# 361°

## White Papers on Brand Diversification and Brand Licensing

**No. 6**


# THE COSTS OF BRAND LICENSING INCURRED BY THE LICENSOR

# PART II—EMPIRICAL FINDINGS

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*The **361°** White Papers Series of Capstone Branding is dedicated to share new findings and pivotal thoughts on brand diversification, brand licensing and brand partnership issues that are not (yet) published. Capstone Branding and the authors appreciate any comment, supplement or dialogue to this white paper. Please direct your contributions via email to the authors.*

## SUMMARY

*Most people and even some valuation experts think that royalty income from brand licensing is easy money representing net profit. Far from it! What people forget is that brand licensing requires resources, efforts, time and investment.*

*We have presented some issues of licensing functions, costs, cost structure and profitability in brand licensing in our White Paper No. 3 in October 2011. This following paper supplements our earlier contribution by new empirical data on the group of “best practice licensors”, and reveals some surprising findings which even disprove parts of our earlier argumentation.*

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## EXPENSES IN BRAND LICENSING

There is no statistical survey available on average expenses in licensing. In White Paper No. 3 we have cited different examples with expense ratios ranging from <10% up to 100% of royalty income:

- Everlast: 7% expense ratio, 10K $ per llicense
- Guess: 10% expense ratio, 650k $ per license
- Iconix: 36% expense ratio, 85 k $ per license
- Ralph Lauren: 31% expense ratio, 2.5 mn $ per license

The figures from these examples are in line with costs for outsourcing brand licensing programs to full-service licensing agencies. 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%. 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 commissions cited above represents only 60% to 90% of total costs. As a result, costs of licensing could vary from 10% to 60% of royalty revenues.

## BEST PRACTICE GROUP

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 detailed in 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 details and profitability of their licensing business in the context of their financial reporting. We have found 12 such companies with annual royalty income of 20 mm USD and higher. These companies represent a total royalty income of 1.750 mm USD from licensing their brands and 3.000 licensing agreements. All of them own

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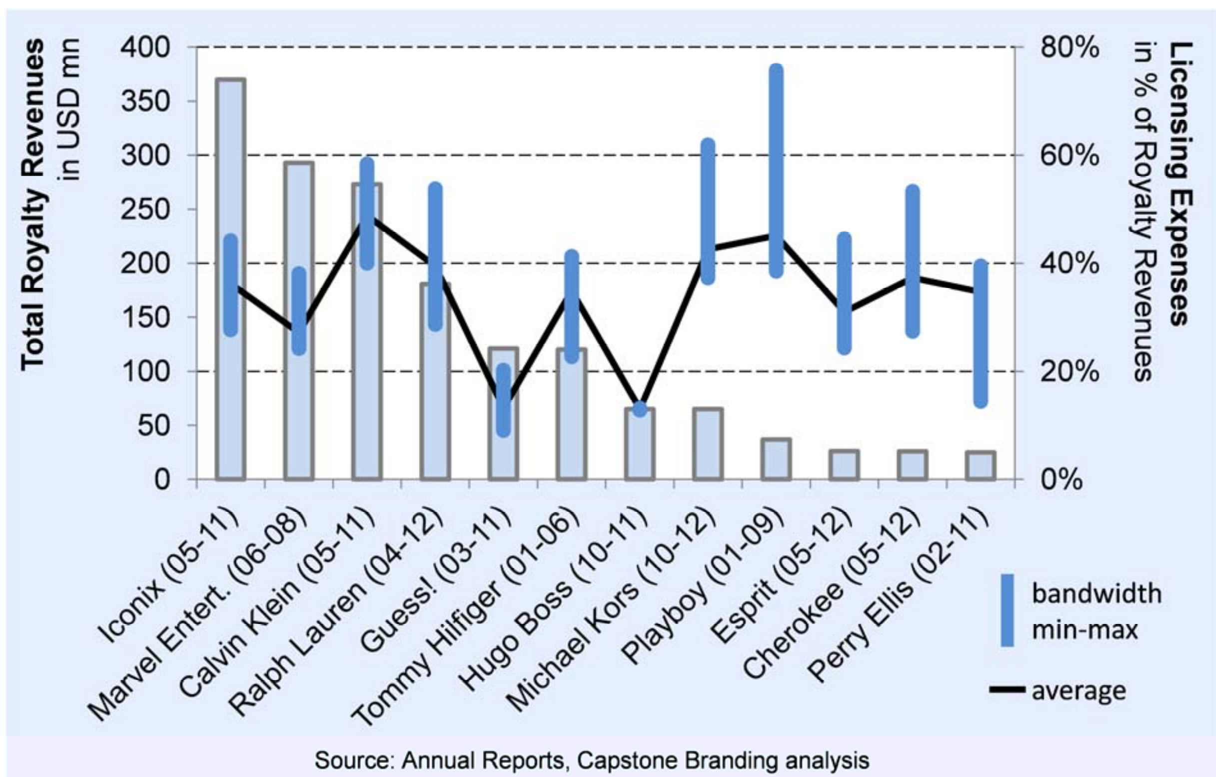
well-known, successful brands which they successfully license to third parties since many years. All of them maintain powerful licensing offices with experienced licensing professionals to support, position and extend their licensed business. Considering the size, the long history and the stability of their licensing operations, one should expect that they all moved far beyond a high-cost licensing start-up stage 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.

