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Brand Equity Excellence©

Volume 2:
Brand Equity Evaluator©

BBDO Brand Equity Excellence©

	Brand Equity Review	Brand Equity Evaluator©	Brand Equity Drivers©	Brand Equity Benchmark©
Focus	BBDO's Five-level Model© Systematic brand classification Mechanism for measuring brand equity (today's best approach)	Computer-aided model for calculating specific brand values	Causal model to explain brand strength and identify brand equity drivers©	Data Envelopment Analysis to be used as benchmark tool in taking account of best practice
Application	Use of BBDO Five-level Model© to determine brand status	Modular calculation of monetary brand values adapted to the purpose at hand	Identification of points of leverage for brand management	A multiple input/output environment modeled to "generate" brand equity values
	Ready	Ready	2003	2003

Brand Equity Excellence© becomes a company's most important asset. But the questions are: How much is the brand actually worth? And how can a brand's value be boosted?

In the second volume of our four-part scientific publication on Brand Equity Excellence©, we present the BBDO Brand Equity Evaluator©, a new model allowing any type of brand to be valued relatively swiftly and simply. A key feature of the BBDO Brand Equity Evaluator© is that it takes into account the particular conditions applying in differnt valuation situations. It stands out from conventional models by applying differnet weightings to the brand equity computation process depending on what type of situation has called for the valuation to be made.

The project of BBDO Group Germany is intended to develop a modular model which is both theoretically and methodologically sound, which clearly illustrates the complex dimensions in the value of a brand, and which defines the points of leverage and the value drivers that can be used to achieve sustained growth in the value of a brand portfolio and hence of a company.

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Editorial

Dr. Rainer Zimmermann, CEO BBDO Group Germany

One of the key issues surrounding brand valuation is the extent to which brands can be represented in financial statements. In their evaluation work, both private and institutional investors and analysts are increasing turning attention to intangible assets such as brand equity. In the current debate on the suitability and transparency of accounting principles, optimizing the presentation of a **"true and fair view"** of economic circumstances remains an important issue for international businesses and their auditors. The scandals at Enron, Worldcom and Xerox have made sure that developing uniform accounting standards and improving listed companies' corporate governance today top the agenda of those bodies responsible for supervising the world's financial markets. To a greater extent in future, establishing a true and fair view of a company's business and financial circumstances will also entail the computation of brand equity, including valuations of individual brands.

Already today, U.S. Generally Accepted Accounting Principles *(US GAAP)* as well as International Accounting Standards *(IAS)* and the German Commercial Code *(HGB)* require the brand equity of any brands acquired through purchase to be determined and itemized in financial statements. But the issue of brand equity reporting in US GAAP financial statements is now more topical than ever following the adoption of Statement of *Financial Accounting Standards (SFAS) No. 141* on *"Business Communications"*, since this requires goodwill to be broken down into fair values for specific asset items – brands included. The new rules will apply to foreign companies such as Siemens or Deutsche Telekom from January 1, 2003 at the latest. Against this backdrop, it will be interesting to see how the new *International Accounting Standards Board (IASB)* and the other national standard setters respond to these changes in reporting procedures. The fact that German and other European listed companies are increasingly adapting their consolidated financial reporting to prevailing international principles *(US GAAP and IAS)*, and thus making use of their options to capitalize intangible assets, is adding further momentum to the discussion in Europe.

These changes have caught business consultants and the accounting profession relatively unawares. Suddenly, they are called upon to apply a uniform brand valuation model that will be transparent to all market participants. Yet as we demonstrated in the first volume *(Brand Equity Review)* in the synopsis of existing valuation models, those currently in use differ substantially from one another and the transparency of their methods is often poor. Moreover, in spite of their fundamental suitability for brand valuation, many of the models have a variety of weaknesses.

In contrast to previously existing models, the *BBDO Brand Equity Evaluator©* presented in this volume can be used with brands of all types. What's more, it can be applied relatively swiftly and simply on the basis of readily available data. The outstanding feature of the *BBDO Brand Equity Evaluator©* is that it can take account of the different types of situation in which a valuation is required. It stands out from conventional models by applying different weightings to the brand equity computation process depending on the particular valuation situation.

For example, the *BBDO Brand Equity Evaluator©* can be used to ascertain the different brand equity values for brand acquisitions, brand licensing, or claims for damages in the wake of brand piracy. By also determining the status of a brand and pinpointing its current level of development, the model allows points of leverage to be identified for optimizing brand steering and portfolio management. We trust that this second volume in our four-part scientific publication on *BBDO Brand Equity Excellence©* will stimulate just as lively a debate as the *Brand Equity Review* in Volume 1, and look forward to receiving your comments.

Dr. Rainer Zimmermann
CEO BBDO Group Germany

Volume 2: BBDO Brand Equity Evaluator©

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1. A brand is an intangible fixed asset

Today, brands generate a large portion of a company's shareholder value. *PricewaterhouseCoopers & Sattler* estimate that brands already account for around 56 percent of total enterprise value for the 100 biggest companies in Germany, with the trend set to rise.[1] The relevance of this "brand capital" is also apparent in investment patterns in the financial community. Studies have shown that analysts and investors, both institutional and private, attach great value to intangible assets such as brand equity when weighing up investment options. Thus brands have become a key factor driving corporate success.

Against this backdrop, tools that quantify companies' potential to create value by exploiting their brands are clearly an absolute must. Thus there is an ever-increasing need for effective and reliable brand valuation.

The outline of existing brand valuation models clearly demonstrates that previous attempts have failed to present a complete picture of brands' success potential.

Unfortunately, the outline of existing brand valuation models presented in the *Brand Equity Review*, the first volume of the *BBDO Brand Equity Excellence©* series, clearly demonstrates that previous attempts have failed to present a complete picture of brands' success potential. However well suited they may be to their own specific valuation tasks, these models are in some cases substantially flawed.

The problem lies mainly in the fact that the individual approaches are not flexible enough for use in varying valuation situations. One reason for this is the choice of components (i. e. causal factors) the models rely on to assess brand equity. As discussed in depth in the *Brand Equity Review*, the various approaches are either company-oriented or consumer-oriented in the composition of the model's components. This precludes a comprehensive depiction of the complexity of brand equity, making the results of brand valuation useless for certain valuation purposes.

Models based primarily on a consumer-oriented (psychographic) approach are best suited to addressing brand-management issues. Here, the main thrust of valuation is to measure psychological brand strength.[2] The findings

[1] Cf. PricewaterhouseCoopers/Sattler, H. (1999), p. 9.
[2] Cf. Brand Equity Excellence©, Volume 1, p. 6.

describe primarily qualitative brand equity and identify potential for optimizing brand management in its narrower, micro-management sense, referred to here as "brand steering". These models frequently do not attempt to actually determine a brand's monetary worth.

If the value of a brand needs to be described in monetary terms, business-finance-driven approaches are used which have corresponding financial causal factors built into the model. Such an approach cannot shed light on issues relevant to brand management, particularly how a brand should be steered. Executive decision-makers receive no guidance on how to shape all individual aspects of a brand so as to create the kind of consumer impact – in terms of knowledge profile, decision-making processes and self-image – that ultimately boosts strategic and monetary brand earnings.

Above and beyond their tendency to focus on either consumer-oriented or business-finance-oriented aspects, the existing models also have practical shortcomings. First and foremost among them is the fact that the approaches are both complex and insufficiently compatible with management requirements. For instance, the base data necessary for brand valuation are often extremely difficult to obtain. As a result, the cost of achieving results is often completely out of proportion to the benefits they provide.

