## PROFITABILITY

# Brand Licensing Does Not Come at Zero Cost

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Many people think that brand licensing is easy money earned along the way, with royalty income representing net profit. In reality, it is far from that. What most people forget is that brand licensing requires resources, efforts, time and some investment. As a result, the net profit resulting from licensing can vary between 95% of royalty revenues and as little as 0%. The following article discusses spending, cost structure and profitability aspects and illustrates best practice in brand licensing.

### Licensing Strategy

There are different strategic approaches to brand licensing, resulting in varying importance of profitability and financial results of the licensing initiative. Some licensors engage in brand licensing simply to earn additional revenues and to improve their financial results. In this setting, licensors are usually cost sensitive and try to minimize expenses related to licensing. On the other hand, some licensors do brand licensing to enhance brand value. Their brand alignment and licensing functions are more intense and strict, and they accept to re-invest substantial parts of their royalty revenues into the activity. And still others do brand licensing to protect the trademark in other classes or territories and thereby prevent third parties from free riding or counterfeiting the brand.

For instance, cigarette and liquor brands started brand licensing activities in order to bypass advertising bans in their core categories. Their goal was to enhance brand value, not to earn additional money. Similarly, designer brands reinvest most parts of their revenues from licensing to run their "core business" which is haute couture, fashion shows and PR.

Depending on its strategic approach, brand licensing requires different management styles. Some companies have centralised, others have decentralised licensing management structures. The centralised licensor tends to control its licensees and their brand related activities—at higher cost, whereas in decentralised licensing the licensees operate rather independently and non-aligned with the business of the licensor—at lower cost. The budgeting method may also influence the cost of licensing. While some licensors base their budget decisions on defined functions and how to perform them effectively, others base it on "usual ratios" or rules of thumb as percentage of revenues.

### Licensing Functions

Licensing functions can be broadly split into two different areas: acquisition and ongoing management. During the acquisition phase, functions include: searching potential partners, due diligence, negotiating deal points, finalising and signing the contract. Sometimes, licensees simply drop in by chance. Usually, acquisition takes not only time (between 6 and 18 months), but also substantial legal support, while revenues from that license relationship are still far away in the future. The costs to initiate and acquire a contract can range from 5% to 50% of the total lifetime cost. Thus, acquisition is an important cost driver.

During an ongoing contract, the licensor's functions include: business strategy/planning, product management, trend previewing, product design guidance, product quality testing, new product and marketing approvals, graphics and artwork, photo shoots, marketing and sales programs, auditing and compliance, reporting, collecting royalties, and contract renewal. Trademark protection is not a function in itself, but may still be very costly.

Major cost drivers are the product innovation rate, the extent of common integrated marketing initiatives, and the number of common customers/sales channels to be coordinated. I.e. fashion licensing is cost intensive because of product innovation (hundreds of new products every season) and point of sales integration (shop-in-shops integrating different categories including both own and licensed products). By contrast, food licensing with fewer products and less innovation can be managed at much lower costs.

The licensor's time needed to manage a brand licensing contract should be no less than 10 mandays of an experienced license manager. For important contracts this figure can increase above 200 mandays. 35 mandays is a good approximation for an average figure to start with.

### Level of Integration

Some licensors require their licensees to buy selected services from them, or even assume selected core functions of the licensee. The payment for such functions can be by unit prices and effective use (i.e. for photo shoots), or by a percentage of sales (i.e. central marketing or sales). As a result, the licensor has additional revenues. As the licensor does not make profits on such functions, his overall profit margin (as % of revenues) will decrease.

Some licensors, i.e. Ralph Lauren, go even a step further and provide centralized advertising and/or sales functions for their licensees. The cost for such centralized services is either invoiced directly to the licensee, or compensated through an additional percentage on licensed revenues. Again, this part of the value chain is "not-for-profit"; all such revenues of the licensor are expensed.

