Set the right royalty rate

Although not a big amount in itself, the royalty rate a brand attracts can lead to significant income for its owner. It therefore pays to make sure that you get the figure right

By **Thayne Forbes**

Changing a royalty rate by just a fraction of a percentage point can mean the difference between merely covering costs and generating huge profits. It is, therefore, of fundamental importance to both licensee and licensor that the royalty rate reasonably reflects the strength of the brand in a defined sector and territory in relation to its competitors, and is set by recognising the correct point on the supply chain.

There are a number of factors that can be applied to determine an appropriate royalty rate which deserve attention. First, the commercial context within which royalty rates exist needs examination to engender a full understanding of their application. Next, it is necessary to have a good understanding of the sales on which they would be based and, in particular, the price point in the supply chain on which royalties are to be based. Then a range of comparable royalty rates can be researched and market research can be used to position within that range. Profitability analysis will then give a view on the reasonableness of the royalty rate to the licensee to assess affordability. There are also a number of other considerations, such as marketing investment, which might impact on royalty rates. Given the significance of intangible assets to many businesses, and that royalty rates are often key in assessing their value, royalty rates will often be key to business and brand value.

Before any analysis aimed at quantifying a royalty rate, it is worth standing back and assessing why such analysis is needed. Licence agreements are drawn up for many reasons and support different strategies. Licensing might be the core activity of a business, it might be a deliberate exploitation of dormant intellectual property, it might be a strategy for markets which cannot be as well developed otherwise, or it might be a strategy for non-core product. So, as an example, the royalty rate for Smirnoff within a distribution arrangement for the Japanese vodka market might be, say, 40%, very different from a royalty rate for the same brand in the US confectionery market (say 5%).

Within a licence agreement, the royalty rate may be interlinked with other factors, most notably minimum royalty commitments and decreased royalty rates, once certain volumes are reached. Minimum royalties are often a commitment for some form of exclusivity or access to the brand in a market. Decreasing royalty rates could be used to incentivise the licensee to achieve higher volumes, as the unit cost of branded products then becomes less.

It is important, however, that the agreement benefits both parties because as the following example illustrates, it can go horribly wrong. Arthur Andersen, the accountancy firm, effectively licensed the use of its name to Andersen Consulting, the management consulting firm. Andersen Consulting wanted to extricate itself from paying for the use of its name, largely because it believed it was paying too much. Arthur Andersen asked as the price of extrication approximately US$14billion – a price at which Andersen Consulting naturally baulked. The case went to arbitration, which ruled that Andersen Consulting did not have to pay this but had to change its name, which it subsequently did, to Accenture. Arthur Andersen got a poor deal: it lost royalty payments, lost the goodwill Andersen

Consulting used to contribute to the Andersen name, lost the US$14billion, lost the settlement offers Andersen Consulting proposed and gained a raft of negative publicity. A little while later Arthur Andersen itself closed in one of highest-profile corporate disasters to date.

Licensing agreements

Licensing agreements relating to brands should, therefore, be designed to benefit and protect both the licensee and the licensor to ensure longevity and success. There are a number of key component sections to any successful agreement and these are discussed below.

Definition of brand

The brand must be defined with trademarks, copyrights and other relevant intellectual property identified.

Definition of sales

The price point to which the royalty rate is attached is one of the most important considerations. Two important price points are wholesale and retail. Retail prices are usually twice those of wholesale, so royalty income or payments can, say, halve or double, depending on where they are set.

Control over brand

Licence agreements do not give licensees carte blanche to use a brand wherever they like. Instead they allocate specific market sectors or products, channels and territories to which the brand can be applied. For example, if the Savoy Group wanted to leverage some of the value that resides in its portfolio of brands – such as, say, the Savoy Hotel, the Connaught and Claridges – it would need to maintain control of its brand's prestige, and so would be unlikely to allow distribution of products through supermarkets. Likewise, if the Savoy Group agreed to license a brand to a raincoat manufacturer, it would need to be stipulated that disposable bin-bag style raincoats were not allowed whereas a premium variety was. This may seem like common sense but unless it is actually in writing problems easily arise.