2. Required elements of a brand valuation model

Based on the flaws in existing brand valuation strategies, we drew up a catalog of requirements – covering content, practicality and formal criteria – that need to be taken into account when creating a new, integrated brand valuation model.

On the content side, an improved model should first and foremost allow for **situation-specific brand valuation**. Only when this approach is taken can a brand valuation model be assured of addressing the particular issues that arise from the type of situation requiring the valuation. In the context of brand management issues, for instance, situation-specific brand valuation means that the model can be used as a **brand-steering tool**. This necessitates measurement of brand status based on *BBDO's Five-level Model©*.[3] Results obtained using this approach can provide brand managers with relevant decision-making aids – founded on a clear, consistent brand strategy – as they plan, deploy and control their brand management tools. From this action-oriented marketing perspective, identification of monetary brand value in absolute terms is not a must, but it can certainly help corporate management to track a brand's contribution to shareholder value on an ongoing basis. For other valuation purposes, however – for instance, the acquisition of brands and/or companies that own brands – identifying monetary brand value is vital.

Identification of monetary brand value can certainly help corporate management to track a brand's contribution to shareholder value.

[3] Cf. Brand Equity Excellence©, Volume 1, p. 16.

The valuation model should also be relatively easy for managers to use and should provide operationalizable results that are actually relevant to day-to-day brand-related decision-making.

Thus a situation-specific brand valuation model must be capable of ascertaining both **monetary** and **non-monetary aspects of brand value**.

In addition, an improved brand valuation model should be capable of making a **distinction between product and brand performance**, thus truly incorporating into the brand valuation only the actual intangible asset generated by branding processes. This requirement is based on the fact that a product can also be marketed unbranded, as a category product; a substantial increase in success potential does not become possible until a product has been branded.

Finally, this new brand valuation approach must allow as wide an application as possible. The model must guarantee that **brands from various sectors as well as of differing types** – i.e. product, service and corporate brands or mono, family and umbrella brands – can be evaluated with equal success.

The **cost-efficiency and feasibility** of the valuation approach, i.e. the requisite time, effort and costs, must be in proper proportion to the usefulness of the findings. In other words, the data needed must be easily available and accessible, not requiring immense effort and investment to generate them. The valuation model should also **be relatively easy for managers to use** and should provide **operationalizable results** that are actually relevant to day-to-day brand-related decision-making.

It goes without saying that a brand valuation model must meet the formal requirements of **validity, reliability** and **objectivity**. It must actually measure the aspects it claims to measure, avoid random errors and as a result provide stable, consistent results no matter who is conducting the valuation.

3. The BBDO Brand Equity Evaluator©

In view of these requirements and the known deficiencies of existing brand valuation models, BBDO Group Germany developed its own model, the *BBDO Brand Equity Evaluator©*. This is a modular, multi-stage approach designed to assess various brand types and geared to various valuation purposes.

3.1 Situations requiring brand valuation

The foremost objective in developing the *BBDO Brand Equity Evaluator©* was to take into account the valuation situations that currently most often arise in practice. At the same time, the modular design of the approach will allow new valuation situations to be accommodated whenever the need arises.

To begin with, the approach has been geared to four different valuation situations:

- Brand monitoring/brand portfolio management
- Acquisition and disposal of brands and/or companies that own brands
- Brand licensing
- Infringement of brand rights

3.1.1 Brand monitoring/brand portfolio management

Successful brand management is becoming harder and harder for product and brand managers. The increasing complexity and information overload, make the development and nurturing of brands more difficult all the time.

The *BBDO Brand Equity Evaluator©* makes it possible to track and place a value on the long-term impact of brand-related activities. The success of brand management cannot be judged solely by the earnings a brand generates in the short term, but rather must be seen in the context of actual brand development over time.

Given today's rise in marketing expenditures and the increasing inefficiency of short-term advertising activities, marketing managers need a quantitative basis (especially when they are involved in budget discussions) that will bring out the quality of marketing expenditures as an investment in the future. The long view of brand value development needs to be taken to establish the return on brand investment (ROBI) attainable by marketing measures and anticipate the efficiency of upcoming investment plans for a brand. For the very first time, this makes it possible for brand equity to be used as a **planning tool** for efficient, high-impact budget allocation.

Today, the major challenge of brand management does not involve merely monitoring an individual brand but rather global management of various brands in vastly different regional markets.

Incorporated into the brand-monitoring process, the *BBDO Brand Equity Evaluator©* can function as a genuine **brand-steering tool** by revealing a brand's strengths and weaknesses as well as points of leverage for brand optimization. In this context, consumer-perceived brand strength – whose relationship to the brand next in order of preference is more important than abstract brand value – serves as an indicator of consumer acceptance. Based on brand strength determined in this manner, a brand's identified weaknesses can be operationalized, allowing brand management to be optimized.

Today, the major challenge of brand management does not involve merely monitoring an individual brand but rather global management of various brands in vastly different regional markets.

The BBDO Brand Equity Evaluator© can lay a firm foundation for brand management decisions.

Particularly for mega-corporations, the increasing globalization of markets and the concomitant concentration processes have considerably increased the size of brand portfolios. In the course of **brand migration** and **consolidation**[4] today, the decision is often made to focus on global brands, integrate local brands into global ones or otherwise redefine the relationship between the two for greater efficiency. Unilever, for instance, has systematically winnowed its brand portfolio (1,600 brands in *1999*, 964 in *2001*) and aims to restructure its portfolio over the next few years, reducing it to 400 power brands.

The *BBDO Brand Equity Evaluator©* is just the right toolkit for enhanced assessment of cost/benefit ratios before such **brand migration** or **consolidation decisions** are made. A migration strategy can involve serious risks if a local brand embodies substantial brand equity. The value destroyed when a brand is relinquished should be quantifiable in advance so that this cost component (in addition to the cost of establishing a new brand) can be weighed against potential synergy effects. This goes especially for brands with a high status and/or strong qualitative brand equity – both of them indicating the high esteem in which customers have held the brand it is proposed to abandon.

The *BBDO Brand Equity Evaluator©* can lay a firm foundation for brand management decisions in another situation, too: brand stretching, a tool ever more popular particularly in the fast-changing consumer goods segment. This strategy involves applying an established brand name to a new product. In this case, a brand valuation model is charged with quantifying the **extension potential of brands** before such a decision is made. A ratio for assessing extension options is vital to brand portfolio decisions such as whether to purchase a brand, licensing rights, etc.

To sum up:
Inline with the various objectives of brand monitoring and brand portfolio management and depending on the specific situation giving rise to the valuation (budget allocation, potential for brand extension, consumer acceptance, etc.), both **monetary** and **nonmonetary expressions of brand equity** may be of interest.

