By Christof Binder

Lease versus ownership – how to establish comparability in trademark valuation

The values of trademark licences and ownership are surprisingly difficult to compare, even though they are based on the same asset. A survey of both kinds of transaction examines the reasons for the disparities and the ways in which trademark appraisers can be more accurate

Relief from royalty or royalty savings is the preferred method of valuation in almost all trademark valuations – 99 out of 100 performed for purchase price allocations – because of its simplicity and plausibility. Royalty relief assumes that renting the trademark in question from a third-party licensor is, in financial terms, equivalent to owning it. For over 20 years now, this equivalence principle has passed as law in valuing intangible assets, even though it has never been tested and validated empirically. Establishing the appropriate royalty rate is key to establishing comparability, but finding such royalty rates from market transactions can be difficult. However, this has not affected the method's popularity. Below, we take a closer look at the assumptive equivalence between leasing and owning trademarks.

How well-known brand licensors value their own brands

As a simple exercise, we look at brands that apply trademark royalty rates in both situations at the same time: for leasing in their licensed business and for ownership in an M&A transaction. To qualify, the licensed business should be thoroughly established and also sizeable, with 10 licensees or more. Such brands include:

- Converse, the athletic and casual footwear brand, which was acquired by Nike, Inc in 2003;
- Spalding, the ball sports brand (basketball, baseball, football, volleyball), which was acquired by Russell Corp in 2003;
- Rawlings, the baseball equipment brand, which was acquired by K2, Inc in 2003;
- OshKosh B'Gosh, a children's wear brand, which was acquired by Carter's, Inc in 2005;
- Carter's, another children's wear brand in the United States, which was acquired by Berkshire Partners in 2001;
- Tom Tailor, a German young fashion brand, which was acquired by Alpha Group in 2005; and
- adidas, the famous sports brand, which acquired Reebok in 2006.

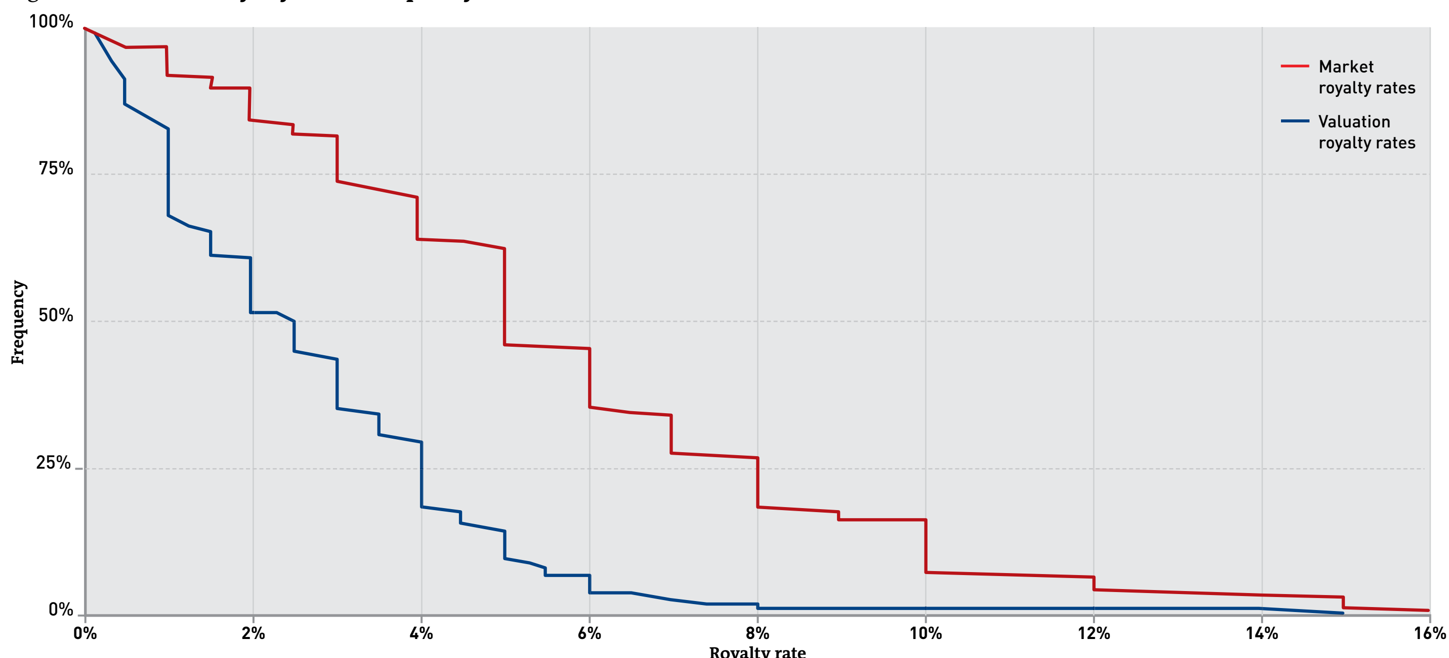
In addition, we look at brands that apply trademark royalty rates for both external and internal licensing. 'External' means licensing to third-party licensees at an arm's-length licensing rate, while 'internal' means intra-group licensing between a trademark holding company and operating group companies at a transfer price licensing rate as a substitute for long-term ownership. Such brands include German fashion brand Hugo Boss, which is held by a trademark holding entity based in Switzerland; Italian sports brand Kappa, run by BasicNet SpA and held by a trademark holding entity located in Luxembourg, and; French broadcasting brand Radio Energy, which is owned by parent NRJ Group SA and licensed both internally and to third-party licensees. All cases included in the exercise are published and open to scrutiny through their financial reporting. All in all, the brands named above represent approximately 275 licensees with a licensed turnover of €2.6 billion, royalty income of €210 million and an average royalty rate of 8% of net sales.

