The Importance of Brand Equity in Creating Firm Value

“If this business were split up, I would give you the land and bricks and mortar, and I would take the brands and trademarks and I would fare better than you.”
— John Stewart (Former CEO of Quaker)

Brand valuation has emerged from its introductory phase and is now on a steep growth slope. In response to the needs of company managers who, in the 1980s, were paying unprecedented sums for brand-owning companies, brand valuation, initially, was a solution to an accounting problem. As such, it was artificially forced into methodologies that would be acceptable in the board room and which would not be in conflict with accounting conservatism. While contemporary techniques conform to accepted business valuation approaches, they have broken free from the more self-conscious constraints and are now more broadly applicable. This paper focuses on the financial heart of brand valuation: isolation of the portion of “super profits” generated by the brand. It is argued that the brand is central to a firm’s ability to earn these profits and that it exerts an influence on the resources and capabilities that are directly responsible for a firm’s success. No other intangible has the same linear link between the market which is the source of a company’s revenues, and the wealth the company creates for its shareholders.

Introduction
Brand valuation is a new science. Its development in the 1980s was stimulated by a spate of mergers and takeovers, the object of which was to acquire brand-owning companies (Farquhar, Han & Ijiri 1991). Companies made these acquisitions because they wanted the cash flows these established assets would generate at a cost less than creating new brands themselves. At a rate of failure of three out of four new product introductions (Aaker 1991), the Net Present Value associated with buying an existing portfolio of brand leaders with loyal customers, distribution, and legally protected trademarks was—and remains—an attractive proposition.¹

What distinguished these acquisitions was the high multiple of price paid to book value. According to Lev (2001): “In the last fifteen to twenty years, most of the value and performance of companies have come from intangible assets.”

The difference between price paid and Net Asset Value (NAV) has been described by accountants as goodwill, and their traditional convention had been to deduct the goodwill portion of the purchase price from shareholders’ funds. This was a convenient way to deal with a cost for which there was no tangible explanation or rationale. When the quantum of goodwill equalled or exceeded the shareholders’ funds—as it did in many of these instances—an alternative had to be found. By recognizing the brand as an asset (hence the need for valuation) it could be treated like a building or piece of machinery and placed on the balance sheet. Thus there was a cost and a counterbalancing asset acquisition.

This practice was quickly banned by the accounting profession because the approach was in conflict with the accounting concept rooted in historic cost principles and the measurement of assets that have physical form.

The basis for brand valuation was, however, established and attracted the attention of a number of disciplines ranging from accountants to economists, corporate financiers, and marketers. More recently, tax authorities have recognized its importance as has the legal profession with regard to trademark registration, litigation, and defense.

As a new science it is still maturing and developing, as illustrated by the modification made by Interbrand—the early developers of the science—in the last few years (compare Haigh 1996 with Trevillion & Perrier 1999).

Valuation experts are agreed on one crucial aspect: the brand must be isolated from the other intangibles that generate value that a non-branded version of the same product would not (for example, Trevillion & Perrier 1999; Bertolotti 1995). In our conception these are the “super profits” in excess of the cost of capital. Since by definition the intangibles, their relative importance to each other, and the influence of the brand are not clearly apparent,

¹ In mid 2000, Unilever paid 2.5 times the sales revenue and 5 times the NAV to acquire the famous brands owned by the American Bestfoods company. The brands they acquired included Hellman’s Mayonnaise and Knorr Soups. The price was $24 billion.
Intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange, or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.” (A.C.129 .12)

The problem of separability can be overcome under certain conditions—for example, if it can be identified by way of a legal right that changes hands for a price. However, the standard states quite clearly later on that internally generated brands, among other candidates, will not meet the recognition criteria and that certain intangibles that are acquired will also not be recognized for inclusion in financial reports. While it is not explicitly stated in the standard, the discussion documents that precede the statement make it perfectly clear that brands will not qualify.

The irony of this situation is it was the brand debate of the 1980s that led to the development of the new standards (Barwise et al 1989). Companies acquiring others in order to gain ownership of their brands were treating the income generating-resource as they would a tangible asset: a value was ascribed to it and it was included in the asset side of the balance sheet. Initially this was done to overcome the destructive effect of applying the cost to shareholder funds.

