By **Stuart Whitwell**

The power of brands – understanding royalty rates

Ensuring that a brand is licensed correctly and that an appropriate royalty rate is in place is essential to secure the longevity and success of a business. Correct calculations are therefore critical

Any form of intellectual property – be it a trademark, copyright, patent or brand – can be valued by assessing the amount that other parties will pay to buy or license it. When licensing intellectual property, a royalty rate must be agreed between the brand owner (the licensor) and the party licensing the brand (the licensee). Royalty rates can vary significantly, depending on the status of the brand in the market and the nature of the agreement.

Many business models are based on licence agreements, which are commonplace in the retail, food, fashion and travel industries. The food and drinks industries in particular are reliant on the licensing model, due to the need to package and distribute fresh produce. For example, Coca-Cola distributes its syrup (made to its famously protected recipe) to bottling and distribution centres in different countries around the world. Unsurprisingly, Coca-Cola retains the lion's share of the profits, due to its leading brand status.

Virgin Group

Richard Branson's Virgin Group has evolved from its origins as a music retailer, record label and pioneering airline into an international conglomerate. The Virgin brand has become synonymous with entertainment, value for money and entrepreneurial spirit. As Branson divested either part or all of his initial investment, acquiring entities have continued to operate under the Virgin brand. This paved the way for the creation of a business model – referred to as 'branded venture capitalism' – whereby the Virgin brand is licensed out to numerous business ventures in different market sectors, including airlines, railways, gyms, telecommunications and financial services. While Branson continues to operate wholly owned or majority controlled companies, in other operations he licenses the Virgin brand name and takes a minority stake.

The Virgin brand retains a high level of consumer loyalty and appeal. Consequently, there is continued interest in licensing the Virgin brand to exploit brand equity in new commercial ventures. A spokesperson for Branson revealed that revenues from companies that license the Virgin brand exceeded £13 billion in 2011, demonstrating how much brands can bolster a company's trading performance.

However, merely applying the Virgin name to a product does not automatically guarantee success – Virgin has had its fair share of failures. The group has lost equity in a number of failed ventures, with Virgin Cola the most obvious example. But at the other end of the spectrum, Virgin Atlantic is an international success – it was recently named the United Kingdom's fifth most valuable brand by a Superbrand survey (measured on brand strength in the United Kingdom). This goes to show that success is reliant on more than a well-known brand – you also need to consider the brand's relevance, investment and execution.

Expansion through licensing

Choosing to license a brand can expand brand recognition for new products in existing markets, which essentially capitalises on successes in other product categories. It is vital that the brand identity be consistently applied and relevant to the new market. Jack Daniels has successful licensed its brand in this way, extending into the food industry with a range of barbecue sauces manufactured by Baxter's and the clothing industry with a range of high-end apparel in conjunction with clothing company Religion/Buddhist Punk.

Royalty rates and licence agreements

It is important to remember that royalty rates make up just one part of a licence agreement. First and foremost, the brand owner and licensee must have the right chemistry and commitment to invest time and resources into developing the brand in the relevant sector/category.

Several other aspects must also be considered when entering into a licensing partnership, which include:

- the brand and the related intellectual property;
- the licensee's use of the brand – the markets, products, channels and territories;
- exclusivity agreements;
- the price point to which the royalty rate is attached – be it wholesale, retail or some hybrid;
- the duration of the agreement;
- the minimum income and initial payment;
- the marketing commitment; and
- performance measurement.

These can and do influence the royalty rate that is agreed. For example, if you were to request exclusivity within a certain territory, the royalty rate would be higher to compensate for the licensor's inability to license out the brand further in that region. This notwithstanding, however, the brand's relative equity will have the biggest influence by far, as it determines who holds the bargaining power.

Once a licence agreement has been finalised and the details have been agreed, the licensor will measure performance according to the agreement. The licensee does the vast majority of the legwork for what is usually a smaller portion of the profits, but it benefits from the price premium and market share of the brand, which it would otherwise be unable to achieve.

Price premium + market share = cash flow = shareholder value

The value of brands

Crucially, brands are the primary vehicle for relationships with customers, which builds consumer loyalty and is the driver behind price premium and market share. Building relationships creates emotional needs in consumers, and the cost of creation is divorced from what they are willing to pay.

Brands are often thought of simply as trademarks, but this is often a narrow and incomplete view. Intangible Business's Brand Jigsaw© diagram below shows that brands are a collection of intangible values as perceived by the consumer. These are attributable to a name, symbol or design used to identify a p roduct or group of services; but they are by no means restricted to a trademark.

