

Brand Value Management: The Achilles Heel of Many Risk Management Systems

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What Do We Mean by Brands?

A brand incorporates both the visual identity that is used to differentiate the offering of one supplier from another and the values and attributes that consumers attach to that identity.

The former can include name, logo, design, strap-line, and packaging, most of which can be protected by law. However it is the perceptions and images that consumers attach to the brand that create value and which need to be nurtured and protected. There are distinct risks and control procures for perceptual as opposed to functional performance and these will be discussed within.

The Brand as a Component of Shareholder Value

A rapid shift in the relative importance of the components of corporate value has occurred in the later part of the 20th century. In the past, shareholder value was largely explained by tangible assets such as land, buildings, machinery, and stock. However, more recently intangible assets, such as brands, patents, and know-how, have become increasingly dominant elements of company value.

The gap between market capitalization and net asset value has become particularly noticeable. A study carried out by Brand Finance revealed that in December 1998 only 28% of the FTSE 350's market capitalization was explained by their net balance sheet assets. Intangible assets are largely responsible for the remaining 72% of value. In most cases brands are the most significant intangible asset. This value gap is partly the result of stringent accountancy standards that make it difficult for companies to fully recognize their intangible asset base.

Despite these rules, intangibles are becoming more evident in balance sheets. This is reflected in a 7-year study by Brand Finance, which draws upon a static sample of the largest UK PLCs based on turnover. Our research shows that the number of companies capitalizing goodwill has increased from 5 in 1993 to 131 in 1999. In 1999, six companies specifically capitalized brands, while a further 32 capitalized other intangibles like patents.

Intangible assets as a percent of total net assets increased from 4% in 1993 to 14% in 1999. The increase over the period was particularly noticeable in 1998 following the introduction of Financial Reporting Standard 10 (FRS10). This standard requires companies to capitalize their acquired goodwill on the balance sheet, yet forbids the capitalization of valuable internally generated intangible assets. Despite the conservatism of FRS10, intangibles and brands are likely to increasingly represent a larger percentage of total company assets.

Risk Management

Risk management is the process of analysing exposure to risk and determining how to best handle such exposure. It is often defined as: "the identification, analysis, and economic control of those risks that can threaten the assets or earning capacity of an organization." A key component of risk management is the prioritization of risks according to their likely impact on the organization. Once the capital value and earnings ability of a brand are known, it follows that the risks attached to those earnings should be analyzed and appropriately managed.

Risk Management Implications

Given the significance of the brand in most organizations, it is only logical that the concepts of stewardship, accountability, protection, and risk management should be applied to them. Why devote more senior management attention to the less material tangible assets?

Yet company directors have been slow to understand the value of their brands and few adopt a clear method of assessing whether these assets are effectively managed. However the tide is turning and brand valuation techniques are increasingly being used to measure and track brand performance.

How Brands Create Value

It is the brand's impact on consumer behavior that tends to be the key area of value generation. Strong brands shift the supply curve upwards. They enable premium prices to be charged and higher volumes to be achieved. Enhanced consumer loyalty secures future earnings streams. During the last decade it has also become more common to stretch brands into new categories, thereby generating new earnings streams indeed the potential benefits of a strong brand are manifold.

The Risks

Brands display many common characteristics with tangible assets. Lack of investment and skilled management attention tends to result in gradual erosion of value, or slower growth than would

otherwise be possible. There is also a risk of sudden value losses that can be catastrophic if adequate risk management procedures are not in place.

Gradual Erosion of Value

It has already been stated that the values and attributes associated with a brand by consumers lead to brand preference, thereby influencing purchasing behavior. Brand preference does not just happen. It has to be developed through careful and skilled marketing support. Once achieved, brand preference is not guaranteed. Without ongoing support and reinforcement it will erode.

A number of power brands have maintained their premium position for over a century. Others, such as Rover and M&S, have recently suffered a decline. Such erosions of value are often only detected once significant damage has been incurred. If it is not being tracked, a decline in brand performance can be concealed by other factors until it reaches the chronic status.