Some firms went as far as having the brands they had developed themselves valued and placed on the balance sheet.

It took the IASC eight years to develop the new standards that then failed to recognize as assets the very items that brought about the project in the first place.3 This grudging achievement is redolent of the lengthy development of the GAAP for life insurance, which has resulted in the

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2 This body has been renamed the International Accounting Standards Board (IASB) and is tasked with developing new standards to ensure that the profession is globally in line with users of accounts’ requirements, and that the profession is internationally harmonized. Acquired goodwill and intangible assets are both on the IASB’s agenda for immediate attention.

3 In the UK and some other markets, accountants are treating the new standards more liberally than elsewhere. Acquired brands are being recognized and carried in the books as long-lived assets that require impairment reviews to be conducted periodically to test the maintenance of value.
acknowledged actuarial method of valuing life offices by the appraisal value approach being rejected as a method of determining profit for audit purposes. In a presentation to the Institute of Actuaries, O’Keefe and Sharp (1999) wrote that the value added system could never be allowed by auditors because “In accounting philosophy it is argued that, because a company does not and cannot have an enforceable claim on future premiums received, they should not be recognized as revenue. All that can be recognized is revenue received. Each premium represents a separate transaction. If a premium is paid, the insurance continues. If it is not, it lapses.”

As the authors wryly comment, “So much for embedded value accounting!” (See the previous footnotes.)

There are at least four clear signs that the accounting profession is aware of the deficiencies in its framework and is setting about dealing with them:

1. The inclusion in the IASB program of the standards dealing with goodwill and intangible assets. These have been noted as priorities.

2. The change in the American accounting GAAP to allow goodwill to be carried in the accounts and not depreciated (e.g., see CFO Magazine 2001).

3. Publication of the book by PricewaterhouseCoopers (Eccles et al 2001) which promotes the adoption by accountants of new reporting methods that capture the full value of companies.5

4. The acceptance in accounting standard A.C 129 which deals with Intangible Assets of the main approaches used by specialists in valuing intangibles. Notably, these are Discounted Cash Flow, and applying a multiple to the weighted three-year average net profit (the original Interbrand approach).

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4 According to the text book The Practice of Life Insurance (1999), appraisal value is the sum of adjusted net worth and value of in-force business (embedded value is the sum of these two) plus the estimated value of new business. Appraisal value has been criticized because of its reliance on inflation projections, selection of a suitable discount rate, and the estimate of new business often based on a multiple of the value of one year’s business.

5 A similar view is held by actuaries who do not anticipate embedded value being accepted by accountants until “…accounting may move closer to recording estimated changes in economic value…” (O’Keefe & Sharp 1999).
Resources can be what a company has and what it is able to do. A patent is a “having” resource; know-how is a “doing” resource. In both cases, the value that the firm derives from these resources is intangible.

Firms optimize their resources through distinctive capabilities that are functional and cultural (skills to produce effective advertising or make products with no defects) as well as positional and regulatory (related to developing and maintaining resources such as brand names and reputation). The concept of resources and capabilities is further elevated by Mahoney and Pandian (1992) who state, “Rents derived from services of durable resources that are relatively important to customers and are simultaneously superior, imperfectly imitable, and are imperfectly substitutable, will not be appropriated if they are non-tradable or traded in imperfect factor-markets.”

Amit and Schoemaker (1993) quote Itami (1987) who said of a firm’s capabilities, “Some of the firm’s invisible assets are not carried by its employees but rather depend on the perceptions of the firm’s customer base (as brand names may do).”

This discussion is important because, as Mahoney and Pandian (1992) point out, “Strategy can be viewed as a continuing search for rent,” which Amit and Shoemaker (1993) explain, “derive from properties unique to the firm’s resources and capabilities.”

What emerges from this stream of research is that successful firms develop intangible resources over time that, when assembled and skillfully applied, result in the company earning extraordinary profits—that is, profits in excess of what would be earned by an ordinary firm that lacked these resources and skill set. Thus, resources and capabilities are the link between the market for the firm’s products and services and its shareholders and investors.

