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THE MECHANICS OF MINIMUM GUARANTEES PART II - ACTUAL TO MINIMUM

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SUMMARY

The minimum guarantee is the most frequent deal breaker in brand licensing negotiations. While the licensee tries to minimize risk and future financial obligations, the licensor's intention is to secure as much of his (insecure) future revenues from the deal as possible.

While both parties negotiate the license agreement under a large deal of uncertainty and risk, it is interesting to understand how the revenues actually achieved during the lifetime of the agreement relate to the figures fixed years before in the agreement.

The following paper discusses the „actual to minimum ratio" (AMR) both theoretically and empirically. It is important to understand that AMR is not constant over time. Between parties that negotiate on a par with each other, the average long-term AMR turns out to be slightly below 2.0.

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THE MINIMUM IN NEGOTIATIONS

While the two parties that negotiate a trademark licensing agreement normally manage to find an agreement on the royalty rate, they often dispute the minimum guarantees much more intensively. This is logical if one considers the binding consequences of such guarantees. The licensee tries to minimize her risk by lowering the guarantee to a minimum, whereas the licensor tries to maximize his own financial benefit. The guarantee is often the major deal breaker during negotiations. In any event there are very few trademark licensing agreements without such a minimum guarantee.

It is common practice that a specific part of the expected turnover is defined as guarantee or minimum turnover which is the basis for minimum royalty payments and for termination rights. The objective of the licensor is to secure or even collateralize as much future revenues as possible by provisions in the agreement.

Usually, negotiations on licensing agreements start on the basis of a business plan first submitted by the licensee and eventually refined during discussions. In a later step, the figures in the business plan lead to a minimum or a guaranteed business plan. Accordingly, the minimum or guaranteed business plan is on average 55%-60% of the original business plan.

THE “ACTUAL TO MINIMUM” RATIO

Another, even more interesting issue is how the actual figures during the execution of the agreement relate to the minimum figures that were fixed earlier when the contract was signed. We all know that there are cases where the licensee constantly falls short of reaching the minima, as well as cases where the licensee outnumbers the agreed minima by far. The guarantee is an expression of the common denominator of business expectations and risk disposition of both sides at the time

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when the contract is negotiated. The question here is whether these expectations are rather conservative or rather optimistic, or in other words how do actual revenues compare to revenues originally fixed in the guarantee?

This phenomenon can be measured as the "actual to minimum ratio" (AMR). It should be higher than 1, otherwise the penalty that is linked to the minimum (i.e. cancellation right or renewal right) would fall due. In practice, the ratio is rarely stable over time as revenue growth in reality differs from growth that was modelled in the minimum clause of the contract (typically a linear growth path).

THE AMR IN THEORY

Firstly, we look at how in an average license relationship between experienced parties negotiating at eye level the AMR would typically develop. Therefore, tt is important to understand that the AMR develops in different stages (see graph):

- We start with a first time license (dark green line). The first 5 year term would typically start at a ratio of 1.2 and then increase up to 3.0 at the end of the first term. After the first term of 5 years, the licensee would draw the renewal option during which the minimum is normally kept rather flat. Due to further growth, the ratio would further increase from 3.0 to 5.0 after year ten (bright green line). At the end of the first renewal term, licensor and licensee would discuss an extension of the contract. As both sides have now high certainty about the achievable revenues, the minimum will be increased to a level that is much closer to the last actual figures. As a result, the ratio will drop drastically from 5.0 to 1.2 and increase slightly to 1.5 in year 15 (blue line).
- A completely different case is when an established, successful