Four factors contribute to the erosion of brand value in many companies:

- the role of the brand in the business model is not understood;
- advertising budgets are regarded as discretionary;
- brand stewardship is not entrusted to senior management; and
- brand performance is not systematically monitored.

Sudden Destruction in Value

Brands are based on a relationship of trust with consumers. This trust takes a great deal of time and capital to develop. A breach of that trust however can occur alarmingly quickly. The impact on consumers' perceptions of the brand and their purchasing behavior can be equally alarming.

Perrier, Farley's, Exxon, and Shell are all companies that have faced disasters that had the potential to decimate the value of their brand. These disasters tend to occur as a result of a functional defect in the underlying product. The impact of this, if unchecked, is to breach consumers trust in the brand and impair the favorable image attributes that were previously associated with that brand. The resulting damage to the brand can be far harder, and more costly, to repair than the functional problem that initiated the disaster. In this respect the relationship between brand and consumer is no different to personal relationships based on trust.

Risk management systems should limit the likelihood of disasters occurring. An analysis of the impact of such catastrophes must incorporate an understanding of the long-term impact that the event will have on brand image and preference. All disaster recovery programs should quantify the financial impact of a damaged reputation. An appropriate level of response can then be built into the risk management program. A vital and inexpensive component of any disaster recovery programme is a swift and appropriate public relations exercise. As long as this is accompanied by the necessary actions, the trust that lies at the heart of the brand's relationship with consumers can be maintained. Crisis management has undoubtedly become a key component of risk management and fundamentally seeks to protect the company reputation with consumers and other relevant publics.

The Remedies

In the likely event of a brand or a portfolio of brands representing a material value, that value should be understood and tracked over time. Additionally, an understanding needs to be developed of the factors that impact on the strength and value of the brand. This provides a better understanding of the nature and scale of risks to brand performance and brand earnings.

In the event of a company not currently being aware of the value of its brand and the risks attached to that value, we would recommend a brand audit as a first step.

Brand Audit

The purpose of a brand audit is to identify and evaluate the existing practices and procedures that are used to develop, support and track brand performance. The audit should cover procedures governing the determination of brand strategy; the use and remuneration of external agencies; levels of marketing accountability; methods used for budget determination and allocation; and availability and use of market research.

The marketing audit will provide a rapid identification of inadequacies in marketing procedures and practices that place an unnecessary risk on brand value. It is often the case that a number of areas of risk can be reduced with minimal expenditure or time lags. It also provides an effective 'situation analysis' that allows a brand tracking and brand risk process to be developed.

Best marketing practice dictates that brand audits should be integrated into ongoing management procedures.

Brand Tracking

At the end of this article we provide an overview of current brand valuation methodology. A brand valuation can be carried out from time to time in order to measure whether value has been added or

destroyed in the period under review. However, we advocate that a brand valuation system should be integrated into a broader reporting process that facilitates effective value-based brand management. This serves the dual purpose of improving brand management procedures and allowing a more regular and thorough review of brand risk.

A brand performance scorecard is an appropriate means of displaying key brand performance measures. This should be informed and supported by a segmented brand evaluation model.

The key measure on a brand scorecard is the movement in brand value during the period under review. In order to provide a better understanding of the brand's current and potential future performance, the value measure is typically supported by perceptual, performance, and customer measures.

Performance measures such as market share and sales growth rate are indicators of the brand's current market position. Perceptual measures, on the other hand, are lead indicators and provide a gauge of future performance. Measures included under this category might include brand awareness, familiarity, and preference. The final grouping of measures provide an insight into the return being generated from the brand's customer base. Customer satisfaction, churn rate, and the proportion of earnings made from core customers can be included in this part of the scorecard.