Some of these resources are rooted in the market in which the firm’s products and services sell. Examples would be customer, channel, and partner relationships. According to Srivastava, Shervani & Fahey (1998) these are market-based assets that, when effectively managed, have the effect of “increasing shareholder value by accelerating and enhancing cash flows, lowering volatility and vulnerability of cash flows, and increasing the residual value of the firm.”

### Table 1: Hall’s (1993) List of Intangible Assets

<table>
<thead>
<tr>
<th>Resources</th>
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<tbody>
<tr>
<td>Intellectual property rights of patents, trademarks, copyrights, and registered designs</td>
</tr>
<tr>
<td>Trade secrets</td>
</tr>
<tr>
<td>Contracts and licenses</td>
</tr>
<tr>
<td>Databases</td>
</tr>
<tr>
<td>Information in the public domain</td>
</tr>
<tr>
<td>Personal and organizational networks</td>
</tr>
<tr>
<td>The “know-how” of employees, professional advisers, suppliers, and distributors</td>
</tr>
<tr>
<td>The reputations of products and the company</td>
</tr>
<tr>
<td>The culture of the organization: e.g., the ability of the organization to react to challenge, to cope with change, etc.</td>
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</tbody>
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6 In 1988 and 1991, Hall conducted a survey among British CEOs. The respondents were asked, among other things, to rank a slightly amended version of the above list in order of importance. In the revised list, company and product reputation were separated. In each of the two surveys, these two intangibles—corporate reputation and product reputation—were ranked first and second, respectively.
value of cash flows."

This is consistent with the way Brealey and Myers (1996) explain the source of Net Present Value (NPV). They reiterate the microeconomic theory that once an industry has settled to long-term competitive equilibrium, all assets employed are expected to return no more and no less than their cost of capital. If they earn more, the industry will expand as others are attracted to it. We have already looked at economic rents—profits earned in excess of the cost of capital—and understand that these rents are often temporary as one firm finds a new benefit which others soon replicate. Long-term rents, when they occur, are due to monopoly or market power.

NPV refers to the present value of these economic rents, and the point that Brealey & Myers make is that NPV must be carefully examined to understand why it has occurred. It might be an error or over estimation or it might be genuine. The latter would be due to some identifiable advantage such as being first to market with an innovation for which consumers are willing to pay a premium price.

Those that are long-lived are driven by the market and the market’s willingness to buy volume and support prices that will allow the firm to exceed the cost of capital. It also depends on the firm’s ability to maintain this competitive advantage through innovation and extension in order to defend this market opportunity (Barwise, Marsh and Wensley 1985; Srivastava, Shervani & Fahey 1998). As Erhbar (1998) facetiously points out when criticizing Hewlett Packard’s former CEO, John Young, for stating that his approach was driven by a winning formula based on satisfying customers: “Yes, Mr. Young, the point is to win. But what is winning? Profits do not automatically flow from satisfying customers as you suggest; only revenues do."

NPV, EVA, or a market premium over NAV—these are all money-based measurement tools. In fact, they are all profit-based. Firms or assets have to make profits in order to record a positive NPV, EVA, or be rated by analysts and earn the right to a positive Tobin’s “q”.

Customers are the primary source of revenue. Investment income comes from having investment funds which had their origin in revenue from sales. Cost savings come from the economic power to negotiate with suppliers or to achieve lower costs through scale economies. Good management is attracted to firms with sound market positions, and they will in turn bring in staff able to sustain and build the market position (Lovelock & Wright 1999).

Brand Is the Focal Point

“Brands are among a company’s most valuable assets.” — The Economist (1991)

“Enron never understood that business is not just about numbers and the balance sheet; it’s about your brand, and the confidence you inspire.” — The Economist (2001)

For over twenty years, academics have been investigating the link between profit and customers (see, for example, Buzzell & Gale 1987). The broadening of the market-to-book gap and the emergence of intangible assets—and brands in particular—as the main drivers of this and other benefits has attracted a growing stream of research. For example, Eccles et al (2001) reported on the work (referred to above) of Wharton Business School researchers, Larker & Ittner, who found that “customer satisfaction levels are indeed leading indicators of future financial performance measure such as revenues, revenue growth, profit margin, and return on sales.”

