

# The role of trademarks in M&A

Those engaging in the M&A process could be making a major mistake if they fail to give serious consideration to the brands involved in the potential deal

By **Tim Heberden** and **David Haigh**

Brands are still sadly neglected in the planning of many M&As. Some transactions are clearly brand-centric, for instance P&G's acquisition of Gillette, Hicks Muse buying Jimmy Choo and Oxford Industries' acquisition of Ben Sherman. Even so, the complexities of brands can expose the acquirer. Quaker Oats can vouch for that. In 1993 the company paid US\$1.7 billion for the Snapple brand. Four years later the brand was sold to Triarc Beverages for US\$300 million. The astonishing loss of value was compounded by the fact that in 2000 Triarc sold the brand to Cadbury Schweppes for about US\$1 billion.

Intangible assets account for the bulk of corporate value. In many segments brands are the dominant intangible asset and informed business valuations are not possible without an understanding of the role they play in revenue generation. Yet in many transactions the risks and potential of brand earnings are not fully understood. This greatly increases the likelihood of either overpaying for a business, or of missing a good acquisition opportunity through underbidding.

Further complications are added by International Financial Reporting Standards (IFRS) and increased tax scrutiny. IFRS requires that acquiring companies disaggregate goodwill into specific categories of intangible assets. This can have an impact on future profits as a result of amortisation differences and possible impairments. Tax authorities are focusing their attention on the inter-group charging for the use of trademarks. Inconsistent and unsupported transfer pricing can result in significant contingent tax liabilities.

## Are brands and trademarks the same thing?

Although the focus of this article is on trademarks, it is often necessary to group trademarks with other marketing intangibles that, in the minds of consumers, are bundled together to form a brand.

The term brand has no legal definition and is not the subject of a single identifiable right. The visual identity of a brand incorporates its name, logo, get-up and design. These can be protected by trademarks, copyright, design rights and common law. Other intellectual property rights can also be bundled into the brand definition despite being separate rights. For instance, in some food and beverage categories recipes and trade secrets would not be sold or licensed without the accompanying trademark.

From a valuation perspective, IFRS are driving practice relating to the separate identification of categories of intangible assets. The accounting standards state that if intangible assets are complementary and could not be separately sold, then they should be recognised as a group of assets. On the other hand, if the individual fair values of the complementary assets can be reliably measured they should be separately recognised, unless they have similar useful lives.

In this article we use the term brand to describe trademark and related marketing intangibles, bearing in mind that the specific intangible assets included in this description will vary on a case-by-case basis.

## Importance of brands

Brand Finance recently conducted a study of all companies quoted on the world's major stock markets. This showed that the majority of corporate value is not reflected in balance

sheets. Our Global Intangibles Study revealed that almost 70% of total enterprise value was represented by unreported intangible assets.

Inevitably, we found that the proportion of intangible asset value varied from sector to sector. Over 90% of global technology company valuations were intangible and most sectors displayed intangible values in excess of 50% of enterprise value.

The dominant intangible asset class also varies from industry to industry. In the pharmaceutical industry the key IP is molecular patents. In the IT industry it is software IP rights. In the film industry it is creative copyrights and in consumer goods sectors the key IP is often the trademarks or brands.

In most sectors brands are significant corporate assets and informed valuations cannot be made without an understanding of their revenue generating ability (and associated risks). Yet brands have traditionally received limited attention from boards and marketing has operated independently from the rigorous financial evaluation that is applied to other investments. This lack of rigour often flows through to M&A planning.

**How brands create value**

Prior to addressing the specific implications of trademarks in the due diligence preceding an M&A, it is useful to consider how brands create value.