Such centralized functions do however change the profit margin of a licensing division quite substantially (see exhibit 1). Assuming a trademark royalty rate of 7%, an advertising contribution of 3%, and an expense ratio of 50% of trademark royalty revenues, the overall profitability drops from 50% (case 1) to 35% if advertising is centralized (case 2). The more centralized licensing management, the lower is the profit margin of the licensor.

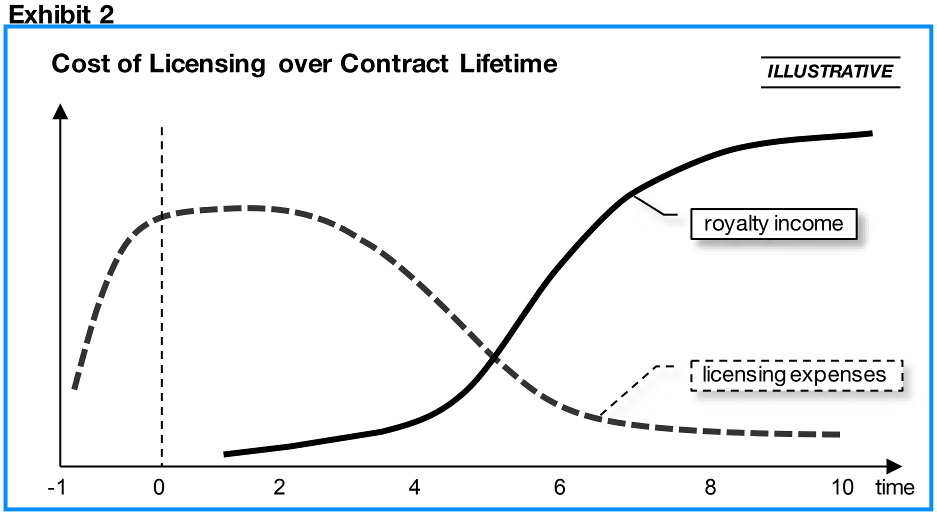
**Exhibit 1**

| | Case 1 | Case 2 |
|---|---|---|
| licensed sales | 1,000 | 1,000 |
| trademark royalty revenues 7% on 1.000 | 70 | 70 |
| advertising royalty revenues 3% on 1.000 | - | 30 |
| **total revenues** | **70** | **100** |
| licensing expenses 50% of 70 | 35 | 35 |
| advertising expenses | - | 30 |
| **profit** | **35** | **35** |
| **profit in % of revenues** | **50%** | **35%** |

### Life Cycle

Royalty income is changing over the life cycle of a contract. During the acquisition phase, income is zero. The launch phase - between contract signing and availability on the shelves - typically takes 12 months, depending on product and development. After that, it often takes 7 to 10 years to reach maximum sales (see exhibit 2).

**Exhibit 2**




Licensee acquisition costs occur during the phase of zero income. Ongoing management costs are still high during the launch phase, but more or less constant over time once licensed products are launched and brand values aligned. As a result, budgeting licensing costs as a constant percentage of royalty income is not really helpful. A flexible approach to budgeting costs according to the contract life cycle is needed.

### Contract Size

Another important aspect is the royalty income per contract. While costs to manage and control a specific contract do barely depend on licensed turnover, royalty income does. Therefore, a contract generating higher royalty income is expected to be managed at lower (relative) costs than a contract with low royalty income. Accordingly, contract size must be considered in budgeting costs of licensing management.

### Contract Portfolio

After all, it is the total portfolio of licensing contracts, their position in the life cycle, and their specific contract sizes, that determine the appropriate costs of licensing. A young licensing initiative requires a much higher cost ratio than an established program with many established and successful licensees.