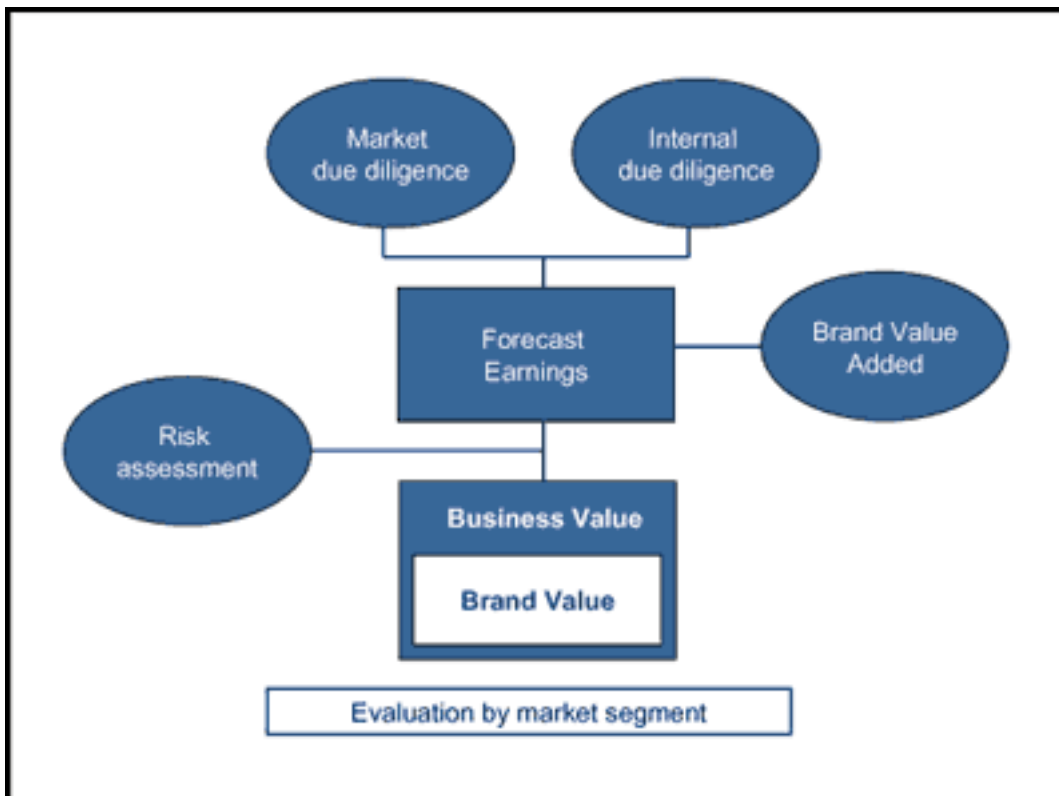
This four-pronged evaluation of brand health will allow management to respond swiftly to any changes in the brand's operating environment or performance. It will also allow management to measure potential risks and brand value fluctuations and react accordingly to minimise or avoid that risk.

Brand Valuation Methodology

In order to assess the scale and nature of the risks attached to a brand, a greater understanding of the brand within the business is required to illustrate the brand's contribution to earnings. This makes an 'economic use' valuation, which is based on future brand earnings, an appropriate methodology for risk management purposes. This methodology provides the detailed understanding of the brand's role in a company's business model. There are typically five work streams in this approach to valuation:

- segmentation;
- forecasting financial performance;
- brand value added (BVA.) analysis;
- risk assessment; and
- valuation and sensitivity analysis

A snapshot of this approach is illustrated below:



(i) Segmentation

In applying the valuation framework, one of the first and most critical tasks is to determine the nature of the segmentation for valuation purposes. It is then important to identify how internal financial and marketing data and external market and competitor data can be obtained in a way which fits with the chosen segmentation.

The principles behind effective segmentation for brand valuation purposes are:

- Homogeneous geographic, product, and customer groupings to ensure that the valuations are relevant to defined target markets.
- Clearly definable set of discrete competitors in each segment.
- Availability of market research data to match the chosen segmentation.
- Availability of volumetric and value data for competitor.

There is little point in choosing a valuation segmentation based on an aggregation of product or customer groupings that obscures important underlying differences. Equally, there is little point in choosing a detailed segmentation against which it is impossible to obtain volumetric or value data to the appropriate level. Without these it may be hard, if not impossible, to estimate relative market shares and to compare performance and forecasts against competitors.