Even within the restrictions that are set out, approval still needs to be granted for activity from the licensor. This is to ensure that the use of the brand by the licensee is consistent with that of the brand owner: it must add value, not dilute the brand. A well-known example of brand dilution through licensing is Pierre Cardin. The Pierre Cardin name was licensed to appear on over 900 marginal products such as pushchairs, olive oil, frying pans, floor tiles, sardines, orthopaedic mattresses, socks, memory pillows, phone holders, pens, coffee pots and thermoses. Also, distribution was not controlled. Pierre Cardin products were retailing at knockdown prices in discount shops and the brand was seen on paraphernalia that many felt detracted from its core values. To be fair, however, Pierre Cardin defended his licensing position by stating that, putting the Euros 30 million profits it generates for him a year to one side, he felt his brands should be available to

Table 1

Market Analysis - Menswear Italy	Actual 2002	Actual 2003	Actual 2004	Forecast 2005	Forecast 2006	Forecast 2007
Overall economic indicators						
Population 000s	58,138	58,005	58,109	58,338	58,569	58,800
Private consumption per head (US$)	14,300	14,600	14,900	15,200	15,506	15,818
Specific apparel indicators						
All clothing, sales value (US$million)	28,267	28,782	29,283	29,727	30,177	30,635
Clothing sales per head	486.20	496.20	503.93	509.56	515.24	520.99
Clothing sales as a % of private consumption	3.40%	3.40%	3.38%	3.35%	3.32%	3.29%
Specific market segment data - menswear						
Market Value US$million	5,615	5,807	6,039	6,261	6,491	6,729
Competitor A share of voice	9%	9%	9%	9%	9%	9%
Competitor A market share	10%	11%	13%	11%	11%	11%
Competitor B share of voice	15%	16%	16%	17%	18%	18%
Competitor B market share	6%	7%	9%	11%	13%	15%
Our Brand share of voice	15%	17%	17%	16%	15%	15%
Brand market share %	23%	22%	20%	21%	23%	24%
Brand sales	**1,291**	**1,277**	**1,208**	**1,315**	**1,493**	**1,615**

everyone. He even adds: "If someone asked me to do toilet paper, I'd do it. Why not?"

Even if this was Pierre Cardin's philosophy, it may not be one that is shared by other brand owners. The example, therefore, highlights the potential need to impose limitations on licensing contracts. One way to achieve this is to ensure they include authorisation procedures.

Time periods

A specific time period needs to be set. Contracts can then be renewed, cancelled or revised at the end of the period, say five years.

Marketing commitment

As well as guaranteeing a royalty rate, minimum income and usually an initial amount, the licensor often insists on a guaranteed marketing commitment – either a percentage or a fixed amount. The licensor may contribute to marketing as well, but investment from the licensee is more usual. This can often affect the royalty rate: if there is no marketing commitment the royalty rate increases, if there is one, the royalty rate reduces.

Other requirements

There are a whole host of other requirements that are also included in a licensing agreement. One important one is the right for the licensor to have access to audit the licensee's company.

These factors will also influence, to a greater or lesser extent, the royalty rate. If a licensee agrees, for example, to contribute to brand marketing, then the royalty rate might be reduced to compensate for this. Invariably there is an initial amount paid to the licensor as well as a guarantee of minimum payments and expected forecast of royalty income.

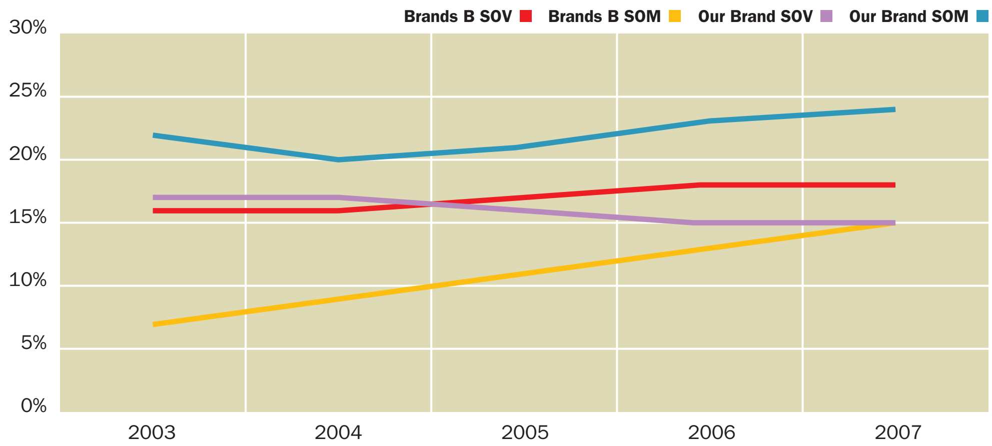
Brand valuation

Brand valuation has been around for a number of years now. The primary method used today is the relief from royalty method, which calculates the amount that a company would be prepared to pay for a brand if it did not already own it – as if it were operating through a licence, in other words.

