brand to the future cash flows of a business.

The Intangible Asset Finance Society's Trademark Committee, in pursuit of the Society's threefold mission of education, advocacy and the promulgation of standards, is now exploring best practices for trademark financial reporting and invites interested parties to participate. ■

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