3.1.2 Acquisition and disposal of brands/brand owners

Brand valuation plays a particularly important role in connection with the sale/purchase of brands or of companies that own brands. The number of brand-right transfers (sale/purchase of brands) has increased considerably, particularly as a result of the trademark fungibility triggered by the elimination of the binding links between brands and companies.[5] One example of a brand's ownership being transferred was when BMW bought the rights

[4] Brand migration or consolidation refers to the merging of two existing brands from the same product category, with one of these brands assuming the name of the other.
[5] Sec. 47 (3) of the Law on the Extension of Industrial Property Rights (Gesetz über die Erstreckung von gewerblichen Schutzrechten), dated April 23, 1992, German Civil Code (BGB), I.I 1992, p. 938.

to the Rolls-Royce brand from VW. In the course of negotiations, brand equity is a key factor in determining the purchase price. The same goes for the acquisition of brand owners. After all, brands often contribute a great deal to a company's enterprise value, particularly in brand-driven markets. Spectacular examples of such transactions include the acquisitions of Kraft Jacobs Suchard by Philip Morris, Rowntree Macintosh by Nestlé and RJR Nabisco by Kravis, Kohlberg, Roberts & Co.

These examples show that impressively high prices are paid for strong brands to avoid the cost- and time-intensive building of new brands.[6] On the other hand, the pricing process during these brand transfers also demonstrated the uncertainty on the part of the investment bankers, analysts and corporate consultants involved when it came to clearly appraising the respective brand or brand owner. In situations such as these, the *BBDO Brand Equity Evaluator©* can enhance transparency for all participants in the capital markets by gearing brand valuation primarily to a brand's future earning potential. To this end, brand equity must serve as both a **monetary** and **future-oriented value** for estimating the profitability of an investment option.

BBDO Brand Equity Evaluator© can enhance transparency for all participants in the capital markets.

3.1.3 Brand licensing

Brand valuation can also be used for price-setting or market guidance when a brand is to be licensed. Here, brand valuation must provide **information for negotiations on licensing fees**, thus helping create a **contractual framework for licensing terms**. For this type of negotiation, identification of a brand's overall value is not as important as its potential value for purposes of the specific licensing agreement.

The *BBDO Brand Equity Evaluator©* can be used to establish a licensing fee rate for a brand based on the ratio between brand equity and brand revenues. In the realm of licensing, brand equity serves as an objective basis for estimating whether standard industry licensing fees (based on revenues) appear suitable for the brand to be licensed.

Because a brand's future potential is a significant factor in a licensing agreement (the licensee purchases rights of use over a future timeframe), brand valuation must take into account **future-oriented monetary earnings items**.[7]

[6] On corporate transactions calling for brand valuations, cf. Schlaberg, F. (1997), pp. 42-43; Irmscher, M. (1997), pp. 64-65; and Rohnke, C. (1992), p. 1941 ff.
[7] Cf. Schlaberg, F. (1997), pp. 40 ff; Irmscher, M. (1997); p. 66-67.

3.1.4 Infringement of brand rights

Companies that market branded products are increasingly falling victim to brand piracy. Pirates make use of trademarks –and thus also the associations that consumers have with the original brands – to sell goods of inferior quality at lower prices. Consequently, they contribute to the "inflation" of these brands. The risk is greatest for upscale, premium brands, whose marketing involves deliberate and artificial tightening of supply so that demand is not met.

In this valuation situation, brand equity can be used to determine how high damages should be when trademark infringement or brand piracy has occurred. Owners of brands will want to be compensated for both lost earnings and any damage to their reputations. In practice, three methods have been used to date to arrive at a restitution figure:

- Compensation is demanded for actual material loss or damage incurred, including lost earnings.
- A licensing fee is imposed ex post to cover unlawful use of the trademark in the past.
- The pirate is required to surrender all net earnings obtained by using the brand.

The BBDO Brand Equity Evaluator© is a suitable tool for calculating restitution to compensate for actual loss or damage incurred, including lost earnings.

The *BBDO Brand Equity Evaluator©* is a suitable tool for calculating restitution to compensate for actual loss or damage incurred, including lost earnings. Proof of lost earnings can also be provided using indicators such as sharp drops in profits or sales slumps (both regionally and over time). However, by focusing on brand equity it becomes possible to determine both the present value of the earnings lost and the reduction in brand equity caused by the pirate product.

In other words, this approach goes beyond pure imposition of a licensing fee after the fact. At the same time, it avoids relying only on pirating profits as a basis for calculation, which effectively is to appraise the imitation rather than the branded product itself.

Strictly speaking, brand valuation ought also to take account of subsequent losses flowing from **future damage to a company's reputation**, even though there is rarely a sure-fire means of quantifying them. This raises substantial methodological difficulties. In addition, because the injured party bears the burden of proof for actual loss or damage, it is very difficult to enforce claims for damages on the basis of future losses.

This is why brand equity valuation for calculating damages produces a **monetary value based on past events**. As a suitable **basics for deciding the level of restitution**, the difference can be calculated between the

actual brand equity value for the period when brand rights were infringed and the projected value (starting from the point at which the infringement began) that brand equity would be assumed to have attained if earnings trends had continued as before. This difference provides a monetary value for the damages incurred due to the infringement, and hence the loss of brand equity.

3.2 Excursus: Accounting treatment of brand equity

One of the key issues surrounding brand valuation is to what extent brands can be represented in financial statements. From the standpoint of external accounting (i.e., financial reporting), incorporating brands into the balance sheet is a fundamentally problematic issue, since a distinction often has to be made between **brands acquired for a consideration (derivative brands)** and **brands developed in house (original brands)**.

As long as the consideration can be clearly attributed, derivative brands must be recognized as an asset under German commercial and tax law. When brands are acquired against payment, valuation can take account of the purchase price and/or acquisition costs. This makes it possible to evaluate brands in monetary terms, with this monetary value objectified by the market. Intangible assets acquired for a consideration appear in the first fixed-assets item on the balance sheet; these are rights and values that can be conceptually and financially defined and individually valued as assets.

To ensure that financial statements are as informative as possible, it would make sense if all assets were appraised with a view to future performance.

Things start to become unclear when considering what value to post for acquired brands in subsequent years of their useful lives. This is left to the discretion of the party preparing the balance sheet and depends on the assumed useful life and depreciation method applied.[8] But in reality, thanks to marketing measures, brands can gain rather than lose value over time, which raises doubts as to the logic behind scheduled depreciation or amortization.

Another topic for discussion involves how the **future earning potential** of intangible fixed assets, particularly that of brands, should be accounted for. To ensure that financial statements are as informative as possible and realistically depict companies' situations, it would make sense if all assets were appraised with a view to future performance and if estimates were made of the future returns they should generate. Thus it seems questionable to appraise a brand on the strength of its acquisition cost when its value really depends on future revenue gains and/or reduced expenditures. However, valuation based on future returns is always fraught with a great deal of uncertainty as well as subjectivity on the part of the reporting entity. What's more, it would be very difficult for an external, independent institution

[8] Cf. Kriegbaum, C. (2000); p. 50.

to verify the valuation; at present, no consensus has been reached on a suitable valuation procedure for intangibles.

For commercial accounting and tax reporting, respectively, the German Commercial Code and German Income Tax Law prohibit the capitalization of **brands developed in house (originals)**. Objective valuation is not considered possible in this case because the cost of producing these brands cannot be precisely calculated, despite what may have been an immense investment in brand building.

In this context, the fundamental question is which objectives the information in year-end financial statements should pursue, i.e. whether the balance sheet should fulfill an informational function seeking to provide a "true and fair view" of a company's financial state, or whether only verifiable facts should be reported, as demanded by the prudence principle aiming primarily to protect the rights of creditors.

Already today, U.S. Generally Accepted Accounting Principles (US GAAP) require the brand equity of brands acquired through the purchase of a company to be determined and itemized in financial statements.