### Agency Cost

There is no statistical survey available on average expenses in licensing. However, the commissions charged by full service licensing agencies might serve as a first indicator. According to a study on “Best Practices in Trademark Licensing” published by EPM in 2003, agent’s commissions range from 10% to 40% of royalties, with the most common range being from 25% to 35%. Considering that “make” (having an inhouse licensing department) or “buy” (outsourcing the licensing activity to an agent) is often a question of size, critical mass and factor cost, agent’s commissions are likely to be higher than the cost of an in-house licensing function. However, even with the best agent, some functions and costs remain with the licensor, i.e. securing and defending the trademarks, design guidance, marketing and sales integration, some approvals, etc. Therefore, the range of agent’s commission cited above represents only 60% to 90% of total costs. As a result, costs of licensing could vary from 15% to 60% of royalty revenues. In practice, the range is even larger. While a few licensors spend little more than 5%, others spend even 100% of total royalty revenues.

### Some Case Studies

Boxing brand Everlast is a good example for very efficient, low-cost licensor. Prior to being acquired by Sports Direct in 2007, Everlast was able to run 88 licensees in a global brand licensing program with only three licensing executives. The licensing program generated US$ 13.4 million in licensing revenues at US$ 0.9 million cost, or 7%. This could be achieved despite low average royalty revenues of US$ 150,000 per contract. Cost per licensee was US$ 10,000. This figure even covers the considerable efforts of Everlast to acquire new and replace old licensees.


Another efficient brand licensing program can be found at Guess Inc., the US fashion brand. Guess Inc.'s revenues from licensing amount to US$ 111 million in 2014. Here, the cost of licensing is 9% of licensing revenues, or a profit margin of 91%. In this case however, the licensor's average cost per license amount to US$ 650,000 per year, or 65 times the amount of Everlast.
Ralph Lauren Inc., the US designer brand, ranks among the champions in brand licensing. Total royalty revenues reached US$ 182 million in 2013.


Operating income from licensing was US$ 130 million, or 71%. Ralph Lauren spends on average over US$ 2.5 million per year on each licensee, showcasing the level of management and support Ralph Lauren provides to its licensees.


The three cases discussed above show different profit margins, as well as different cost levels per licensee. Still, the profitability levels are very high in all three cases, as is typical for brand licensing divisions. However, these cases do not account for the original cost to build the brand; typically, licensing divisions get the brand "for free". In this regard, Iconix Brand Group Inc. is an interesting case study.

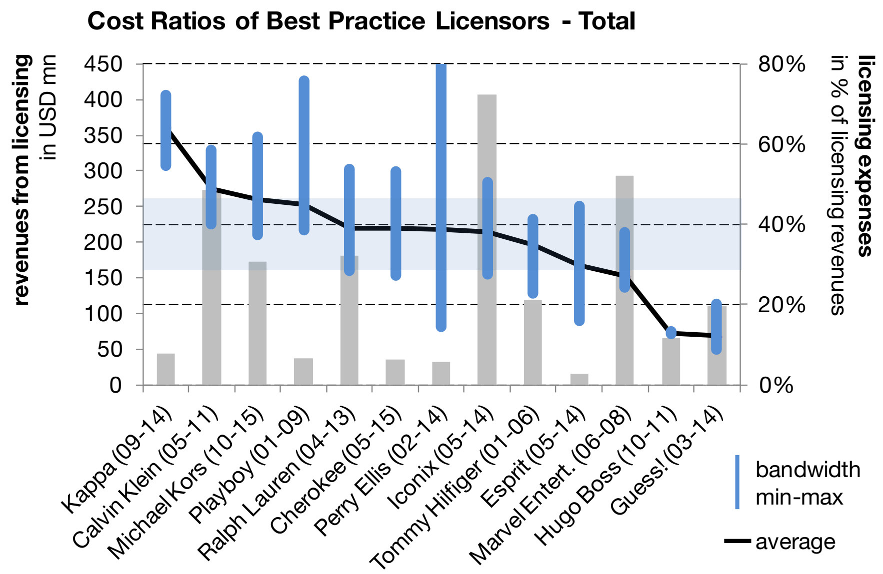
Iconix is a pure licensing management company with currently 35 brands, nearly 1.200 licenses and licensing revenues of US$ 407 million. However, Iconix acquired all of its brands (including some license agreements) from third parties, usually from insolvency or restructuring situations. In contrast to the other three cases, Iconix is not in a position to use its brands "for free" but has to bear the cost of financing and depreciation for the acquired brands. Iconix's average operating expenses are 38% of revenues or USD 175,000 per licensee. In addition to that, expenses for depreciation and interest amount to 14% of licensing revenues, adding up to a remaining profit margin of 48%.