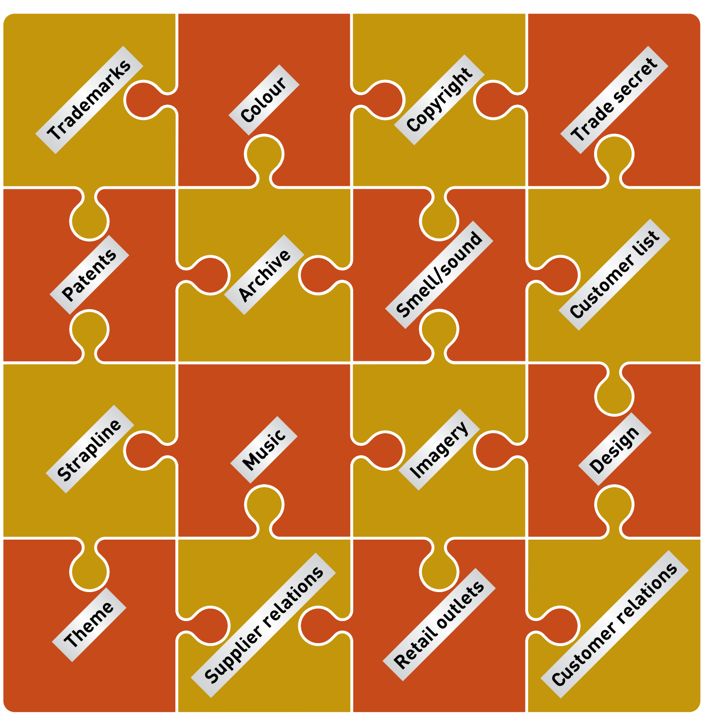
Calculating and negotiating royalty rates

When entering into any form of negotiations, both parties will likely have a figure in mind. A significantly flawed rule of thumb says that the 25% rule may be applied, whereby the royalty rate is equivalent to 25% of the profits that the licensee makes from the branded product. This broad generalisation would not hold its own at the negotiating table, as rates vary greatly depending on the nature of the brand. For example, luxury brands can charge a premium, as licensees are more assured of profit projections due to the prominence and value that these brands enjoy with consumers; while new or lesser-known brands may have to settle for a less favourable rate in order to reap the benefits of expanding recognition of their brand.

The royalty rate negotiation and the royalties finally agreed will be influenced by the balance of power between the licensor and licensee, which is often determined by the strength of the brand. In most scenarios, the balance of power will rest with the brand owner, due to the financial benefits that brands bring. The stronger the brand, the greater the brand owner's bargaining power.

In practice, top brands will be demanded by consumers and every other brand in the portfolio carried by a business will be fitted around them. These so-called 'locomotive' brands have huge strength and truly command their brand category. Examples include Diageo's Smirnoff and Johnnie Walker and Coca-Cola Enterprise's Coca-Cola. Locomotive brands drive the product portfolio and are a lead brand in their category.

Intangible Business Brand Jigsaw Matrix ©



Calculating the true value of your brand contribution

When calculating royalty rates, a brand owner should know its market and benchmark itself against other similar brands. By considering comparable transactions in the market, a brand owner can deduce a benchmarked estimate as to the royalty rates it should charge. However, comparable transactions do not always take into consideration the specifics of the licence agreement, the particular brand's operating profitability and the current economic climate, so they should be used as a guide only.

By far the most accurate measure of a brand's contribution can be assessed through conducting an excess of earnings calculation, which (at its most basic level) calculates the excess income generated purely by the brand – price premium and market share.

In licensing agreements, this will be split to allow the licensee some share of the profits and the royalty rates will be agreed as a percentage of sales. The percentage negotiated will depend on the brand strength. Locomotive brands can command a net brand contribution of more than 20% at wholesale level; this moves down in bands of around 20% to 15%, 15% to 10% and less than 10% as you slide down the relative value chain.

Intangible Business Brand Matrices©

The matrices opposite illustrate how royalty rates are determined by a brand's positioning, size and level of growth.

These matrices review relative brand equity in a three-dimensional grid aligning size (universe of relevance), brand positioning and growth. The two diagrams seek to demonstrate how these factors impact on royalties:

- All brands can be aligned within these grids, benchmarked accordingly and, most importantly, compared against their direct and indirect competition.
- Brands within these grids demonstrate commonality of brand equity and earnings potential within the universe to which they are relevant.
- Top power brands – such as McDonald's, Johnny Walker, Coca-Cola, Apple and Google – can command royalty rates of between 25% and 30% of net wholesale prices.
- The brands mentioned in this grid for illustration are extremely valuable and in most cases possess recognition and relevance in multiple territories.