The first school of thought holds that brands developed in house should be represented in financial reporting; the second eschews reporting at least of internally developed intangible fixed assets in the interest of protecting creditors. While accounting principles in the English-speaking world attach greater weight to relevance of information and hence the provision of a true and fair view of a company's finances to meet investors' information needs *(investor orientation)*, European accounting standards place more emphasis on reliability and hence prudent valuation.

If all assets influencing a company's value are to be shown on the balance sheet, it is not sufficient that only material assets and those acquired for consideration be included. Indeed, enterprise value and/or future performance potential are often influenced precisely by intangible fixed assets developed in house (such as brands). To date, these have been excluded from balance-sheet reporting in Germany and the United Kingdom as well as under the tenets of the former *International Accounting Standards Committee (IASC – now the IASB).* Because these assets are often decisive competitive factors, this prohibition can run counter to the external-accounting goal of providing a **true and fair view** of a company's condition and may result in a distorted picture. Failure to consider intangible asset items can, for instance, result in too conservative an estimate of enterprise value based on balance-sheet information. If, on the other hand, the intangibles concerned were permitted to be reported, the balance sheet would appear stronger. It would be easier to compare companies that have acquired brands (and are thus permitted to capitalize them) and those that have developed their own brands. What's more, the capitalization of original brand equity could also bolster the motivation to act with more sustainable value creation in mind.[9]

[9] Cf. Kriegbaum, C. (2000), p. 56 ff.

Already today, U.S. Generally Accepted Accounting Principles *(US GAAP)* as well as *IAS* and *HGB* require the brand equity of brands acquired through the purchase of a company to be determined and itemized in financial statements.

Since the adoption of *U.S. Statement of Financial Accounting Standards (SFAS)* No. 141 on “Business Communications” dated June 30, 2001, US GAAP has required **goodwill** to be broken down into fair values for tangible and intangible assets (with brands included in the latter) when preparing consolidated financial statements, thus requiring the value of brands to be appraised individually and posted on the balance sheet. In the **impairment-only approach (IOA)**, capitalized goodwill will no longer be amortized on a scheduled basis but rather checked for “impairment” (loss of value) on a case-by-case basis at least once a year, and adjusted downward as needed (SFAS 142). Against this backdrop, it will be interesting to see how the new *International Accounting Standards Board (IASB)* and the other national standard setters respond to these changes in reporting procedures.[10]

Because the financial and capital markets are growing increasingly global, **harmonization of the different accounting systems** is, however, an urgent necessity. The fact that German listed companies are increasingly adapting their corporate accounting practices to prevailing international principles *(US GAAP and IAS)* – and thus may be relying on guidelines for **reporting intangible assets** that deviate in some areas from the German Commercial Code – has sparked a spirited debate.

Because the financial and capital markets are growing increasingly global, harmonization of the different accounting systems is, however, an urgent necessity.

Overall, however, we have to wait and see how the legal situation regarding reporting of intangibles developed in house shapes up in Germany. In the mean time, financial reporting of intangible assets in a supplementary report is a conceivable option.

In accordance with currently valid legal provisions, the **acquisition cost of a brand**, i.e. a **monetary value based on a past event**, is used to value brand equity for accounting purposes. Because this brand equity can only be posted as a fixed asset for brands acquired for consideration, not for brands developed in house, the *BBDO Brand Equity Evaluator©* does not currently cover financial reporting purposes in view of the problems outlined above. If accounting practices were to be changed, however, it would be possible and would make sense to appraise the value of original brands (those developed in house) especially since the problem of objectification would no longer exist thanks to the new *US GAAP* treatment. Brand equity developed by an acquired company now appears on the balance sheet as part of goodwill when capital is consolidated following business combinations. Pursuant to *SFAS* 141, this brand equity is itemized (since goodwill must be broken down into as many individual components as possible, with only components that cannot be itemized appearing simply as “goodwill”)

[10] Cf. Pellens, B., Sellhorn, T. (2001), p. 713 ff.

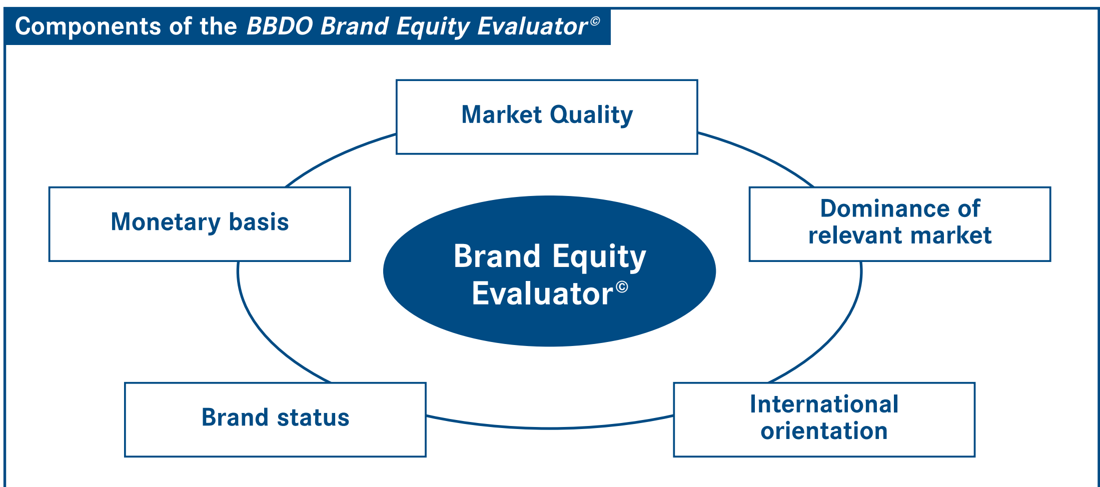
and thus indirectly objectified. This would make it altogether feasible to report brand equity in each individual company's financial statements, too.

In the event that the legal framework is altered to provide for financial reporting of brands developed in house, this additional valuation situation could also be integrated into the *BBDO Brand Equity Evaluator©*.

3.3 Components of the Brand Equity Evaluator©

The *Brand Equity Evaluator©* has a modular design enabling it to properly address the different situations requiring valuations outlined above.

The model comprises five different components. **Market quality, dominance of the relevant market, international orientation of the brand, brand status** and **monetary basis** are taken into account in the valuation and ultimately aggregated to form brand equity. The choice and weighting of components is patterned on the valuation purpose and the type of brand in question.



The following sections outline the individual components as well as the indicators used to measure them.

a) Market quality

The market quality component describes the environment in which a brand operates. Depending on the brand type, this includes the brand's industry and/or relevant market. This factor is gauged by means of the following indicators for each industry, or other relevant market defined on a different scale:

- Sales performance in the industry/market
- Net operating margin in the industry/market
- Extent to which industry/market is brand-driven

For the purposes of determining market quality, **sales performance in the industry** (or other relevant market) is expressed as an average growth rate over the past three years. This serves as an indicator of a brand's sales potential, with the values for sales trends evaluated within a multi-industry context.

The second factor in market quality, **net operating margin in the industry or market**, is recorded as the average percentage return on sales over the past three years. This factor is used to represent the inherent value of sales; as in the case of sales performance, valuation takes place within a multi-industry context.

The **extent to which the industry/market is brand-driven** is the final factor that shapes the component of market quality. It is measured by recording advertising spendings in the industry/market, as a percentage of total sales.