ICONIX
BRAND GROUP, INC.

### Best Practice Licensors

Some of the most successful brand licensors run their licensing business as a separate division. According to the rules of segment reporting under IFRS 8, a licensing business must be reported in

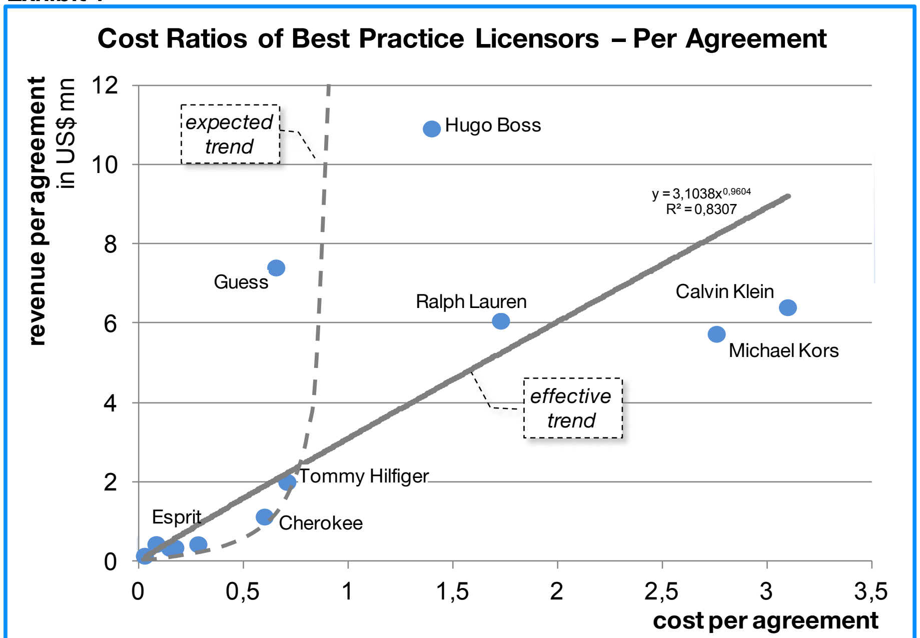
Exhibit 3




Source: financial statements, Capstone Branding analysis

separate accounts if its operating profit makes up 10% or more of the company's total operating profit. Brand licensors falling under this rule have to disclose revenues, costs and assets of their licensing business in the context of their financial reporting. We have identified 13 such companies with annual royalty income of US$ 20 million and higher. These companies represent a total annual royalty income of US$ 1.8 billion from licensing their brands in some 3.000 license agreements. All of them are well-known, successful brands which are successfully licensed to third parties since many years. Moreover, all of them maintain fully staffed licensing offices with experienced licensing professionals to manage, support and extend their licensed businesses. Considering the size, the long history and the stability of their licensing operations, one should expect that they all left the high-cost start-up stage and moved into a cost-effective, stable and well-organized stage. There is reason to call them the "Best Practice Group" in brand licensing—not necessarily because they are cost-efficient, but simply because they are large, successful brand licensors since long.

Exhibit 4




Source: financial statements, Capstone Branding analysis

## Best Practice Cost Ratios

Exhibit 3 illustrates the annual royalty income (bars in grey) and the bandwidth and average of operating costs related to licensing (not including D&A and interest expense) over a couple of years observed which is indicated in brackets behind the company name. Some of the licensors ceased reporting the licensing business as a separate segment at some point in time, for different reasons (i.e. being acquired, delisted, or no longer material).

Here are the key findings:

• There is nothing like a "typical approach" to brand licensing. The average licensing cost ratio of the thirteen companies varies widely between 12% p.a. and 64%. Some licensors decide to re-invest very substantial parts of their royalty income, others decide to operate more "economically".