In all of these cases the royalty rates applied for lease and for ownership vary significantly. However, confounding assumptions that market royalty rates for trademark licensing understate the true value of trademark ownership due to the limited and restricted use of the licensed trademark, leasing rates are in fact between one-and-a-half and three times higher than ownership rates.

The example of adidas illustrates this perfectly. adidas has had brand licensing arrangements in place for brand extension into different products (ie, toiletries, eyewear and other) and into some territories with import restrictions (ie, Korea) for some time. Between 2002 and 2005, its annual revenues from licensing averaged €45 million, at a royalty rate of at least 8%. Valuing adidas' trademarks during this period at a royalty rate of 8% of net sales and an indefinite lifetime would have resulted in a trademark value that exceeded the total enterprise value of adidas Group, which would mean assuming that all of adidas' other assets – including stock, trade receivables, distribution network, supplier network, product technology, design and copyrights, patents, software and human resources – were worth less than nothing. It is a simple matter of fact that adidas' revenues valued at a rate of 8% into perpetuity and discounted back simply do not fit into the company's total present value. As adidas is an independent group and has not been the subject of a takeover, this observation cannot be tested in a purchase price allocation. However, adidas' own financial reporting supports these findings. When adidas acquired Reebok in 2006, the Reebok mark was valued with a royalty rate of only around 4% of net sales, equating to 49% of the enterprise value (net of financial debt) and 29% of total assets. These ratios seem plausible considering the value of all the other tangible and intangible assets that were part of Reebok International Ltd.

Apparently what happened in adidas' and the other cases is that the trademarks were worth considerably less than their market royalty rates might have suggested. This was less because of any pessimism on the part of the appraisers than because of simple facts and restrictions. Applying the (high) market royalty rates charged to licensees would have resulted in the trademark value going beyond the limits the purchase price to be allocated. In other words, the sum of all of assets of an enterprise – including the trademarks – cannot possibly be higher than the enterprise value. In order to stay within these constraints, the appraiser has two options: either to apply a lower trademark royalty rate or to limit the remaining lifetime. While it is uncommon in trademark valuations to limit the lifetime of trademarks in non-tech industries, this is always done for the licensing business of the same mark. Lower royalty rates and shorter lifetimes result in a lower trademark value. In transfer pricing cases, it is likely that the tax authorities in the royalty paying territories insist on royalty rates that are lower than the high market rates of the licensor, in order to keep taxable profits within their countries.

Figure 1. **Trademark royalty rates – frequency curves**



Source: Capstone Branding, Markables®

How trademarks are valued in M&As

To find out whether these cases are typical, we compared the royalty rates from two much larger, independent samples of market (lease) and ownership royalty rates. For market royalty rates, we analysed the royalty rates from 2,500 trademark licence agreements from the Capstone Branding licensing database and their distribution. This is probably the largest known sample of trademark licensing arrangements; it is certainly the best representative for the global market of arm's-length trademark licensing, covering all industries where trademark licensing exists. Mixed agreements including more than trademark licensing rights were eliminated, as were agreements between related parties. The distribution of these 2,500 royalty rates is illustrated in the red curve in Figure 1. For better comparison, the curve shows cumulative figures, meaning that 50% of the cases have a royalty rate of 5% or higher. The statistical summary is as follows: the range of royalty rates observed starts at 0.02% and extends to 30%. The mean rate is 5.8%; the 0.25, 0.5 and 0.75 quartile rates are 3%, 5% and 8% respectively. These findings are in line with other sources that observe real rates (ie, USTA 1993, NISTEP 1998, RoyaltyStat). Higher average rates – as sometimes published by participants of the licensing profession – can be explained by the fact that they represent the personal, hence positively biased, views of selected experts expressed in surveys and not effective, agreed and real rates (ie, EPM Communications, Battersby/Grimes).