(ii) Forecasting Financial Performance

As the valuation is based on the net present value of future earnings generated by the brand, it is essential that the financial forecasts are as realistic as possible. This necessitates an understanding of the market in which the brand operates, the competitive landscape and the strength and sensitivity of the brand. The initial study is into the trends within the sector or category within which the brand operates. Account must be taken of the impact of economic, technical, legal, and other macro-factors on the market volumes and margins. In assessing the likely share of the market that will be achieved by the brand, it is necessary to evaluate its historic and probable future strength in relation to the competitor set. This is best achieved through a competitive benchmarking study that also provides a feed into the assessment of the risk attached to future earnings.

It is also necessary to review the cost structure of the brand, specifically the relationship between brand investment and brand performance as well as production costs at different levels of output.

This analysis will result in market based financial forecasts rather than the internally driven budgets and forecasts that many companies produce. If extensive analysis is carried out, it is possible to develop a dynamic forecasting tool that allows key assumptions to be flexed.

(iii) Brand Value Added

It is this part of the valuation process that specifically identifies the extent to which future earnings are dependent on the brand as opposed to other drivers of value. This can be achieved either by quantifying the brand's contribution to the purchase decision or by a royalty relief calculation. Both methods are based on a study of market research.

Large sample trade-off research identifies the relative importance of the brand's impact on the purchase decision. The weighting of the brand contribution, in comparison to price and various functional attributes, is likely to vary between market segments. In certain instances, econometric modelling is a useful tool for isolating and quantifying the impact of the brand and marketing activities. This technique is based on statistical analysis of historic data, whereas trade-off research is based market research into consumer decision making. In both instances the quantification of the brand contribution is used to strip out earnings that are generated by the brand as opposed to other drivers of value.

(iv) Risk Assessment

The fourth step in the brand valuation is to determine the appropriate discount rate to use in the DCF analysis. Many companies already have weighted average cost of capital (WACC), which can be applied as the discount rate. Where this is not feasible, we build up the discount rate from first principles as follows:

$$\text{Discount rate} = \beta_{\text{Brand}} \text{ adjusted cost of equity} \times (\text{proportion of equity funding}) + \text{cost of debt} \times (\text{proportion of debt funding})$$

$$\beta_{\text{Brand}} \text{ adjusted cost of equity} = \text{risk free rate} + (\text{equity risk premium} \times \text{sector beta} \times \beta_{\text{Brand}})$$

This is derived from the Capital Asset Pricing Model. The 10-year risk free borrowing rate in the geographic market under review is the starting point. The equity risk premium is the medium-term excess return of the equity market over the risk-free rate. This sector specific discount rate is finessed to take account of the relative strength of different brands in the given market. We call this β_{Brand} analysis and generally base it on the key criteria that, in our view, represent the best indicators of risk in that business.

A score of 50 implies that the brand offers average investment risk in the sector under review and therefore attracts a β_{Brand} of 1. This means that the discount rate used in the valuation will be the average composite rate for the sector.

A score of 100 implies a theoretically risk-free brand that would be discounted at the risk-free rate. A score of 0 implies a particularly weak brand, which doubles the equity risk premium.

(v) Valuation and Sensitivity Analysis

The result of the foregoing analysis is a branded business value for each segment identified. The branded business value expresses the full net present value of the business earnings in each segment.

Conclusion

Brands have become an important business driver and value generator. Brands and other intangible assets have also over the last decade become an increasingly large fixture in the balance sheets of listed PLCs. These two factors make brands a valuable commodity that needs to be managed and protected. Managers need to ensure that they have a thorough understanding of their brands and the value that they generate; this is possible by conducting thorough brand valuation and brand tracking studies as outlined within this piece.

Brand valuation and brand value trackers enable managers to measure and monitor any changes and potential decreases in value and react appropriately to minimize any potential falls. This proactive form of brand risk management needs to be backed by the more reactive crisis management and contingency plans in the event of an avoidable crisis. Such crises may impact upon customers' perception of the brand and company and in turn impact negatively on revenue streams.



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