This is consistent with the work of other surveys and analyses. For example, the PIMS project created by Harvard professors Brad Gale and Bob Buzzell and which built on prior work by McKinsey and General Electric, has proven a powerful link between return on investment and customer relative perceived quality. They established through analysis of their database of many hundreds of American companies, that those which deliver consistent product quality perceived by its customers to be superior to the competition will achieve enhanced returns.

Strongly in line with brand equity theory, they concluded
that companies that do achieve a perceived, relative product quality advantage will generate these better returns due to stronger customer loyalty, more repeat purchases, and less vulnerability to price wars.

Liebowitz (whose work is basic to our model) confirms this in his seminal paper on the sales-driven franchise concept when he states, "The high-value firms will be those that can command premium pricing across a range of product markets. Virtually by definition, such firms will be able to achieve higher-than-normal margins—in other words, they will possess a powerful sales-driven franchise." (Liebowitz 1997)

He goes further by stating that this franchise margin is a proxy for identifying the pricing power of the firm which, in his belief, represents the true and special value of intangibles such as the brand.

It was the thought that this might be the case that stimulated the original Brand Equity conference convened by Boston-based Marketing Science Institute (MSI) in 1988, at which Brand Equity was designated a Capital Topic (Leuthesser 1988).

Capital Topic status means MSI will favor requests for funding from academics and researchers whose work is in the designated area. So important was this subject that its Capital Topic status was extended until 1995—a double period. The result was a rich stream of research that looked at the brand equity topic—its measurement and management—from a variety of viewpoints.

While this period of concentrated study produced a vast pool of refereed information, analysis, and conclusion (much of which has been factored into the Wits model of brand valuation), a common finding was summed up by this extract from the report of Simon & Sullivan (1993), one of the most cited works from the series: "Brand equity is the capitalized value of the profits that result from associating the brand’s name with particular products or services."

Brand equity is defined as such because the brand is the anchor used by customers to associate the perceived relative quality singled out by the PIMS investigators (Keller 1993). As an anchor that signals quality and attracts loyalty, the brand is also the link between customers and the firm. As such, it is from the brand that customers defect when they are dissatisfied.

Bain & Company partner Fred Reichheld, working with colleagues at Harvard Business School (1990, 1996), reported the startling findings that if companies can increase customer retention by as little as 5% per annum (in other words prevent defections), the Net Present Life Time Value of those retained customers rises by between 35% and—in the case of insurance companies—90%.

These vast increases in value arise due to the trust that is built up between customers and the brand. The brand signals quality, reliability, and consistency to the consumer and sets up a formidable barrier discouraging potential rivals from entering the market (EIU 1997).

While it is the bundle of resources, capabilities, and attributes that bring this about, it is the brand that captures these intangibles in one identified package for the consumer.

Discussion and Conclusions

Companies use a number of metrics to measure their financial performance. In this paper we have mentioned NOPAT, EVA, NPV, and market-to-book ratio. In statistical terms they are all dependent variables because they are each a function of the way the company is managed.

We have shown that intangible resources coupled with capabilities are major drivers of these measures. However, these are intervening variables in the sense that they mediate the link between the source of a company’s revenue flow and the profits that accrue to the shareholders. This flow is summarized, conceptually, in Diagram 1.

This flow is supported in the literature with numerous

7 See also the literature from economics and psychology on signaling theory, e.g., Erden & Swait 1998; Reekie and Crook 1995.
8 Their work should be useful in computing life insurance appraisal value sensitivities.
Naturally, brand equity itself is a dependent variable when it comes to its own development. Here it is influenced by, for example, advertising, word of mouth, personal consumer experience, direct selling, promotions, etc. That is consumer brand equity which is primarily concerned with its source. However, in its financial sense brand equity is the independent variable that is the outcome on which the company is dependent for its flow of revenue (Keller 1993; see also Moorehouse 1990; Chaterjee, Jauchius, Kaas and Satpathy 2001).

We do not make the claim that brand equity is solely responsible for firm profits. Clearly, profit is achieved through a combination of resources—hence the resource set as the driver of “super profits.” Simon & Sullivan (1993) have demonstrated, though, that the brand influence can be significant: in the case of food products, 82%; textiles, 45%; and chemicals, 41%.

We do, based on substantial support from the literature and our own research, make the claim that since brand equity, in our conceptualization, is the primary source of the company’s revenue flow, it exerts a differential influence on each of the downstream profit drivers or resources.