As brand prestige, market share and growth rate increase, so too do the royalties that a brand can charge. Brands such as Ferrari, Google and Rolex are at the top of the matrix and excel in all three areas, which helps to explain why they can charge royalties of well over 20%. Alternatively, value brands and brands in niche markets tend to operate on a smaller scale and are unable to charge large price premiums. These brands, such as Primark and Sweaty Betty, possess a comparably lower market share and in turn a lower value to licensees, resulting in a lower royalty rate – although there can be a compensation volume.

Very few brands can be classified as prestigious or super premium and national. These characteristics allow brands to move easily into international markets, as when a brand gains prestige, it invariably increases in value. UK brands Fortnum and Mason and Harrods are internationally recognised, but are accessible only to UK consumers. The prestige of the Harrods brand lies in its exclusivity,

Intangible Business Brand Jigsaw Matrix ©

The following matrices illustrate how royalty rates are determined by a brand's positioning, size and level of growth

Size	Value: Value	Value: Premium	Value: Super premium	Value: Prestige
Global	McDonalds	Coca-Cola Smirnoff	Johnny Walker BMW	Ferrari Rolex Rolls Royce
International	easyJet Walmart	Zara Jack Willis	Virgin Atlantic Windsor & Newton	Burberry Lenox
National	Primark Poundland*	Robinsons*	Fortnum & Mason*	Harrods*

Level of growth	Size: Niche	Size: International	Size: Global
High	**New market entrants**	Jaguar	Coca-Cola Google Apple
Medium	Holland & Barrett	Hollister Hotel Chocolat	British Airways French Connection
Low	Sweaty Betty Tatty Devine*	Krug	Marlborough

* These brands are UK based. Primark is a value clothing retailer; Poundland is a retailer of basic consumables for £1; Robinsons is the United Kingdom's top concentrated juice brand; Fortnum and Masons is a super-premium food retailer; Harrods is a department store stocking prestigious brands; Sweaty Betty is a sports clothing and accessories brand for women; and Tatty Devine is a handmade jewellery brand

which makes its London store a landmark for tourists and UK citizens alike.

Brands that are categorised as niche with high growth often progress rapidly to the next level on the brand matrix. You will find it difficult to think of brands that fit these criteria, as they accelerate quickly from niche to mainstream with high growth.

Understanding the position of your brand is vital when assessing its true value in the market, which has implications for bargaining power and subsequent royalties.

Resurrecting brands

In the prevailing economic climate, several UK high-street retailers have entered into administration due to strong competition from online trading. Music retailer HMV is one example of a company that lacks sales revenue, but has a wealth of value in its brand, as well as related trademarks. HMV has been acquired by restructuring specialist Hilco, which has the potential to preserve HMV's most valuable asset – its brand, including its NIPPER THE DOG trademark. Licensing it out would be a viable method of capitalising on this.

Polaroid, which declared bankruptcy in 2009, has enjoyed similar success with its brand. The company's intangible assets were bought by PRL IP Holdings and resurrected by licensing the brand to be used on numerous photography-related products, and even expanded to other electronic products in a joint venture with Asda. Such 'resurrections' have led to brands that rise from the ashes of bankruptcy being dubbed 'phoenix brands'. Consumer confidence in Polaroid and HMV is largely due to them being considered 'heritage brands' – or brands with nostalgic value – which allows them to retain brand value through their intellectual property after insolvency.

Trademarks and intangible assets across a broad spectrum are often a company's most valuable asset, which explains the lengths that companies will go to protect and maintain their brands. A brand propagates a company's reputation; its related intellectual property must thus be licensed in line with the message that it wishes to express to consumers. Therefore, before negotiating royalty rates, companies must consider the effect that licensing their brand will have on their overall brand value, and not simply on the increased revenue that they may earn – which may in any case be wishful thinking.

Pension securitisation

The combination of reduced investment returns, low interest rates and increased life expectancy has had a major impact on defined benefit pension schemes. According to the UK Pension Protection Fund, 82% of defined benefits schemes were in deficit at the end of 2012, with the aggregate deficit standing at £252.2 billion. The economic downturn has restricted cash flows within companies, which have responded by seeking innovative ways to preserve cash flow while continuing to meet their obligations to finance their pension schemes.