An applicable royalty rate is therefore extremely important as a single percentage difference can significantly alter the value of a brand. The relief from royalty approach is the most commercial realistic approach and is used in a number of circumstances.

Licensing agreements do not always go according to plan. In licensing disputes, brand valuations are often used to determine the value lost to a brand as a result of a contract being terminated. If a soft drinks manufacturer suddenly reneges on the licensing agreement

Chart 1: **Brands market analysis**



it has with a brand owner, then there may be an entitlement for compensation based on a number of factors including the minimum royalties in the contract. Additionally there may be room for lost profits and brand value.

Brand valuations are required under specific circumstances under International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP). Here, a royalty rate can have a tangible effect on a company's balance sheet as a significant portion of the brand value – which has to be reported on the balance sheet.

Brand valuation is used for a variety of marketing reasons including market and opportunity analysis and calculating and monitoring return on brand investment. One of the most effective ways to use a brand valuation is in portfolio management. Identifying the value that all the different brands, licences, contracts, copyrights and patents contribute to the enterprise enables effective decisions on resource allocation to be made on an informed basis.

Once the context for a brand valuation is established, and if the relief from royalty method is the primary brand valuation method, royalty rates will be extremely important. They are also likely to have some influence over other valuation parameters such as forecast sales growth and the discount rate. The need for a thorough understanding of the mechanics that go into creating a royalty rate therefore becomes starkly apparent.

Sales on which royalties are calculated

Royalties are based on sales and so it is helpful to have an understanding of the market, its projected growth, competitor activity and the brand's market share. This will give projected

Chart 2

Supply chain	Raw material	Manufacture	Distribution	Retail
Price point	US$10	US$30	US$60	US$100
Royalty	US$5	US$5	US$5	US$5
Equivalent royalty rate	50%	17%	8%	5%

sales of branded products to which the royalty rate can be referenced. In Table 1, we set out an analysis for a hypothetical menswear brand in Italy. It can be seen that the analysis helps in assessing the branded sales which will ultimately drive the royalties.

Such an analysis brings greater understanding of the sales carrying the brand. Key figures can also be charted for an easier comprehension of trends and anomalies. For example, Chart 1 indicates that Brand B has gained market share rapidly and its share of voice now exceeds that for our Brand. Given that share of voice and share of market are generally thought to converge in the long term, this highlights an issue of how realistic the forecast growth in market share is, on which a royalty rate can be calculated.

Price points and supply chain

Even if a brand drives value at retail level, market dynamics may not allow for royalties to be charged on retail prices. The manufacturer may, for example, pay them to the brand owner, and the royalty rate will then be based on the manufacturer's price point rather than the retail price point. So a higher royalty rate will be needed to give the same royalties. This could mean that a royalty rate of 17% on the manufacture price point is equivalent to a royalty of 5% on the retail price point, as illustrated in Chart 2.

This chart illustrates the significance of positioning the royalty rate to an appropriate price point. Royalty rates at retail level, as the chart illustrates, are usually about 5%. If, however, this royalty rate were to be applied not at the point of retail but at the point of distribution, then the royalty income would only be US$1.50, a loss of US$3.50 per item sold. It is therefore of considerable importance that the point at which the royalty rate is applied is correct and stipulated.

Certain caveats are often included in licensing agreements to make them more affordable for licensees and more beneficial to the brand owner. Once a certain royalty level has been paid, the royalty rate can often decrease. This can serve as an incentive.

