VRC

Strong values.

Valuing the Brands of Consumer Product Companies

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Valuation Research Corporation

- Formed in 1975, VRC has eight U.S. offices and nine international affiliates.
- VRC provides M & A services, fairness and solvency opinions in support of corporate transactions, and valuations of intellectual property and tangible assets for financial reporting and tax purposes.
- VRC maintains relationships with corporations, lenders, accountants, investment banks, private equity firms, and law firms.
- VRC was instrumental in forming the Appraisal Issues Task Force (AITF), a valuation industry group that meets quarterly with representatives from the FASB, the SEC, and the PCAOB to discuss valuation issues surrounding financial reporting.

P.J. Patel, CFA

- Mr. Patel specializes in the valuation of businesses, assets and liabilities for financial reporting purposes. In particular, he has focused on the valuation of intellectual property/intangible assets such as trademarks, technology, software, customer relationships and IPR&D.

- Mr. Patel is an active member of the AITF and is currently a member of the Appraisal Foundation's Working Group, which is preparing a Practice Aid for valuing customer relationships.

- Mr. Patel is a frequent presenter on valuation issues for financial reporting purposes and has recently presented on valuation issues relating to ASC 805 (SFAS141R), ASC 350/360 (SFAS142/144), ASC 820 (SFAS157) and other emerging issues. In addition, Mr. Patel was on the Fair Value Panel at the 2008 AICPA SEC Conference. He has been quoted numerous times in the press regarding valuation issues.

Brand Valuation Experience

- Annual valuation of over $20b of Brands – book, tax and financing

KRAFT

pepsi

Kellogg's

STEVE MADDEN

Cadbury

HARTMARX
CONSUMER APPAREL PRODUCTS

IKE BEHAR
NEW YORK

Mondelēz International

kate spade
NEW YORK

LU

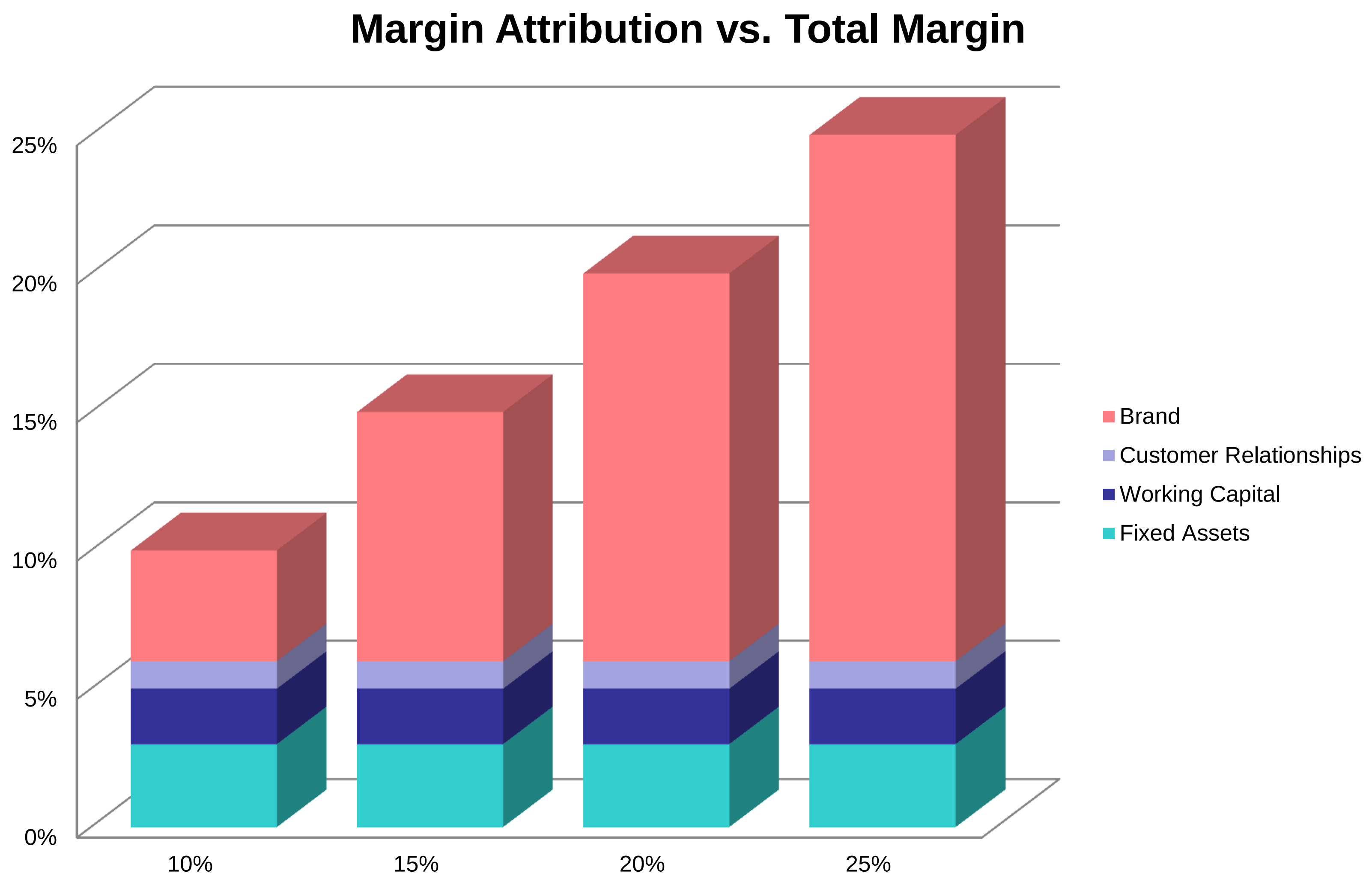
Introduction

Introduction

What is a Brand?