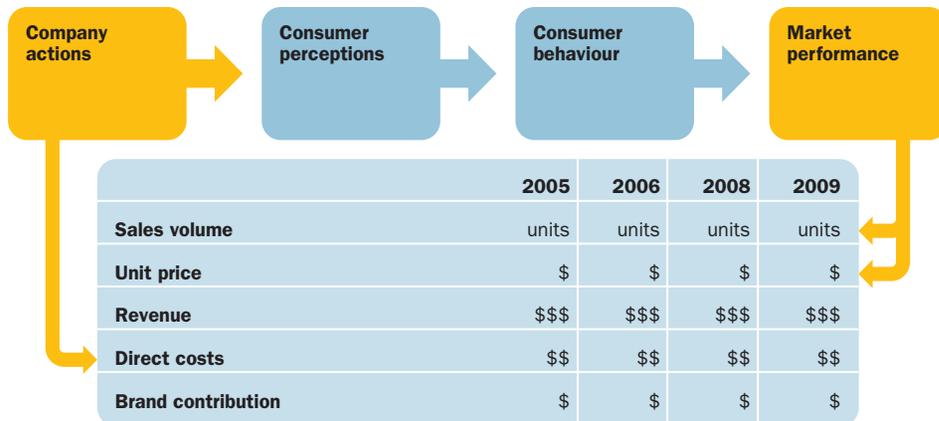
Brands influence the perceptions and behaviour of consumers. The shift in consumer behaviour drives cash flows through:

- Price premiums.
- Higher sales volumes.
- Reduced volatility in earnings streams.
- New earnings streams.

The influence of consumers' perceptions on their behaviour is often illustrated by blind tasting tests of drinks brands. An individual's choice between two brands is often reversed when they are aware of the brands as opposed to a blind tasting. This illustrates how brand preference shifts the demand curve by driving incremental sales volumes or a higher price. Enhanced consumer loyalty also increases the security of future earnings streams.

During the last decade, companies have started using strong brands more aggressively. New earnings streams are generated by stretching the brand into new categories and markets. This can be done by the brand owner or by licensing the brand to a third party. The benefit of licensing is that it does not consume capital and, if properly

**The role of brands in the value chain**



managed, reduces risk.

Brand can also influence the perceptions and behaviour of staff, investors and other corporate stakeholders. This too can increase the value of an enterprise.

**M&A implications**

A 360 degree understanding of trademarks and associated marketing intangibles is an essential component of a corporate transaction. This should cover:

- Ownership and protection.
- Future earnings.
- Management capabilities.
- Financial reporting.
- Contingent tax liabilities.

**Trademark ownership and protection**

This is the domain of intellectual property lawyers and will not be covered in detail in this article.

Some components of brands lend themselves to specific types of legal protection, namely names, symbols, logos, strap lines and get-up. Different forms of legal protection are available for each component. As a result, a brand owner must rely upon a mixture of trademark, copyright, design right, common law and codes of practice for legal protection. These must be combined in order to be able to evaluate the level of legal protection enjoyed by a brand as a whole. Sub-categories such as colour, shape, sound and design must also be considered within each component.

VW's purchase of Rolls Royce Motor Cars from Vickers in 1998 is a classic example of getting it wrong. Only after paying £493 million for the business, two-thirds of which was for goodwill, did VW realise that

the coveted Rolls Royce trademarks belonged to another company, Rolls Royce Plc. These were subsequently sold to BMW for a mere £40 million.

#### Future earnings

Brand equity, the aggregation of consumer brand perceptions, is a lead indicator of consumer behaviour and sales. Brand equity is constantly shifting. It is influenced every time the consumer has any direct contact with the brand, or is influenced by advertising or word of mouth. It has to be evaluated in order to forecast sales sensibly. It is important for a potential acquirer of a brand to know whether its brand equity is stable, in decline or strengthening.

It is this intangible component of a brand that is most likely to be damaged by poor management. Recent history is littered with examples of the destruction of brand value, either through gradual erosion or in more dramatic fashion. This is often as a result of brand owners forgetting that the consumer is the ultimate arbiter of a brand's worth.

The reverse also holds true. There are many cases illustrating the extent to which value can be created by revitalising an under-performing brand. This is not a recent phenomenon, and has become a favoured hunting ground of private equity players.

Misunderstanding the current strength of a brand and new management's ability to revitalise it can be expensive. The US\$1 billion write off made by Quaker in respect of Snapple is one example. Vodafone's US\$23 billion write off of goodwill is a bigger and more recent wake up call.

Both the risk associated with current brand earnings and the potential to generate incremental earnings should be considered.

Questions to ask when evaluating risk associated with current earnings include:

- Is the strength of the brand, relative to competitors, adequate to achieve the forecast market share and earnings?
- Are there any changes in consumer requirements or new products that will challenge forecast growth rates?
- Is the level of brand investment sufficient to drive forecast sales?

