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Brand building: Companies deriving business value from intangibles

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John Stuart, the Chairman of Quaker, knew what he was talking about when he said in 1900:

"If this business were split up, I would give you the land and bricks and mortar, and I would take the brands and trade marks, and I would fare better than you."

A century later, Stuart's quote resonates even now among those in the corporate sector. Today, the only differentiator that companies have is brands. A brand is the most intangible element to a company and in many cases, the most important one.

For instance, if all the tangible assets of Colgate were to suddenly get destroyed in a natural disaster, the company would simply move to secure funding and get back to business in just a few months. How can Colgate pull it off ?

That is because of the strength of the brand Colgate which is embedded in our mind. If ten people are randomly asked to name the toothpaste they use, nine out of ten may well mention Colgate without hesitation. It has become synonymous with toothpaste.

The hidden worth

Today it can be said that a good part of business value derived is from intangibles- be it the brand of a product such as Parachute or an organisation such as Infosys or a conglomerate such as the Aditya Birla Group . There is a perception that branding is critical only in the consumer industry.

But it is quite evident that the kind of influence brands have on the choices of all its stake-holders other than customers - employees, investors and government are as important to add value to a business. For instance brands like Goldman Sachs and Google attract the best of talent, who in turn run the business.

Brands of companies add tremendous economic value and that is why in a business, a company with a better brand always trades at a premium to a company that does not have an equally strong brand. However, the importance of brands started getting recognized only in the 1980s, when firms which were acquirers paid huge premiums when buying out companies with strong brands.

Mehul Savla, founder of investment bank-Ripple Wave Equity and former Executive Director at JP Morgan says,"During deal negotiations, not much stress is given to the brand. However, it is indirectly linked to the valuation that a company gets."

According to him a company with a stronger brand commands a higher pricing power than its peers, which is reflected in its higher earnings. " For instance, for a similar footwear product, Bata will always be able to command a higher price than an unbranded company but won't be able to match the price of a Nike product and this will reflect on each of their earnings.

The brand also assures future cashflows acting like a fixed income instrument. " That is why the stocks of the companies that own brands always trade at higher valuations than the ones that do not own brands, Savla says while adding that all this together forms the basis while valuing a company.

Companies can leverage brands to launch new products under the same brand and also to enter new industries providing them with a low barrier to entry. During mergers and acquisitions, brands can be of varying importance to different acquirers.

For instance, when Emami acquired Zandu, paying a big premium for the brand made a lot of sense. Emami had its products- Mentho Plus and Sonachandi chyavanprash in the balm and Chyavanprash category. However, it was unable to create a brand like Zandu in those categories.

Balm and Chyavanprash category, being a very niche segment have very few players with the major players being Zandu and Amrutanjan. Acquiring Zandu helped Emami emerge as a dominating player in the industry, giving it a larger share and higher pricing control. This move was well accepted by investors and the stock was up by 9% on the day when this news was out.

Though the brand definitely adds economic value, it is important to value it. This valuation is critical for companies to finalise various decisions such as business investments, marketing investments, mergers and acquisitions besides being important for investors.

Brand valuation approach

Although there are many approaches to value a brand, the one that dominates brand valuation worldwide is 'Royalty Relief Approach'. 'Royalty Relief' determines the value of the brand in relation to the royalty rate that would be payable for its use were it owned by a third party.

It ties back to the commercial reality of brands - their ability to command a premium in an arm's length transaction. The method involves estimating likely future sales, applying an appropriate royalty rate to them and then discounting estimated future, post-tax royalties, to arrive at a Net Present Value (NPV).

This is held to represent the brand value. If a company has more than one brand in its portfolio, the brand value of the company can be estimated by valuing different brands and then adding it up.

Using this approach, Brand Finance, a UK based firm specialising in brand valuation, has taken out the list of most valuable brands in India. According to a study

done by them, Tata Motors is the most valuable brand among Indian companies. They have valued just the brand of Tata Motors at USD 8454 million.

Accounting regulations do not give importance to intangibles. However, with the growing importance to intangibles in mergers and acquisitions in the last few years, these are being factored in accounting standards. According to the new IFRS3, the value of the brands and other intangible assets acquired should be mentioned on the balance sheet. But the value of in- house brands still finds no place on the balance sheet.

It is quite ironic that the world's biggest brand- Coca Cola finds no place on the balance sheet. But thanks to the development in various brand valuation techniques, the real worth of brand can now be quantified.

It is universally accepted that companies which are in a position to market better provide better returns to their shareholders over a period of time. Unni Krishnan, Managing Director, Brand Finance says that a study carried out by his firm showed that companies with strong brands reported three times the return than non branded companies over a period of 15 years.

Increasingly, it is becoming evident that brand is the one asset that would provide that edge for a longer term to a company. That this has registered with companies in India is reflected in the fact that firms operating across sectors such as banking, telecom, auto, cement and consumer to infrastructure are attempting to build their brand.

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