If trademark valuations under the royalty relief method were based on comparable market royalty rates – as the methodology recommends – this frequency curve should be reflected in the results of trademark valuations. To find out whether this was true, we analysed a second independent sample comprising trademark royalty rates used in royalty relief valuations from the Markables database, which lists data from over 5,000 published trademark valuations from purchase price allocations and other transactions. The royalty rate underlying the initial valuation or subsequent impairment testing is explicitly published for approximately 600 of these marks. These 600 royalty rates represent ownership rates used for trademark valuations under the royalty relief method. As the method suggests, the appropriate royalty rate reflects a rate which a hypothetical independent third party would pay (or charge) for the use of a comparable property. There follow some samples of widely known trademarks and the royalty relief rates applied by them as published in their financial reportings and retrieved from Markables:

- Ducati (motorbikes, 2005) – 7.4%.
- Wendy's (fast-food restaurants, 2008) – 4%.
- Chiquita (fresh fruit, 2009) – 3%.

- Parmalat (dairy products, 2011) – 2.5%.
- Kleinwort Benson (private banking, 2010) – 1.5%.
- Debitel (mobile communications, 2008) – 1.5%.
- Swiss (airline, 2007) – 0.4%.

The distribution of the royalty relief rates for the sample of 600 is illustrated by the blue curve in Figure 1. The distribution has a bandwidth from 0.02% to 15% and a mean value of 2.7%, and the 0.25, 0.5 and 0.75 quartile rates are 1%, 2.5% and 4% respectively. Overall, the relief rate curve (blue) is more than 50% lower than the market rate curve (red). The comparison between the two curves suggests that trademark appraisers tend to select royalty rates from the lower end of the range of available market rates.

One problem arising from the search of comparable market royalty rates is their bandwidth occurring within the same industry. Often, the highest rate found in royalty databases is 10 times higher than the lowest rate. This is observable not only at category level, but even at a company level. Fossil – one of the largest suppliers of fashion watches worldwide and a renowned licensee – reports royalty rates paid to its trademark licensors ranging from 5% to 20%, all in the same product category. Luxottica – a world market leader in eyewear frames and sunglasses – reports royalty rates for its various trademark licences as standing at between 5% and 14%. Leading cosmetics company Estee Lauder performs the annual impairment testing for its acquired trademarks with royalty rates ranging from 0.5% to 12%. These examples illustrate the reality of royalty rate bandwidths in peer groups. Determining the appropriate royalty rate for a royalty relief exercise is thus not easy. In a valuation situation for a specific brand, the analyst must position the appropriate royalty rate for the trademark in question somewhere inside this range by applying quantitative and qualitative criteria. In large statistical samples, royalty rates would be on average somewhere in the middle of the bandwidth – in other words, close to the mean or median. As these empirical findings suggest, analysts typically position the appropriate royalty rate over 50% lower than the statistical average or quantitative brand strength testing would suggest.

Why lease and ownership are different

It is evident – from both the individual cases and the analysis of larger samples – that there is an important and systematic difference between market royalty rates for leasing and ownership rates. But what are the reasons for this difference? Answering this question involves examining conceptual equivalence or the difference between lease and ownership.

Financial equivalence between ownership and lease is a widely known phenomenon. We know it from real estate, from cars, from industrial goods, even from consumer goods financing. Equivalence between purchase and lease is established through interest rates, taxation and discounting. If leasing rates are too expensive, market participants shift their preference towards purchasing and vice versa. All of us have been in such trade-off situations. It is ample availability of the goods in question (oversupply) which allows buyers to choose between purchase and lease. This is the main difference with trademarks. Every trademark is singular and only one company can offer it. Normally, the offer is either a lease (licence) or purchase. Thus, the prospect has no option between buying and leasing – it is either one or the other. There is thus no active market with choices and equilibrium prices for trademarks. Because of this, market royalty rates require some additional understanding of the specifics.