When looking for upside potential, there are other issues to evaluate:

- Is the brand punching below its weight? Can its performance be improved in its core markets?
- Does the strength of the brand enable it to be used in new categories or markets?
- Can new earnings streams be developed

through trademark licences?

- Are there any opportunities to leverage value through tax or structured finance?

There are also portfolio implications to assess:

- Will there be any cannibalisation within the brand portfolio of the merged company?
- If a change in brand architecture is required, what are the risks and opportunities?

#### Management capabilities

Good brands do not become valuable by accident. Value is created by good strategy, skilful marketing and customer service that matches the brand promise. Academic research has supported the fact that strong internal branding capabilities result in better market performance. These capabilities cannot be bought or developed overnight. In particular, the cultural changes associated with strong internal branding require time and inspired leadership. The converse is that a lack of branding capability destroys brand value.

The due diligence of a successful brand owning company should evaluate the branding capability of both the target and the acquirer. Should the acquirer lack the capabilities that have enabled the target to develop strong brands, consideration has to be given to how plausible it is for the merged entity to retain the brand management expertise of the target and to benefit from its brand-centric culture.

#### Financial reporting

Since the introduction of IFRS, trademarks and other acquired intangible assets have to be separately recognised on the balance sheet. At the date of acquisition, the acquirer must allocate the cost of the business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities at their fair value. This requires the disclosure of specific categories of intangible assets that are separately identifiable, controlled and are a source of future economic benefits that can be reliably measured. The accounting standards specifically refer to the following types of assets: marketing related, customer related, contract based, technology based and artistic related.

In the past goodwill was amortised over its useful economic life, which was presumed not to exceed 20 years. It now has to be recorded at cost less impairment charges – amortisation is not permitted.

Similarly, the new standards require estimates to be made of the useful life of all intangible assets. Those with an indefinite useful life are to be subject to an annual impairment test.

Greater transparency, rigorous impairment testing and additional disclosure result in the risk of future impairment charges and enable greater scrutiny of future performance by the market. This is starting to have a significant impact on the way that companies plan their acquisitions.

In terms of pre-acquisition planning, a detailed analysis of all potential assets and liabilities is required in order to assess the impact on the consolidated balance sheet and post-acquisition P&L. This has to take account of the expected future use of the intangible assets.

For instance, assume that during the pre-acquisition planning process 25% of the anticipated cost of a business combination is attributed to its portfolio of trademarks. This should trigger a thorough review of how these trademarks will be used in the future.

In the event of the acquirer planning to migrate its existing brand names to acquired products, there will be an impairment charge to the P&L in future years. The identification and attribution of value to intangible assets are complex. In this case further investigation might have revealed that value should also have been attributed to other specified marketing intangibles and customer based intangibles. This could have a material impact on future reported profits.

Even factors such as a reduction in the level of advertising support for a brand might infer an impairment in its value.

IFRS also introduces new disclosure requirements; the principle requirement being the disclosure of the key assumptions used to measure the recoverable amounts of intangible assets. The gist of all this is that once value has been ascribed to trademarks and other intangible assets, there is little room to manoeuvre in the future.

#### Contingent tax liabilities

Traditionally, companies have devoted significantly more attention to the management of tangible assets than intangibles. Prior to the last quarter of the 20th century this was understandable, as the bulk of corporate wealth was generated by tangible assets. As a result, the ownership and management of trademarks within multinational groups has often developed on an *ad hoc* basis.

In instances where a trademark is owned

in one jurisdiction and used by operating companies in other jurisdictions, there is the potential of transfer pricing disputes. This could be with the tax authority in the home market, claiming that foreign operating companies are under-paying for the use of the trademark. Alternatively, tax authorities in local markets might claim that profits are being stripped from their jurisdictions by excessive charges from the use of the trademark.

Many multinationals have increased the likelihood of transfer pricing disputes by being inconsistent in the trademark royalty charged to group companies and third parties. Tax authorities in countries such as the US, the UK and Australia are increasing their focus on both in-bound and out-bound royalties. Resulting back payments of tax and penalties can be highly material. Nasty surprises of this sort should be avoided by incorporating a review of trademark licensing in the due diligence.

#### Brand due diligence

How can you tell whether a company's performance has peaked due to a worn out portfolio of brands, or whether the best is yet to come? A brand due diligence encompasses the necessary 360 degree brand evaluation and provides an independent opinion, expressed in business valuation terms, covering financial, commercial and legal angles.