Asset-backed pensions securitisation through pension funding partnerships (PFP) has become increasingly popular. Under a PFP, assets are transferred to a special purpose vehicle (SPV) and licensed or rented back to the company. The licence/rental income generates an income stream which is paid to the pension fund. The pension fund's interest in the SPV represents a plan asset which is valued on the basis of the discounted value of future cash flows to be received from the SPV, and the pension deficit is thereby reduced. In the event of default, the pension fund takes control of the asset,

> **While royalty rates can increase revenue significantly, in order to build successful, long-lasting brands, royalties are often shared among all those involved in the creation of the brand. This dilutes the revenues received for the brand owner**

which it can sell to reduce any outstanding deficit. The benefit to the company is that it enables it to preserve cash flow by funding the pension deficit over a longer timeframe than a conventional deficit funding scheme, while the pension scheme is provided with additional security against its deficit.

The majority of schemes have used tangible assets such as land and buildings or inventory. However, innovative schemes utilising intangible assets such as brands and trademarks have been used by companies such as TUI Travel and GKN, and are becoming increasingly popular. Where intellectual property is used within a PFP, the royalty rate to be paid by the company to the SPV and the value that the pension fund is likely to receive in the event that the assets are sold in a distressed scenario are critical factors in setting up the PFP.

Music industry – brand/band equity

The music industry is a good example of the division of revenue using royalties, as an artist's brand is rarely controlled and disseminated solely by him or her. When a song gets played on the radio, the broadcaster is effectively licensing it from the record label and royalty fees are paid per play. This fee is then shared out between various parties, including the songwriter, the publisher, the producer, the artist and the artist's management. Each party is entitled to a share of the royalties earned, ensuring that every participant involved in the creation of the song – and in turn, the artist's brand – shares in the success.

While royalty rates can increase revenue significantly, in order to build successful, longlasting brands, royalties are often shared among all those involved in the creation of the brand. This dilutes the revenues received for the brand owner; however, it reflects the efforts of all parties involved in the song or artist's success, which have contributed to a strong and enduring brand.

The division of royalties has been highlighted by recent claims that the Spotify music-streaming service, which relies on licensing agreements with music labels, is attempting to renegotiate lower royalty rates in order to turn a profit. Spotify currently pays record label royalties of approximately $0.004 per play, which are then split between all of the different parties involved in creating the song. Its strict licensing policies have previously caused high-profile artists – including Adele and Taylor Swift – to refuse distribution of their music through the channel. While big-name artists may feel that such low royalty rates devalue their brand, new artists can benefit from showcasing their music to Spotify's 20 million users worldwide.

Monitoring a brand has a considerable impact on the royalty rates that can be charged. Global superstar Beyoncé recently spoke about becoming the chief executive of her own brand, which has given her complete control over what her name is associated with. By taking control of her brand, she can be selective and associate her brand name only with companies and products that align with her values and those that she wishes to present to the public. It also reduces the number of people with whom she shares her royalties, giving her greater bargaining power with licensees and a larger share of the royalties paid for the Beyoncé brand.

New brands – inspirational people

To create more brand equity in any sector from scratch needs more than just a good idea – after all, thousands of ideas ultimately fail, or never even get off the drawing board.

To develop, a new brand requires both a great idea and innovative people with real business savvy to drive the business consistently over the years. You must also have proper resources to make this happen, together with the ability to access distribution and handle the many protective blocks that will get in the way (barriers to entry).

New market entrants disrupt the status quo and meet with competitive protectionism until they become established themselves. The success stories – Absolut Vodka, Google, Apple, Microsoft, Innocent and so on – have all been driven by creative people who possessed a vision and belief in their brand that was also helped by others. Inspirational people are the key.

Understanding royalty rates

Ensuring that a brand is licensed correctly and that an appropriate royalty rate is in place is essential to secure the future longevity and success of a business. Profitability – especially in the current economic climate – remains the bottom line for companies. It is doubtful whether megabrands such as Virgin and Coca-Cola would have flourished globally if their licence agreements and royalty rates were not implemented diligently.

A correct, robust and sensible brand valuation, coupled with a watertight licence agreement which clearly states the royalty rate considering the brand's placing in the market and excess of earnings calculation, is key. Only then can a brand confidently grow with licensees at the helm. WTR

Stuart Whitwell is joint managing director at independent brand valuation consultancy Intangible Business