## BEST PRACTICE COST RATIO

The following graph shows the annual royalty income (bars) and the bandwidth and average of operating costs related to licensing (not including D&A and interest expense) over a couple of years observed (indicated in brackets after the company name).




Source: Annual Reports, Capstone Branding analysis

Here are the key findings:

- There is nothing like a “typical approach” to brand licensing. The average licensing cost ratio of the twelve companies varies widely between 13% p.a. and 50%. Some licensors decide to re-invest substantial parts of their royalty income, others decide to operate more “economically”.
- Only two out of the twelve (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) through “strategic spending” based on market needs.
- There is no direct correlation between (positive or negative) growth of royalty income, and cost ratios. Expenses seem to be variable; on average, expenses increase or decrease as fast as revenues.
- There is no law of expenses decreasing with size and growing income.
- The overall average is **35%** which is fully in line with our earlier estimates. To make it very clear: this is the best practice ratio. Less important brand licensors (smaller licensing businesses, younger licensing initiatives) will have even higher average cost ratios.

## COST DEGRESSION EFFECTS

From the graph above it is obvious costs do not decrease with size or revenues. In a second step, we analyzed the existence of step-fixed costs. This would describe the effect that costs behave according to the size of agreements (not the overall size of the licensing business). High-volume agreements could be managed at lower cost, and vice versa. For this purpose, we divided for each licensor the royalty income and expenses by the number of licensing agreements in place, arriving at average revenue and cost per agreement (see graph).

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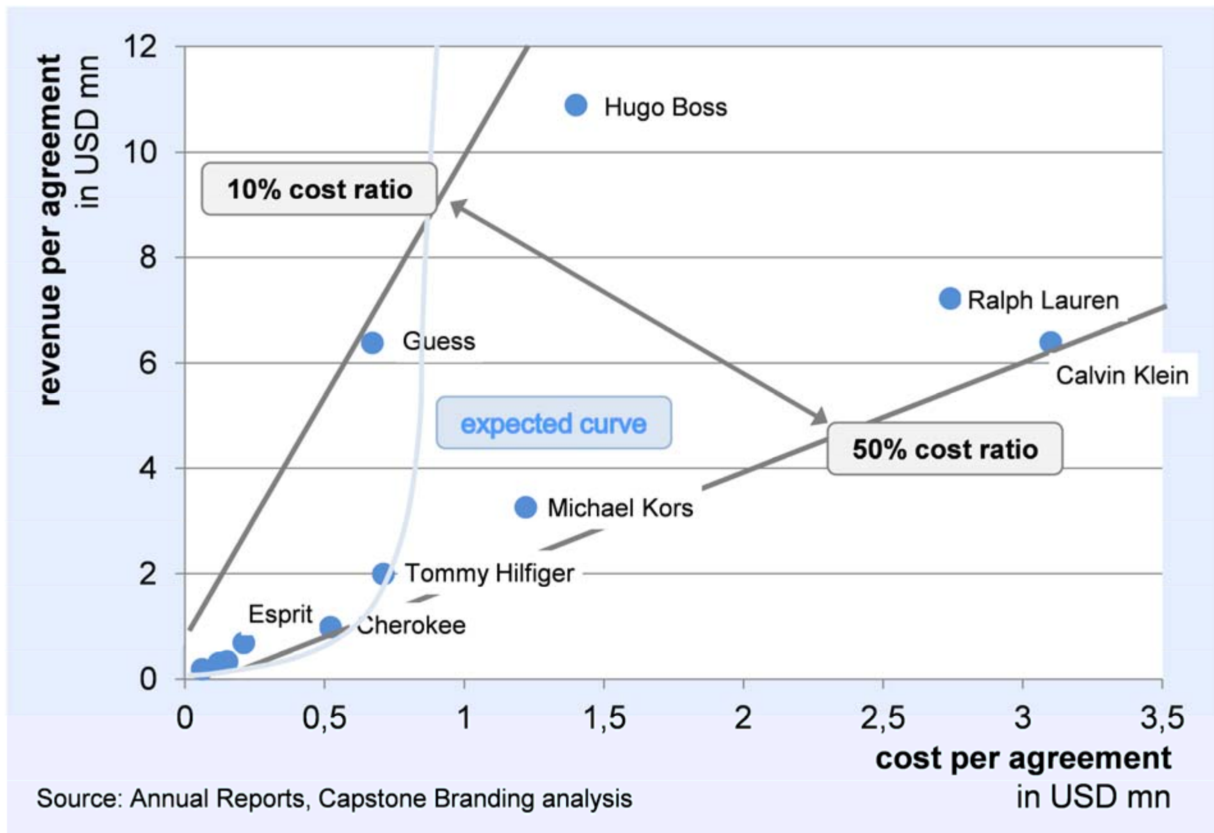

Source: Annual Reports, Capstone Branding analysis

- The "expected curve" (bright blue) 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. 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; cooperative marketing and sales; integration of activities.

## CONCLUSION

*Costs related to brand licensing activities are substantial. Although it is hard to find general patterns of expensing, it was made clear that costs are on average 35% and more licensing revenues, and that such costs do not decrease with either overall size or contract size.*

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