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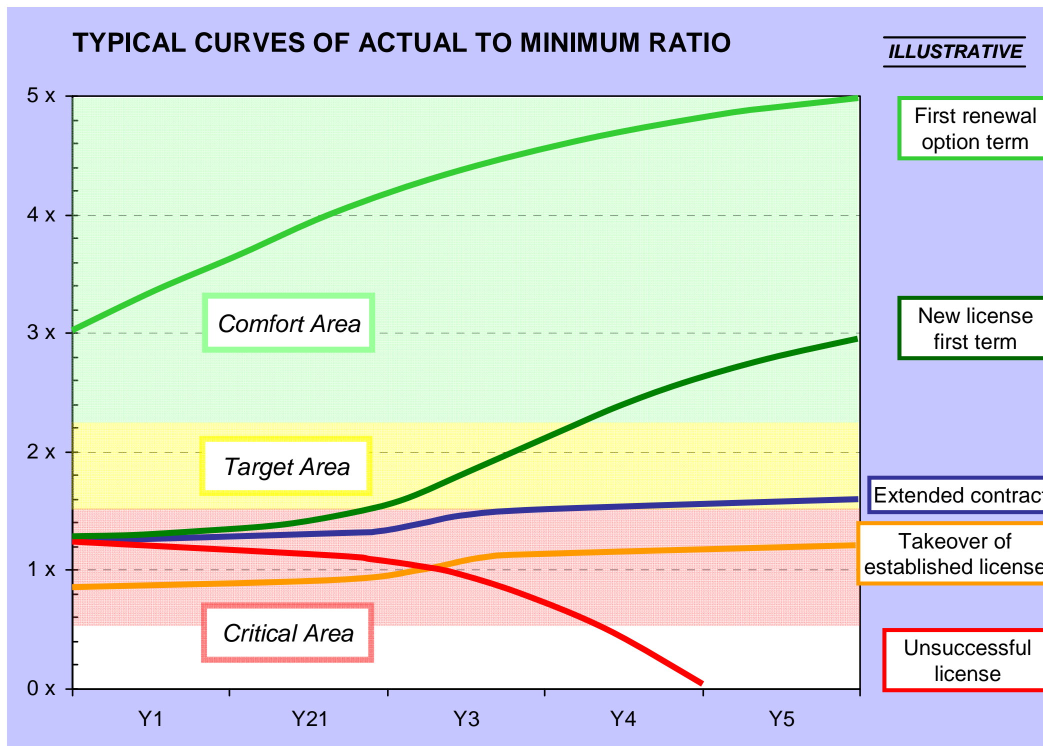

license is switched from one licensee to another (golden line). Here, the ratio typically starts below 1.0 because the relapse due to the switch is commonly underestimated. Later on, the ratio struggles to exceed the 1.0 value during the next 5 years.

- A typical unsuccessful license would start at 1.2 and then decrease to values below 1 (red line). As a consequence, the licensor would either terminate or suggest not renewing into a second term and the licensee would then cease its efforts. In this case, the licensee was either inexperienced or in any way dependent on getting the license or otherwise in problems.

We resume: the AMR depends very much on the date in the lifetime of a license. Under uncertainty, i.e. at the beginning of a contract, the target area of the AMR should be between 1.5 and 2.25. Under certainty, i.e. when the license is established in the marketplace, the AMR may range somewhere between 1.0 and 1.5.

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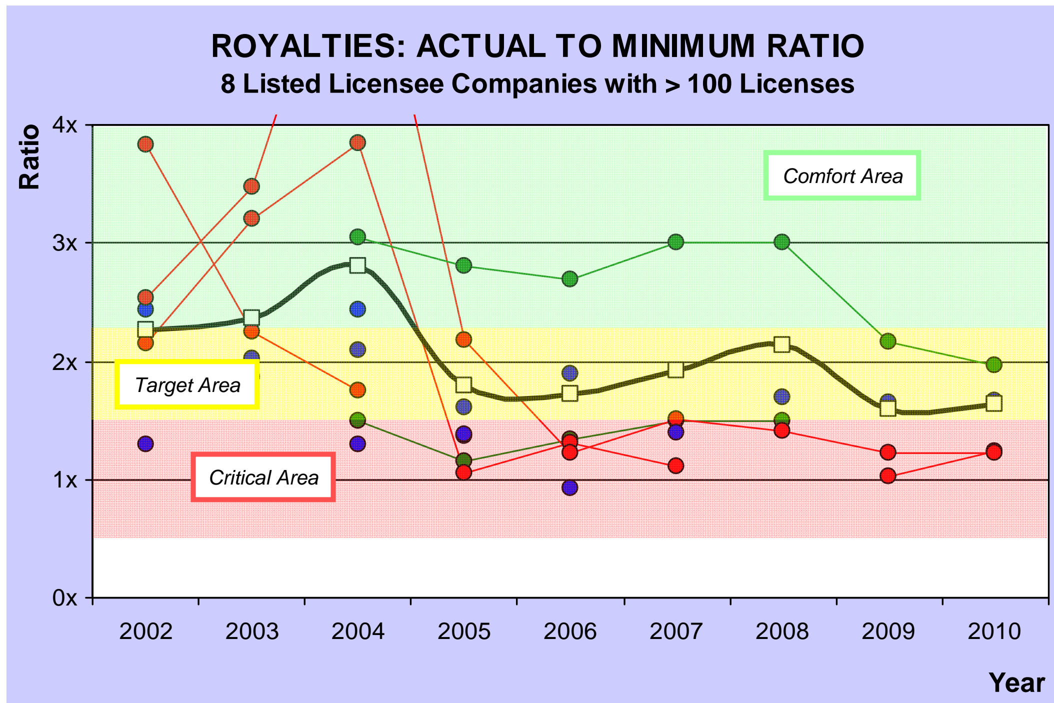
THE AMR IN REALITY