Benchmarks

For any royalty rate analysis it is useful to find out comparable royalty rates – any analysis is easier when relevant benchmarks in the market can be referred to. Comparable royalty rates can be obtained from a variety of sources, including:

- Analysis of existing available agreements. This can sometimes be, for example, a supply agreement for a range of goods including the use of the brand. Such agreements can be analysed to give brand royalties.
- Searching on the SEC database, which contains a number of disclosed licence agreements.
- Research or enquiry in the industry or comparable industries.
- Buying information from licensing database holders.
- Analysis of business acquisitions or share prices.

An analysis of comparable royalty rates can also reveal products and sectors not previously exploited. Such analysis exposes opportunities not previously considered. For example, if a charity such as Save the Children were to evaluate the use of its brand through licensing it might discover that other comparable charities, such as Oxfam, Barnados and the Red Cross, have

Table 2: **Illustrative brand strength analysis**

Factor		Score 0	1	2	3	4	5
Market factors							
1	Economic growth	1					
2	Substitution				3		
3	Strength of competition			2			
Brand factors							
4	Brand perception						5
5	Loyalty					4	
6	History, heritage, longevity					4	
7	Price premium					4	
8	Share of market					4	
9	Potential for line extensions					4	
10	Share of voice			2			
		1		**4**	**3**	**20**	**5**
	Total score						**33**

Scoring: Each factor is scored on a scale of 0 - 5, with 5 being highest. Scores are relative to the defined competitive set

Royalty rate range	**1.0%**	**7.0%**
Derived royalty rate		**5.0%**

considerably more successful; and licensing arrangements in operation that these arrangements contribute significant amounts to the charities' bottom line, enabling them to do more to help their causes.

Brand strength analysis

The next stage is to assess how a brand can be positioned in such a range. There are many ways in which this can be done but a simple and practical approach can be to use a brand strength analysis. This takes a number of key value drivers for a brand, based on market research, and scores the brand against those drivers relative to the competitive set. This then gives a score against a minimum and a maximum possible and is used to position the brand in the royalty rate range. An example of this is shown in Table 2.

Profitability

Royalties are a way of showing value brought to a business by a brand and determining compensation to the brand owner. Such value will often be based on the profitability of the business, together with other factors such as the strength of the brand. An analysis of this profitability can be done on a see-through basis across some or all of the supply chain. The resulting see-through profit can be attributed to various business functions, but one will be the brand. In the long term, royalties relating to this part of the supply chain will be a proportion only of the see-through profit. For commercial arrangements to be successful on a long-term basis the value brought by the brand will need to be shared by all concerned in bringing it to market.

Significance

Royalty rates are typically small percentages, but they are applied to sales figures, meaning that royalty values are often significant. They drive brand values that are in themselves often highly significant (the Malibu spirit brand was bought by Allied Domecq in May 2002 for £560 million – this transaction was mostly attributed to brand value). Given this significance they warrant in-depth analysis – so that significant decisions are made on an informed basis.

The royalty rate analysis illustrated in this article has been 5%. When applied to the forecast sales (in the illustration of brand sales in menswear in Italy) this gives significant annual forecast income of £80 million in 2007, and when capitalised as a brand value using a relief from royalty methodology it can amount to £674 million: significant by any standards.

What this article demonstrates is that there are important repercussions for the application of a royalty rate. It may be a tiny number, but that tiny number can generate untold millions for a brand in direct revenue, stimulate access to new markets, territories, products and sectors; increase the relevancy of the core product; and ultimately increase the overall value of the brand. Because so much is at stake, investment in setting an appropriate royalty rate – for both parties – is critical to ensure the success of the licensed products and brand. ■

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Table 3: **Territory: Italy, Segment: Mens Outerwear**

Discount rate	**10%**
Tax rate	**30%**
Royalty rate in 2005	**5%**
Profit growth rate after 2005	**2%**

All amounts in US$m	**2003**	**2004**	**2005**	**2006**	**2007**
Our Brand retail sales	1,277	1,208	1,315	1,493	1,615
Percentage change		*-5.5%*	*8.9%*	*13.5%*	*8.2%*
Royalty rate %			5.0%	5.0%	5.0%
Royalties			**66**	**75**	**81**
Taxation			20	23	24
Profit after tax			**46**	**52**	**57**
Discount factor			1.100	1.210	1.331
Present value			**42**	**43**	**43**

Value calculation	
Value to 2007	128
Value after 2007	546
Total Value	**674**