Once they have been isolated, the factors of sales performance, net operating margin and extent to which the market is brand-driven are aggregated and merged to express market quality.

b) Dominance of the relevant market

The factor of dominance in the relevant market refers to **the brand's sales strength relative to competing companies in the same sector**. The resulting value can be interpreted as an indicator of the brand's potential for dominance of the relevant market. Valuation is based on the sales share of the brand at hand in relation to sales by the industry leader.

c) International orientation of the brand

The aspect of international orientation is calculated by stating the level of international sales as a proportion of the brand's total sales. The resulting value serves as an indicator of **the brand's capacity for global development** and is determined relative to the industry as a whole.

d) Brand status

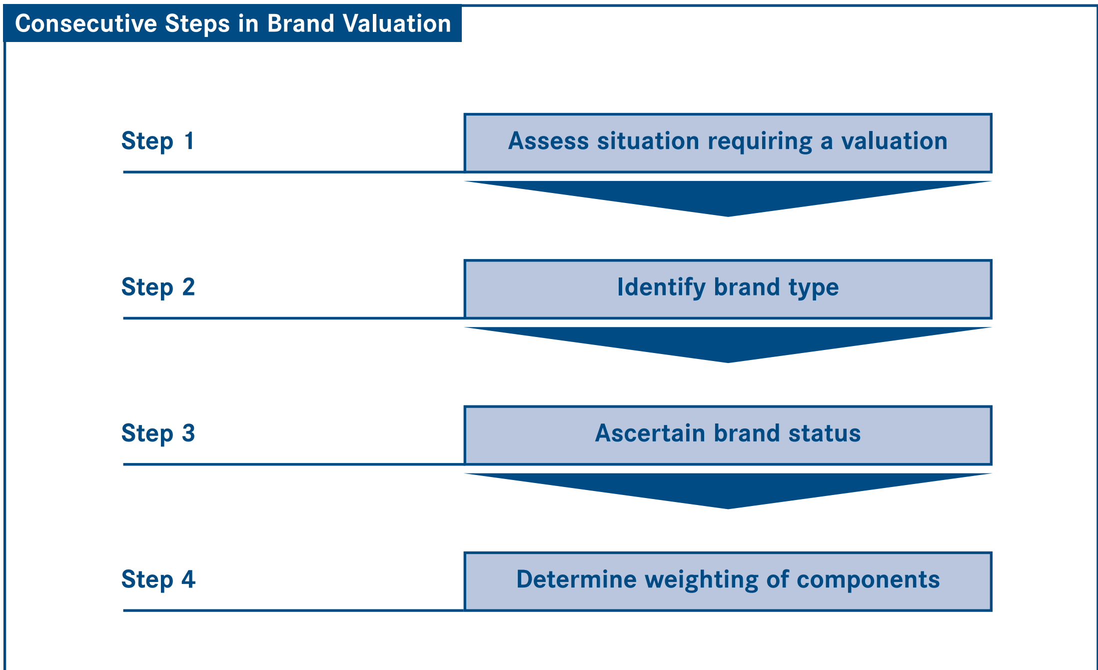
Brand status is expressed as the **brand strength perceived by consumers** and **brand appeal**. The *BBDO Five-level Model©* is used to determine this value, which is expressed as a point count based on various factors and indicators elicited through consumer and expert surveys. No distinction is made between industries in determining brand status.

e) Monetary basis

Depending on the reason for conducting the valuation, the last component may be a monetary basis as an **indicator of a brand's value potential**. The specific monetary value used for brand valuation depends on the respective valuation purpose.

3.4 Example of an evaluation of non-monetary brand equity

The fundamental process of brand valuation using the *BBDO Brand Equity Evaluator©* can be broken down into four process steps.



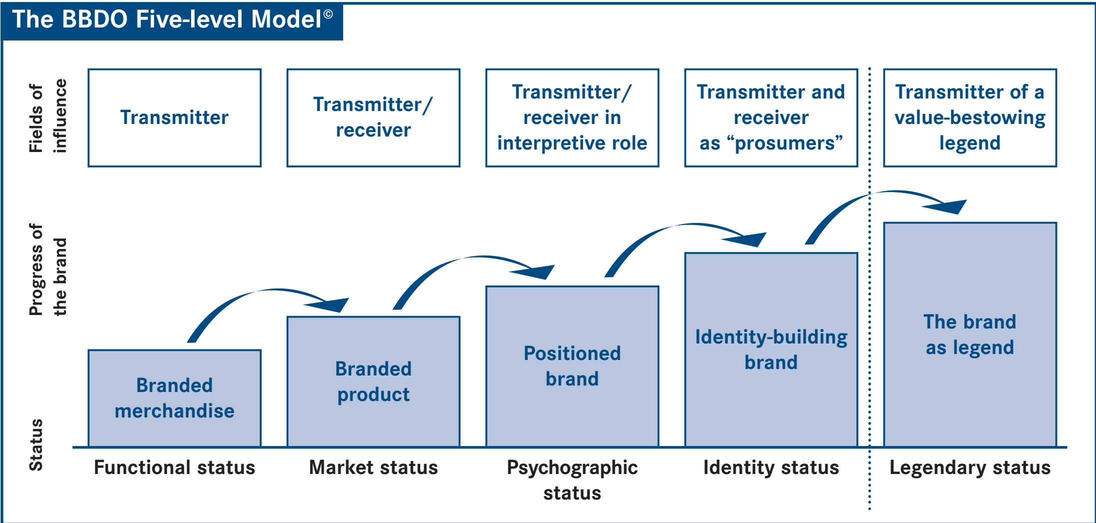
The first step is to **define the concrete valuation situation**, i.e. the reason for conducting the valuation. Next, the **type of brand** to be evaluated is identified (e.g. product vs. corporate brand). The first two steps reveal the aggregative degree of the base data and thus the complexity of data capture for the brand valuation process. The third step is to assign a particular **brand status to the brand** based on the *BBDO Five-level Model©*. Finally, the necessary components of brand valuation are selected based on the decisions made in the previous steps, and these components are **weighted**.

The following valuation example is intended to shed light on the procedure for determining a non-monetary indicator value for consumer-oriented brand strength – as needed, for instance, within the framework of internal brand monitoring for the purposes of brand steering. The example is followed by an exploration of valuation purposes necessitating information on monetary brand value.

As the *BBDO Brand Equity Evaluator©* operates, the indicator value for brand strength is calculated by determining **brand status**. To this end, the brand to be appraised is assigned to one of the potential brand progress levels included in the *BBDO Five-level Model©*. The assumption here is that a brand with increasing brand strength will "ascend" to higher developmental

levels in the model. Accordingly, a brand must first pass through a lower developmental level to reach the next-highest level.[11]

The BBDO Five-level Model©



A brand's respective development levels can be characterized by certain influencing factors, or drivers.