- A brand is a name, term, design or other feature that distinguishes one seller's product from those of others. Source: Wikipedia
- A trademark is a word, phrase, symbol, and/or design that identifies and distinguishes the source of the goods of one party from those of others. Source: USPTO – www.uspto.gov
- Book vs tax vs common perception
- Trademarks vs Brands
- Brands typically comprise various elements, such as:
  - Name: the word or words used to identify a company, product, service, or concept
  - Logo: the visual trademark that identifies a brand
  - Tagline or catchphrase
  - Graphics
  - Shapes: the distinctive shapes are trademarked elements of those brands
  - Colors
  - Sounds
  - Scents
  - Tastes
  - Other elements

What Drives the Margin of a CPG?



Valuation Approaches

Cost Approach

- The cost approach is a valuation technique based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost).

Market Approach

- A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business).

Income Approach

- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts.
  - Relief from Royalty
  - Multi-Period Excess Earnings
  - Excess Margin

Background Info

- Launched over 70 years ago
- Brand is a leading biscuit brand in the US
- Strong awareness, market penetration
- Sold nationwide in all channels including modern trade, traditional trade and AFH
- In 2014, performance was negatively impacted by disruptions at two customers and category weakness
- Going forward, the margin improvement is due to positive pricing and including brand extensions.

Actual and Projected Data	2013	2014	2015	2016
Net Sales	2,969,982	2,694,795	2,538,496	2,553,728
Net Sales Growth	2.1%	-9.3%	-5.8%	0.6%
Operating Contribution	658,848	569,649	579,486	621,877
Operating Contribution Margin	22.2%	21.1%	22.8%	24.4%

Income Approach – Relief From Royalty

Relief from Royalty Method

- The Relief from Royalty is a form of the income approach and measures economic benefits directly by calculating the profit (or cash flow) attributable to an asset by reviewing market based royalty rates/license fees.
- Key Inputs are as follows:
  - Revenue and earnings generated by the subject asset
  - Royalty rate
    - Market transactions
    - 25/33% rule of thumb
    - Other profit split methods
  - Appropriate discount rate

Relief from Royalty Method

Assumptions				
Royalty Rate	20.0%			
Long-Term Growth Rate	1.5%			
Tax Rate	19.0%			
Discount Rate	12.0%			

	2013	2014	2015	2016
Net Sales	2,969,982	2,694,795	2,538,496	2,553,728
Royalty Rate		15.0%	15.0%	15.0%
Royalty Savings		404,219	380,774	383,059
Income Taxes		76,802	72,347	72,781
After-Tax Royalty Savings		327,418	308,427	310,278
Implied After-Tax Royalty Rate		12.2%	12.2%	12.2%
Partial Period Adjustment		0.25	1.00	1.00
Period		0.13	0.75	1.75
Present Value Factor		0.99	0.92	0.82
Present Value of Royalty Savings		80,703	283,295	254,460

Determination of Fair Value	
Present Value of Finite Period	1,238,512
Present Value of Residual Value	1,814,268
Present Value of Royalty Savings	3,052,780
Tax Benefit	306,725
Value Indication	3,359,505

Assessing an Appropriate Royalty Rate

- Data Sources

- Using a Relief from Royalty Method is appealing
  - Easy for everyone to follow and understand
  - Key input (royalty rate) based on market transactions

- Using royalty rate data is problematic due to the following factors:
  - Lack of sufficient information
  - Lack of comparability
  - Dated transactions
  - Many transactions bundled
  - Differences in terms of agreement (e.g. non-exclusive vs. exclusive)
  - Geographic regions may differ

- 25%/33% Rule of Thumb

Income Approach - MPEEM

Multi-Period Excess Earnings Method (MPEEM)

- The MPEEM is a form of the income approach and measures economic benefits indirectly by calculating the profit (or cash flow) attributable to an asset after adjusting for appropriate returns on contributory assets.

- Contributory assets are the assets that are assisting the subject asset in generating revenue and earnings.