• Only two out of the thirteen (Guess!, Hugo Boss) operate below the 20% cost ratio threshold.

• Surprisingly, licensing expenses are anything else than a constant. All companies (except Hugo Boss with only 2 observable years) show a considerable bandwidth of cost ratios over time, reflecting:

a) substantial fluctuations of royalty income (i.e. through one-time payments or accruals and deferrals at year-end) and

b) "strategic spending" based on needs of licensees and/ or market.

• If there is something like a "typical" cost ratio of brand licensing, this would be somewhere between 30% and 45% of licensing revenues. The overall average is 35% which is fully in line with our earlier estimates. To be clear, this ratio must be considered best practice. Less important brand licensors (smaller licensing businesses, younger licensing initiatives) tend to have higher average cost ratios.

• When looking at the cost ratios, one must consider the royalty rates charged by these licensors. Royalty rates per licensor range from 5% to more than 10%, with a mean value of 8.5% on licensed revenues. Licensing businesses with lower royalty rates will show higher cost ratios.

• There is no direct correlation between growth of royalty income, and cost ratios. Expenses seem to be variable; on average, expenses increase as fast as revenues. However, if one looks at cost ratios in the maturity stage of a licensing activity, a (very) slight decline of cost ratios can be observed with decreasing revenues and/or number of agreements. Thus, an important share of licensing costs is determined by the licensor's attempts to grow the business.

Moreover, it would be reasonable to expect a size effect of cost ratios. In particular, relative costs (or cost ratios) would decrease with increasing revenues. However, no such effect can be observed in exhibit 3. An expected size effect of costs would result from step-fixed cost, or parts of the costs that are constant per agreement and decrease with increasing revenue under an agreement (agreement-fixed costs). Exhibit 4 illustrates this correlation between average revenue and average cost per agreement for the thirteen companies.

• The expected trend line (dotted line) describes the effect that there would be something like a decreasing cost per agreement, or even a maximum cost per agreement.

• In practice, such effect does not exist. The effective trend line (bold line) shows a very small (immaterial) contract-fixed size effect of licensing. Apparently, licensing costs do not depend on the contract size, and thus are not contract-specific.

• Instead, they depend on other factors, like size of the product range; rate and number of new products launched; degree of involvement of licensor in product design and communications; stage of the initiative in the lifecycle, cooperative marketing and sales; integration of activities.

## Conclusion

There is no successful brand licensing business without significant investment from the licensor – both upfront and ongoing. There are very few success cases with expenses below 20% of revenues from licensing. The typical long-term cost ratio of best practice licensors is between 30% and 45% of revenues. This holds true for the best licensing brands. Weaker brands will need to spend even more to achieve long-term success. Many licensors try to harvest brand licensing by underspending. While this approach might pay off in the short term, it might have an unhappy ending. True and sustainable partnerships are a give and take. Strong licensees do not only expect a strong brand, they also expect the licensor to invest and to seriously support the licensing initiative as a long-term profit center. If it is no more than just a cheap cash cow, they will not renew and turn elsewhere. Numerous brand licensors have vanished. Some because their brand became weak. And some for not giving enough back into the business and to their licensees. It is very clear that a serious brand licensing business needs an adequate operating budget.

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Christof Binder is a veteran in brand licensing. Since 1994, he is president of Germany based Capstone Branding GmbH, an advisory firm specializing in brand licensing, brand transactions and brand extensions. As an advisor to both brand licensors and licensees, he was involved in over 2,000 brand license partnerships in Europe and worldwide, of which he initiated close to 500. He is known as one of the leading experts in Europe on royalty rates and licensing economics. He also acted as financial expert in trademark valuation, as well as in trademark infringement and transfer pricing litigation issues to courts and arbitration panels in Europe. He is a regular author and speaker on brand licensing, royalty rate and brand valuation issues. In addition to Capstone Branding, he is one of the founders and a managing partner of MARKABLES, an online database for the valuation of brands.