Stages of Brand Development and Drivers

Brand status	Drivers
1. Functional status: Branded merchandise	• Constant level of quality • Legal protection (trademark)
2. Market status: Branded product	• High degree of awareness • High level of distribution
3. Psychographic status: Positioned brand	• Strength, quality, uniqueness of associations • Brand personality
4. Identity status: Identity-building brand	• Brand attachment • Prestige value, self-portrayal • Brand community • Brand trust • Brand identification • Brand loyality
5. Legendary status: The brand as legend	• Conveys individual values • Conveys social values • Helps determine "meaning of life" • Timelessness • Tradition, originality • Longing, unattainability

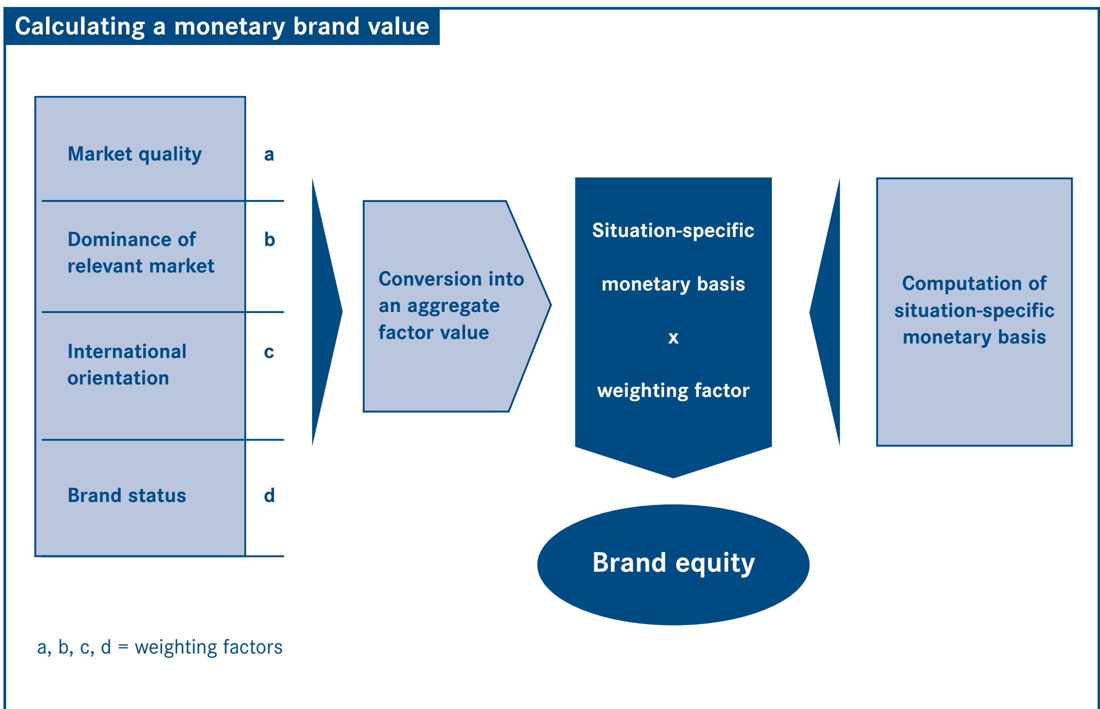
In order to ascertain a brand's status, the drivers for the various status levels must be operationalized using an extensive catalogue of questions. This yields a point count that can be used to determine the actual status of a brand (brand strength).

[11] Exceptions to this rule are, of course, possible: A brand may on occasion "skip" a level in the brand development process and "make up for it" later.

To be assigned a particular brand status, a brand must at the very least achieve a pre-defined total point count. An additional requirement is based on the assumption postulated earlier, that a brand will pass through all stages of progress in the *BBDO Five-level Model©*. Thus a brand must also achieve the requisite point count on each of the lower progress levels to be ultimately assigned a brand status.

Another telling factor is the determination of brand status in relation to the competition. To arrive at this value, the absolute brand status of a brand is gauged in relation to the aggregate strength of competing brands in the same specific market or industry. Thus this process serves as a kind of "positioning system" within the relevant competitive environment and can offer additional guidance for the purposes of optimizing brand steering.

As a result, brand status measurement using the *Brand Equity Evaluator©* allows both absolute and relative brand status to be determined and assigns brands to one of the five status levels. Further progress up through the hierarchy of the *BBDO Five-level Model©* is a fundamental goal for most brands since we can assume that enhanced brand status goes hand in hand with enhanced brand strength – and with it, greater monetary value. It represents an essential component of effective brand management.



Concrete valuation using the *BBDO Brand Equity Evaluator©* is a **multi-stage task**. First, the indicators of sales performance, net operating margin and extent to which the market is brand-driven are aggregated into the factor of market quality. Next, market quality is merged with the factors of dominance of relevant market, international orientation and brand status, forming a new **aggregate factor value**. The weightings accorded to individual factors depend on the specific valuation situation.

With this brand valuation model, a monetary value for brand equity is determined specifically based on the valuation purpose and brand type in question. Depending on the valuation situation at hand, the monetary basis must be past, present or future-oriented. The respective brand type determines the aggregative degree of the data to be collected for the purpose of ascertaining a monetary basis. For instance, a company's cash flow or pre-tax earnings must be reviewed to evaluate a corporate brand, while appraisal of individual product brands requires a disaggregative approach at product level.

Monetary brand value is then derived from the product of the aggregate factor value determined earlier as well as the monetary basis.

3.5 Example of an evaluation of monetary brand equity

The concrete process of monetary brand equity calculation is described in detail below, illustrated by a valuation example for the **acquisition and transfer of a brand and/or brand owner**. The example is followed by a brief outline of the particulars of the remaining valuation situations.

a) Acquisition and transfer of a brand and/or brand owner

The valuation situation at hand is primarily a matter of estimating the profitability of an investment option. To create an adequate foundation for decision-making in this arena, the *BBDO Brand Equity Evaluator©* makes use of net present value procedures to identify a monetary basis. This ensures that the future orientation crucial for this valuation situation is incorporated into the brand valuation.

In this valuation scenario, the monetary basis is determined based on forecasted **gross cash flow** values.

Cash flow computation

Derived from the **management's performance metrics:**	or	Derived from the **income statement:**
Sales		Sales
– Products costs of volume sold		– Products costs of sales
= Contribution margin I		**= Gross margin**
– Structural costs (not incl. interest)		– Distribution costs
= Earnings before interest and taxes (EBIT) (= contribution margin II)		– Administration costs
		+/– other income/expense
		= Operating earnings

= Operating profit
– Taxes
= NOPATBI (Net Operating Profit After Taxes Before Interest)
\+ Depreciation
\+ Additions to pension accruals
= Gross cash flow (after taxes/before interest)

For the purposes of concrete brand equity calculation, specific gross cash flow is forecasted for a **planning horizon of three years** – a period within which cash surpluses can be projected on a relatively reliable basis.[12]

In the first instance, the raw projected values accrue at different times and as such are not directly comparable. Not until the future cash flows are **discounted** to the base date of the valuation does it become possible to obtain the aggregate net present value needed as the monetary basis.

It should be noted that the discount rate has a huge influence on the level of brand equity. The discount rate is used to define the relative weightings of revenue surpluses accruing at different times to make their contribution to brand equity.

The *BBDO Brand Equity Evaluator©* relies on the **Capital Asset Pricing Model (CAPM)** to set the discount rate.