Risk of opportunistic behaviour and cost of licensing management

In contrast to other intangible properties such as patents or software, a trademark has external visibility and spillover, which can impact back on the licensor's business. What a licensee does with a mark will influence the perception of that mark by the licensor's existing customers and vice versa. When a trademark licensor grants a licence, it expects that such influence will be positive (or, at the very least, neutral). However, this cannot be taken for granted. The licensee might behave opportunistically by milking the mark's positive image and selling low-quality products at high profit margins. This risk is priced into the royalty rate as a premium, which can be used either as an insurance against the risk of dilution or as a budget for the licensor to organise tight licensing management and thereby prohibit the licensee from acting in such a way as to weaken or damage the mark. In fact, leading trademark licensors spend substantial parts of their royalty revenues on licensing management, including product testing and approvals, quality control, branding and marketing alignment, and coordination of distribution. The average expense ratio of best practice licensors is between 35% and 40% of royalty revenues. Such ratios can be derived from financial reportings of leading licensors such as Iconix, Calvin Klein, Ralph Lauren, Michael Kors, Tommy Hilfiger, Perry Ellis, Esprit, Playboy Enterprises and Marvel Entertainment. It is thus evident that ensuring that a trademark licence aligns with the licensor's business carries an extra cost, which is not incurred under a pure trademark ownership model.

Investment risk

As for any investment, the maximum risk of purchasing or licensing a trademark is to lose all of the money that was invested. When comparing purchasing a trademark against licensing it, the difference in the cash flow is huge. In licensing, the cash flow is *pro rata*, in line with future sales. In a purchase, the cash flows in one total upfront amount and the total amount for ownership will be much higher than for a (partial) licence. Ownership assumes an indefinite period of cash flows, whereas a licence agreement has a finite term, allowing the licensee to quit after a few years if things go wrong. Thus, the risk of taking a licence is much lower than that of purchasing the trademark. This lower risk is reflected in the higher royalty rate which the licensee agrees to pay. No licensee would ever accept such high royalties in perpetuity. However, royalty relief transfers the higher price resulting from a limited, temporary perspective of a licensee one to one to the indefinite, perpetual perspective of trademark ownership.

Cost structure and margin

In an ownership situation, a company needs to calculate the fully loaded cost in order to stay profitable over the long term. However, a trademark licensee often calculates the marginal cost only. The reason for that is simple. A typical trademark licence is no more than an add-on business for the licensee, representing on average 3% of total sales. The add-on is based upon an existing business infrastructure, with all of the major investments and resources already in place and paid for – it is rarely a new, standalone business division. For that reason, licensees often base their calculations on gross profit or on profit contribution after royalties paid, allowing them to factor in a higher royalty rate compared to a fully loaded profit calculation as required in a long-term ownership calculation. Further, the fact that a licensee risks losing the licence at the end of a contract term implies that it is quite restrictive with regard to additional investments made specifically for the licence. This marginal or add-on thinking allows the licensee to account for higher royalties than a brand owner.

Slipstream effect

In some trademark licensing arrangements the licensee hopes to operate in the slipstream of the licensor's marketing investments, enabling it to save on marketing expenses. The slipstream is a sub-set of the cost structure discussed above. If the licensee has reason to expect that the licensor's future marketing expenses will support its licensed business, it has more room in its profitability calculation to factor in a higher royalty rate. The slipstream effect can be substantial in brand extension licensing where the licensee operates in the same territory as the licensor.

Bargaining power

Finally, the price for a licence depends on the options on each side and on the resulting bargaining power. In the majority of negotiation settings, the power will be more on the licensor's side. A typical licensor has no urgent need to license. The brand as it stands is fully paid up and will not decrease in value over time (as opposed to technology or copyright licensing). Thus, the trademark licensor has time to sit and wait. However, the licensee has a current overcapacity and growth opportunity which it needs to fill. Its time is limited; it needs to decide and take action, but it has only limited options. The brand in question must exactly fit as an add-on to its existing business (ie, match its existing resources and infrastructure without cannibalising them). The brand owner is typically a larger company than the licensee. The first royalty rate call and the draft version of a licence agreement typically come from the licensor, which tends to dominate negotiations. Although market royalty rates have been falling slightly in recent years due to a shift in supply and demand, it is still the licensee which is under more pressure in a typical licensing situation. On average, this will result in higher royalty rates.

Conclusion

For these reasons, a trademark licence and trademark ownership are conceptually different and thus difficult to compare. To establish comparability under the royalty relief method, a trademark appraiser must either reduce the royalty rate to something that a rights holder can afford long term or apply the limited-term perspective of a licensee through a finite lifetime of the future royalty savings. Both adoptions lead to the same result: a lower ownership trademark value. Almost naturally or intuitively, trademark appraisers have selected reasonably cautious (low) royalty rates for trademark valuations in purchase price allocations in the past. Performing trademark valuations with the knowledge of the systematic differences between market and ownership rates will further improve the determination of appropriate royalty rates and the quality of trademark valuations in the future. Taking the results of thousands of published trademark valuations performed in purchase price allocations in the past 10 years as additional cross-check can be of great help to appraisers and their audience. WTR

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