It breaks down the performance of the target enterprise into segments, which represent homogenous markets. Within each market segment it interrogates forecast revenue on the basis of category trends, competitive forces and brand strength. At a macro level the due diligence considers the financial reporting and tax implications of trademarks and other intangible assets.

The diagram on page 41 illustrates how a thorough brand due diligence informs a purchaser's understanding of the intrinsic value of a business. An overview of each component of the study follows.

#### Components of a brand due diligence

The due diligence exercise can be broken up into a number of parts. Each one plays an important role in ensuring the integrity of the overall process.

#### Market mapping

The market might be segmented by brand, region, product category, channel or customer group. Growth rates, competitors and margins often differ significantly between market segments so the granularity

#### Anticipated asset split of target company

##### Enterprise value (US\$)

Residual goodwill:	US\$10m
Contracts:	US\$12m
Patents:	US\$15m
Trademarks:	US\$25m
Net tangible assets	US\$35m

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Residual goodwill:	US\$10m
Contracts:	US\$12m
Patents:	US\$15m
<b>Customer based intangibles:</b>	<b>US\$10m</b>
Trademarks:	US\$15m
Net tangible assets	US\$35m

### The components of a brand due diligence

Size of market segment	units	units	units	units
Estimated segment growth	%	%	%	%
Relative brand equity	score	score	score	score
Market share	%	%	%	%
Sales volume	units	units	units	units
Unit price	\$	\$	\$	\$
<b>Revenue</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Unit cost of sales	\$	\$	\$	\$
Advertising and promotion	\$	\$	\$	\$
Other variable costs	\$	\$	\$	\$
<b>Contribution</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>

- 1. Market mapping
- 2. Customer and brand evaluation
- 3. Marketing capabilities audit
- 4. Financial evaluation and valuation
- 5. Financial reporting and tax review

**Note:** Items 1, 2 and 4 are carried out for each market segment

tends to yield more insights and a better grasp of value than a study carried out at an aggregated level. In addition to forming a view on growth trends within each segment, the study will benchmark performance among the leading brands.

#### Customer and brand evaluation

The twin objectives of this evaluation are to quantify the extent to which the brand drives earnings in each market segment, and the strength of the target company's brand relative to competitors.

#### Marketing capabilities audit

The track record of the current management team in marketing and brand development. This looks at things such as:

- Brand management systems and procedures.
- The impact that a change in ownership is expected to have on brand performance.

#### Financial analysis and valuation

This will cover a number of areas:

- Margin analysis within each market segment.
- Level of brand investment and how this compares to competitors.
- Comparable analysis covering margins and multiples.
- Discount rate.
- Development of valuation model, with the ability to flex key assumptions.

#### Financial reporting and tax review

At a macro level the due diligence attributes the value of the enterprise to intangible assets categories, and considers future amortisation and impairment scenarios.

Additionally, internal and external licences are scrutinised and compared to industry norms to assess whether there is a risk of transfer pricing disputes. The structure of trademark ownership within the group is also reviewed.

#### Deliverables of a brand due diligence

Once the due diligence process is completed, the body that requested the exercise can expect to have an independent opinion on a number of crucial issues. Such as:

- Expected growth rates and competitive forces in key market segments.
- The strength of the target company's brands, relative to competitors.
- Forecast market share and revenue for the existing and proposed marketing strategies.
- Operating risks associated with brand forecasts.
- The resulting enterprise and brand value.
- Unexploited opportunities to leverage the brand. These may stem from brand extensions, licensing, structured finance or tax planning.
- Existing transfer pricing policies and procedures, and the risk of tax audits.
- Indicative split of the enterprise value into asset categories, and the P&L impact of the amortisation of intangible assets.

#### Pain avoidance

Brands touch most operational areas of a business. As a result, M&A planning cannot be limited to the legal due diligence of trademarks. In many instances, commercial due diligence touches on the issues mentioned in this article; however, in the absence of a multi-faceted brand due diligence there is a risk of either overpaying for a business or missing a good acquisition opportunity through underbidding. New accounting standards mean that there is no place to hide. Avoid the pain of future impairment charges. Carry out a multi-faceted brand due diligence. ■

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