Discount Rate

The discount rate is calculated on the basis of CAPM as follows:

$$E(R_j) = i_{CAP} + [E(R_M) - i_{CAP}] \times \beta_j$$

$E(R_j)$ = Expected return on investment j
i_{CAP} = Risk-free interest rate (generally flat yield)
$E(R_M)$ = Expected market return (e.g. industry index)
$E(R_M) - i_{CAP}$ = Market risk premium
β_j = Beta factor = Volatility of return on investment j relative to expected market return

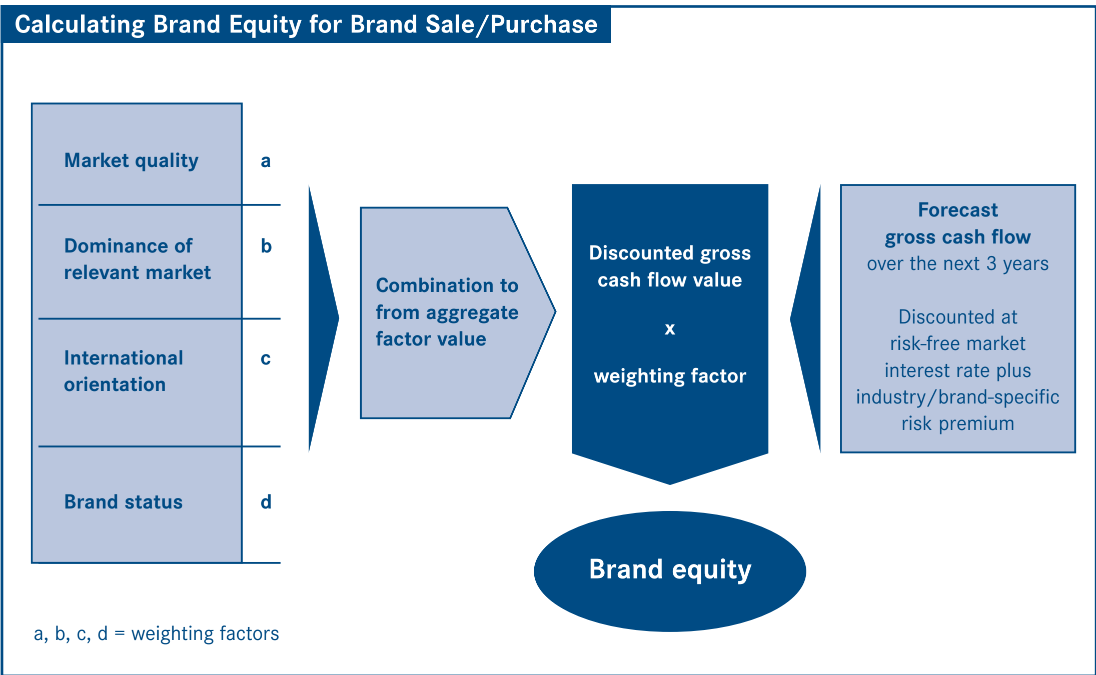
[12] Forecasts of cash flow over longer periods are subject to extreme uncertainty; even experts with far-reaching knowledge of their industries are not in a position to make concrete, well grounded forecasts for such an extended timeframe. This is particularly true of brands in fast-evolving sectors.

The first step in determining this rate is to look at the interest rate obtainable in the market on risk-free investments (generally the flat yield). The yield on government bonds, considered more or less risk free, is normally used for this purpose. Because the brand's future earning power is a matter of uncertainty, a corporate or product-brand-specific **risk premium** (depending on the respective brand type) is also applied to the risk-free interest rate to determine the discount interest rate.

In line with their weightings, **market quality, dominance of relevant market, international orientation** and **brand status** are then factored into the aggregate factor value. It should be remembered that environmental factors (sales performance and development of earnings in the industry, and the extent to which it is brand-driven) as well as the international reach, dominance and psychographic status of a brand are important indicators of future earning potential.

Finally, the aggregate factor value is used as a **weighting factor** for the **monetary base component**. The last step in determining the brand's monetary value (brand equity) is to multiply the monetary basis by the **weighting factor**.

Calculating Brand Equity for Brand Sale/Purchase



Particularly in the case of mergers & acquisitions, brand equity can serve as an additional factor to complement overall company appraisal. Purchase of brands is frequently a deciding factor in corporate takeovers, and brand valuation using the *BBDO Brand Equity Evaluator©* helps reveal whether the price of a company is justified based on brand equity findings – thus creating a valid foundation for buyout negotiations. In addition, the incorporation

of psychographic brand status into the valuation model helps demonstrate whether the brands under consideration are suited to a company's own portfolio and overall corporate strategy.

Brand valuation for other valuation situations proceeds according to the same principle. However, the weighting of the individual factors, in particular, needs to be adapted to the specific situation in which the valuation is required.

b) Brand licensing

In the case of **brand licensing**, brand equity serves as a key factor determining the applicability of industry-standard licensing fees to the brand in question. As with the purchase or sale of brands, a future monetary value must be calculated (after all, the licensee acquires licensing rights for a future timeframe). Thus forecasted gross cash flow must also be used here to identify a monetary basis. The brand-specific licensing rate is then calculated based on the ratio between brand equity and brand revenues. An important distinction here is that licensees, who merely acquire the right to use a brand, do not themselves need to bear the costs of marketing (in contrast to parties purchasing brands). This is why the respective marketing spendings have to be factored out of the formula determining the monetary basis.

The licensor runs the risk of any damage to its trademark the licensee might cause.

Because the licensee generally uses the acquired licensing rights to introduce the brand into new markets, the factor of **market quality** (which describes the brand's environment in its relevant market) plays less of a role. **Market dominance** and **international orientation** are also less relevant to brand licensing than to brand purchase. These three factors are therefore weighted less heavily in this type of brand valuation.

As the owner of the brand, the licensor runs the risk of any damage to its trademark (for instance, loss of reputation) the licensee might cause. As a result, **brand status** must be weighted considerably more heavily in this valuation situation.

c) Infringement of brand rights

When brand equity is established to help **gauge damages claims**, the aim of the brand valuation is to create a decision-making platform for setting the amount of restitution for unlawful use of trademarks or brand pirating. Because the injured party must prove the asset impairment sustained, brand equity determined to this end is generally a monetary value based on past performance. This is why average pre-tax earnings during the infringement period constitute the brand's monetary basis.

For this valuation situation, the basis for weighting factors is derived from the fact that brands marketed internationally are potentially at risk of pirating

by multiple parties. That is, they are exposed to a higher risk of damage than purely local brands, so this risk has to be taken into account through a greater weighting for the factor of **international orientation**.

Market status is also weighted more heavily to reflect the risk of potential loss of reputation as a result of damage to the brand. This is in view of the fact that, when a brand has a higher status and thus consumer identification is stronger, losses resulting from potential brand-right violations are greater and longer-lasting.

The actual value of a brand equity for the period in which brand rights were infringed is established as follows. Average earnings before taxes during the infringement period are used as the monetary basis. This mean figure is multiplied by the aggregate factor value established from the components of market quality, dominance of the relevant market, international orientation and brand status (as currently assessed). The product is the value of brand equity following an infringement of brand rights.

The place of an value on the damaged suffered as a result of the infringement, we need to estimate the brand equity that would have arisen had the rights not been infringed. In this case, the monetary basis consists of the projected average earnings before taxes if previous earnings trends had been maintained without any infringement. Estimates also need to be made, based on past data and planned activities, for the three components of international orientation, dominance of the relevant market (based on projected sales) and brand status.

Decisions regarding the amount of a damages claim can then be made based on the difference between the projected estimates of brand equity without infringement and the actual, past-oriented value established following infringement.

4. Summary

The brand valuation approach introduced here stands apart from other valuation methods mainly through its adaptability to different valuation situations. In contrast to conventional models available, this new approach allows the components comprising brand valuation, as well as their weightings, to be geared to the objectives associated with a specific valuation scenario.

BBDO Brand Equity Evaluator© can address a host of both financial and brand-management issues.