To better understand the ratio in practice, we analyzed the annual reports of a number of listed licensees that report both their effective royalty payments for the last year as well as their minimum royalty commitments for the next year. The licensee companies analysed include Luxottica and De Rigo (eyewear), Inter Parfums and Parlux (fragrance), Fossil (watches and jewelry), G-III Apparel and Kellwood (fashion), and Wolverine (footwear).

This sample might look arbitrary, but it represents over 100 different licenses and 350 Mill US$ in annual royalty payments. All companies have long experience as licensees; their licensed brands include some of the most notable and successful brands in the world (i.e. Chanel, Prada, Versace, Ralph Lauren, Armani, Adidas, Diesel). Some brands are licensed several times in the sample in different product categories (i.e. Burberry, Calvin Klein, Paul Smith). It must be assumed that the results of the sample best represent licensing negotiations on a par level playing field *"between knowledgeable and willing parties, on the basis of the best information available"* (IAS 38). Our analysis covers the period from 2002 to 2010. Of course, inexperience or dependence on one side of the table would lead to higher or lower ratios. The results of the analysis are shown in the graph as "actual to minimum ratios".

The yearly ratios are average ratios for all licenses of a licensee company; they vary between 1 and 6.2 (scaled off in the graph), meaning that the actual royalty payment is between 1 time and 6.2 times the minimum. A number of different findings can be drawn from the analysis:

- The average ratio (black line) of all companies varies between 1.5 and 2.8 around a mean value of 1.95. It used to be higher until 2004, and then dropped to about 1.6, then increased again to 2.1



Source: Capstone Branding, analysis of annual reports of:
Luxottica, De Rigo, Inter Parfums, Parlux, Fossil, G-III, Kellwood, Wolverine

in 2008, to finally decrease again to 1.5. It is obvious that ratio is decreasing with increasing experience and maturity of the underlying licenses.

- Licensees manage the minimum risk in different ways. While companies like Wolverine and Luxottica achieve – over time – a comfortable average ratio of 3.0, others like Inter Parfums and Kellwood achieve only 1.4 on average and come close to the critical 1.0 edge in some years. Therefore, some companies have better skills – or power – during negotiations than others and succeed in obtaining the license despite low guarantees which they exceed easily during contract execution.

- The ratios are not constant over time. On a company level, they oscillate depending on the composition of the portfolio of licenses (disposals, additions or renewals respectively). Only Wolverine

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and G-III show relatively stable ratios over time (green lines).

- In contrast, some companies show sharply decreasing ratios after certain events (red lines). Luxottica for example had a comfortable ratio of 5.8 in 2001. In the following years, Luxottica disposed of the successful Armani license after 14 years (2002), renewed old but important contracts with Chanel (2004) and Bulgari (2004) at increased guarantees, and acquired new "expensive" licenses from Versace (2003), Prada (2003), Dolce & Gabbana (2004) and Donna Karan (2004). As a result, the ratio fell to only 1.75 in 2004.
- Another example is Inter Parfums whose ratio was 3.8 in 2004. During 2004, the 12 year old license with Burberry which represented 70% of Inter Parfums' business was renewed at improved conditions for Burberry. As a result, Inter Parfums' ratio dropped down to 1.06 in 2005.
- Similarly, Parlux's ratio of 6.2 (2004) dropped to 1.2 (2006) after the "expensive" Paris Hilton license was acquired in 2004 and more new licenses were secured during 2005 (Maria Sharapova, Andy Roddick, Gund, XOXO).

CONCLUSION

Licensing management is an issue of both risk and uncertainty. The longer a contract has lived, the higher is certainty, and the lower can be the ratio. In contrast, uncertainty is much higher for a young contract, and a higher safety margin in the ratio is required. As shown above, changes of the ratio occur over time, both during the lifetime of a single license and during the composition of a license portfolio. The most successful licensees have diversified their risk into several single licenses. For a diversified license portfolio, a ratio between 1.5 and 2 must be considered as healthy. Ratios above 2.25 tend to be lowered

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in the event of contract renewals or amendments by retightening the minimum guarantees. For a single license, the healthy ratio depends on the stage in the lifecycle of the license. During contract negotiation, both parties must understand that the AMR needs to achieve a healthy level for a healthy partnership.

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