- Key Inputs are as follows:
  - Revenue and earnings generated by the subject asset
  - Contributory assets
  - Rates of return on contributory assets
  - Appropriate discount rate
  - Economic life

Multi-Period Excess Earnings Method

Assumptions				
Long-Term Growth Rate	1.5%			
Tax Rate	19.0%			
Discount Rate	12.0%			
Customer Relationship Royalty Rate	0.3%			
WC to Revenue Ratio	15.0%			
Return on Working Capital	5.0%			
PP&E to Revenue Ratio	30.0%			
Return on PP&E	8.0%			
	2013	2014	2015	2016
Net Sales	2,969,982	2,694,795	2,538,496	2,553,728
Net Contribution		569,649	579,486	621,877
Income Taxes		108,233	110,102	118,157
Debt-Free Net Income		461,416	469,384	503,720
Debt-Free Net Income Margin		17.1%	18.5%	19.7%
Returns on Supporting Assets				
Customer Relationships		8,084	7,615	7,661
Working Capital		20,211	19,039	19,153
Property, Plant, and Equipment		64,675	60,924	61,289
Total Returns on Supporting Assets		92,970	87,578	88,104
		3.5%	3.5%	3.5%
Net After-Tax Cash Flow		368,446	381,806	415,617
Implied After-Tax Royalty Rate		13.7%	15.0%	16.3%
Partial Period Adjustment		0.25	1.00	1.00
Period		0.13	0.75	1.75
Present Value Factor		0.99	0.92	0.82
Present Value of Royalty Savings		90,816	350,694	340,848
Determination of Fair Value				
Present Value of Finite Period		1,672,448		
Present Value of Residual Value		2,653,759		
Present Value of Cash Flow		4,326,207		
Tax Benefit		434,671		
Value Indication		4,760,878		

With and Without Method – Excess Margins

- Excess margin method is a form of the with and without method and income approach and measures economic benefits directly by calculating the profit (or cash flow) attributable to an asset by comparing it with another similar asset.

- Key Inputs are as follows:
  - Revenue and earnings generated by the subject asset
  - Profit margin for the subject asset and for comparable companies
  - Appropriate discount rate
  - Economic life

Excess Margin vs. Private Label

Assumptions				
Contract Manufacturer Margin	5.0%			
Long-Term Growth Rate	1.5%			
Tax Rate	19.0%			
Discount Rate	12.0%			
	2013	2014	2015	2016
Net Sales	2,969,982	2,694,795	2,538,496	2,553,728
Operating Contribution Margin		21.1%	22.8%	24.4%
Less: Contract Manufacturer Margin		5.0%	5.0%	5.0%
Excess Margin		16.1%	17.8%	19.4%
Excess Earnings		434,910	452,561	494,190
Income Taxes		82,633	85,987	93,896
Excess Net Income		352,277	366,575	400,294
Implied After-Tax Royalty Rate		13.1%	14.4%	15.7%
Partial Period Adjustment		0.25	1.00	1.00
Period		0.13	0.75	1.75
Present Value Factor		0.99	0.92	0.82
Present Value of Royalty Savings		86,830	336,704	328,282
Determination of Fair Value				
Present Value of Finite Period		1,611,287		
Present Value of Residual Value		2,564,166		
Present Value of Excess Net Income		4,175,453		
Tax Benefit		419,524		
Value Indication		4,594,977		

Summary of Values

Relief from Royalty	Excess Margin	Excess Earnings
3,359,505	4,594,975	4,760,880

InterBrand – Brand Value/Risk

	2000	2005	2010	2013
1	Coca-Cola	Coca-Cola	Coca-Cola	Apple
2	Microsoft	Microsoft	IBM	Google
3	IBM	IBM	Microsoft	Coca-Cola
4	Intel	GE	Google	IBM
5	Nokia	Intel	GE	Microsoft
6	GE	Nokia	McDonalds	GE
7	Ford	Disney	Intel	McDonalds
8	Disney	McDonalds	Nokia	Samsung
9	McDonalds	Toyota	Disney	Intel
10	AT+T	Marlboro	HP	Toyota

Source: Interbrand www.bestglobalbrands.com

InterBrand – Brand Value/Risk

	Apple	Yahoo	Google
2013	#1	NA	#2
2010	17	66	4
2005	41	58	38
2000	36	38	NA

Source: Interbrand www.bestglobalbrands.com

InterBrand – Brand Value/Risk

Nokia	Rank	Value
2013	57	$7.4b
2010	8	$30b
2005	6	$26.5b
2000	5	$38.5b

2014 - Not in top 100

Source: Interbrand www.bestglobalbrands.com

VRC Case Study

	Value	Value Change	Notes:
1999	$1.0b		Brand acquisition
2004	$2.0b	+100%	#1 market share, fast growing sector
2007	$2.3b	+15%	Continued growth
2009	$1.0b	-57%	Mistakes on pricing, commodity price increase and significant increase in competition
2010	$1.3b	+30%	Slight recovery of market share, margins
2012	$1.8b	+40%	New opportunities for brand extensions

Conclusions

- The value of the brand encompasses more than the trademark
- Brands are very valuable but risky
- Valuation methodology selection is very important
  - RFR - simple, objective but may not be appropriate
  - MPEEM – multiple moving parts – may be appropriate
  - Excess Margin – simple, objective – may be appropriate if good comps are available

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