Thanks to this conceptual foundation, the *BBDO Brand Equity Evaluator©* can address a host of both financial and brand-management issues. The *BBDO Brand Equity Evaluator©* can, for instance, calculate brand equity to support decision-making and create a basis for negotiations on brand

acquisition, brand licensing or determination of damages. In addition, the model makes it possible to identify points of leverage for optimization – and thus for targeted brand steering and brand portfolio management – by pinpointing brand status and assigning brands to corresponding development levels.

Based on the *BEES* model[13], developed earlier by BBDO Consulting for the valuation of corporate brands, the multi-stage *BBDO Brand Equity Evaluator©* is a factor-based model with an approach that differentiates by industry. This is underscored, for instance, by the model's attention to the brand-driven quality of different industries. The approach also makes use of impacting factors from both the brand's direct environment (e. g. brand status) and its indirect one (e. g. market quality), making it possible to paint a complete picture of brand potential.

The model is designed to make brand valuation relatively fast and easy to realize.

In principle, this new approach is capable of appraising any type of brand, in contrast to *BEES* and most other models. To guarantee this performance, the data required for valuation must be disaggregated at the proper level and/or the industry environment must be replaced by the relevant market. In addition, the factor of **brand status** allows an in-depth analysis of consumer-oriented brand strength and categorization of a brand based on the *BBDO Five-level Model©*. The approach is also expandable, allowing a number of new valuation scenarios to be added to its armory.

In view of the need for a valuation approach that is cost-efficient, practicable and acceptable, the model is designed to make brand valuation relatively fast and easy to realize. One special advantage is the easy availability and accessibility of the necessary data.

In spite of all these benefits, the new valuation model does not solve all of the problems mentioned earlier. As with other models, subjective influences due to experts' selection of factors impacting brand strength **(brand status)** cannot be completely excluded. Another difficult area is the implicit independence of the indicators that shape brand strength. In addition, for the sake of a relatively fast, pragmatic valuation process, brand-specific and non-brand-specific earnings and costs are not precisely differentiated, e. g. through a conjoint analysis. Instead, the *Brand Equity Evaluator©* determines the income specifically attributable to a brand (= brand equity) based on two multipliers: an aggregate factor (encompassing the decisive components of a brand) as well as a monetary basis geared to the valuation situation.

Despite these shortcomings, the *BBDO Brand Equity Evaluator©* is a brand valuation model that allows brands to be appraised for various purposes.

[13] Cf. Brand Equity Excellence©, Volume 1 (2001), p. 43.

To further reduce subjectivity in the selection of brand strength indicators, it is appropriate to analyze causal relationships and to validate the brand-strength drivers. The aim for the next stage in the *BBDO Brand Equity Excellence©* project (Volume 3) is to build a causal model that helps identify complex correlations involved in the development of brand equity in the hearts and minds of consumers. In addition, the relationship between the psychological, pre-purchase construct of brand strength and actual brand preference or propensity to buy will be analyzed, and consumer-, sector and product-category-related particulars taken into account.

The aim is to build a causal model that helps identify complex correlations involved in the development of brand equity in the hearts and minds of consumers.

The proposed causal model in Volume 3 will address the true source of brand equity, at the consumer level. Because consumers ultimately make the choice among various market alternatives and drive brand success, brand equity as perceived by consumers is of prime importance for judging the strengths and weaknesses of a brand. Brand strength valuation can help explain consumer behavior, track the success of sales strategies, serve as a market-segmentation tool, enhance product positioning and help frame communications concepts. What's more, the inclusion of a behaviorally oriented value such as buying intention allows the impact of brand strength to be analyzed in the sense of brand equity capitalization.

Appendix

1. Theoretical background on cash flow

Cash flow is normally understood to be the cash surplus (surplus of cash income over cash expense items) in a given period. This is how the concept is used in the investment-appraisal context. In a dynamic approach such as the net present value method, an investment is examined in terms of a series of cash flows arising from the difference between budgeted streams of payments and receipts in particular periods. These flows are normally discounted at a predetermined rate to establish their value in a set time period (t_0), and the sum of the net receipts discounted to t_0 is compared to the capital tied up by the investment.

Cash flow is also a term used in the analysis of a company's finances and financial statements, particularly when valuing the company's stock or assessing its creditworthiness. It is an important indicator both of the ability to generate income and of liquidity. Because of the different purposes for which it is used, and also because of differing valuation methods depending on data availability, the term has not been uniformly defined. The calculation is modified depending on whether the objective of analysis is income generation or underlying liquidity.

2. Accounting for risk in the discount rate

The risk premium built into the rate used to discount future cash flows is arrived at by first establishing the difference between an overall market rate of return (as reflected in a market or sector index)[14] and the capital market interest rate on risk-free investments, then multiplying the figure by what is known as the **"β factor"** This is an expression of the degree of fluctuation anticipated in the returns on the investment under examination (i.e., the volatility of the returns) relative to the volatility of those expected in the particular market or sector. If the returns on the investment move in unison with those in the market or sector, the investment's β factor is 1. In that case, the risk premium applied will be precisely the same as the **market risk premium**, i.e. as the difference between the returns expected in the market or sector and the risk-free interest rate. A β factor of 1.5 signifies that the volatility of the returns on the investment under appraisal will be half as high again as that of the expected market or sector return. In that case, the risk premium built into the discount rate will be 1.5 times the market risk premium.

The β factor is established by referring to business publications and to those of financial services providers. For current purposes, the β factor is assumed to match the systematic (i.e., market) risk for a particular brand, so that the company's β can be applied equally to the brand. This is normally a good

[14] Risk is determined by comparing companies from the same sector as they are exposed to almost identical operational risks.

approximation when valuing corporate brands if brand equity constitutes a substantial portion of the company's assets and brand strategies play a dominant role in the risks to its earnings.[15] However, if it is not safe to assume that the brand β is identical to that of the company (e.g., when evaluating brand equity for a single product produced by a large conglomerate) a separate β ought strictly to be computed for the brand alone. Because in practice this is a difficult process, the method used instead is to establish a β factor from the mean of comparable companies operating in the same industry as the brand under examination. Similarly, if the brand being evaluated does not belong to a listed company, β values of comparable companies that are listed, from the same industry, are used.

[15] Cf. Kriegbaum (2000), p. 224.

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Dr. Rainer Zimmermann
Chief Executive Officer BBDO Group Germany

Born in 1956, Rainer Zimmermann studied German, Media Studies and Sociology, and initially worked as a freelance sub-editor and journalist. Dr. Zimmermann joined ABC/Eurocom as a consultant in 1988, becoming a member of their executive management in 1991. He was appointed Managing Director of Kohtes Klewes in 1992, Managing Partner in 1993, and CEO in 1996. When Kohtes Klewes Kommunikation GmbH (Holding) was renamed European Communications Consultants GmbH (ECC) in September 1999, he became Managing Partner and CEO of ECC. Dr. Zimmermann has been Managing Partner and CEO of BBDO Group Germany since January 2000. He writes regularly on communications topics, and is co-editor of *Handbuch der Unternehmenskommunikation* (first published in 1998) with Professor Klaus Merten. He sits on the Executive Boards of GWA, Deutsche Werbemuseum e.V., Düsseldorfer Kunstverein and Westdeutsche Akademie für Kommunikation e.V. (WAK). He is married with two children, and lives in Düsseldorf.

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Udo Klein-Bölting
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Tharek Murad-Aga

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Alexandra Valtin

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