We do not believe that the opposite is true to any proven extent.

Concluding Comments and Summary

In this paper we have attempted to show that companies earn extraordinary profits, over the cost of capital, if they can deliver a product or service to the consumer that is perceived to be beneficially different. This will be short-lived unless some advantage that is sustainable can be developed. The reason why massive premiums have been paid for brand-owning companies over the last twenty years has been for this very purpose: new product development is simply too risky and expensive, and it is a more viable solution to buy an existing company that owns established brands than to start from scratch. This is not withstanding the apparently excessive cost of these purchases.

Companies such as Coca-Cola, Unilever, Procter & Gamble, and Colgate have brands that have been leaders in this process. Researchers focusing their attentions on the link between brand equity and shareholder wealth. For example, Kerin & Sethuraman (1998) conducted a literature survey and then tested certain hypotheses empirically to validate their contention that there is a positive relationship between a firm’s accumulated brand equity and its market-to-book value. Their conclusion is simply and clearly stated: “Firms with higher accumulated brand values have higher M/B ratios.”

Working in conjunction with Citibank, Interbrand conducted an analysis of British companies’ share performance for the fifteen years from 1982 to 1998. They demonstrated that companies that were in what they called the branded group—companies such as Cadbury and Unilever whose businesses rely on brands—performed significantly better than the FTSE 100 index (Trevillion & Perrier 1999).

A company which has a market orientation—which means it is responsive to consumer needs and demands as well as competitive activity, and it manages its response to these forces inter-functionally—is ultimately dependent on the consumer to generate the revenue stream through volume purchasing at prices that permit the firm to make a reasonable margin (cost control is an internal function).

Diagram 1: Path Dependency In an Established Firm With Market Share (Conceptual Framework)

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9 There is a substantial body of literature on market orientation which was an MSI capital topic in the mid-1990s. While references are not included in this paper, we will gladly make them available upon request.
for decades. There are two reasons for this. First, they have created high levels of consumer trust. Their brands are bought without question of quality or consistency. For this, consumers will buy regularly and pay a premium price. Second, over many years they have developed channel control and management. These companies are built around their brands—everything they do is designed to enhance and protect the brand assets that are the foundation of their wealth.

As the McKinsey article (Chaterjee et al. 2001) indicates, the American car industry should learn from this. Their case study focuses on a production line that produces two nearly identical vehicles, the Chevrolet Prizm and the Toyota Corolla. Even though they are produced on adjacent lines and are differentiated only by cosmetic differences, the Toyota badge allows the Corolla to sell at a higher margin than the Prizm because Chevy dealers have to provide greater cash incentives to force sales.

Other examples have been shown to illustrate that in almost any industry—banks and insurance companies now have brand management directors; engineering and commodity companies now embrace marketing and brand management; Barlows is now Barloworld: Leading Brands; and Andersen Consulting spent a vast amount of money to transfer the mental associations with the old brand, built up over twenty years, to their new name, Accenture—it is the brand, as a proxy for the company’s reputation and the quality of its products or services, that is one of, if not the most crucial driver of, sustainable advantage in the form of volume of sales and customers’ willingness to pay a competitive, if not premium, price. It is brands, among other intangibles, that are also at the heart of the high market-to-book ratios.

Internally, companies develop a set of resources and capabilities that are directly responsible for a company earning a profit in excess of the cost of capital (see Diagram 1). Our task is to value the brand which we have defined as the primary source of the company’s sustainable advantage in the market. Our interest is then to carve out from the profit generated over the cost of capital, that portion attributable to the brand. In a highly branded business we would expect this to be very high—as indeed has been the case. In businesses that are not so highly branded such as Eskom and the insurance industry (due to the broker network), we expect these to be lower—as indeed has been the case. In this regard we draw comfort from the fact that our percentages are more or less in line with those produced by others who have published their work (e.g., Simon & Sullivan 1993), and we have also had convergence in two cases where we have valued brands previously valued by Interbrand (Langeberg and Eskom).

In Table 2 below we show some of the industry percentages that have emerged from our dilution workshops:

Finally, we make two points that are of central significance to brand valuation in general and this issue in particular:

First, after fifteen years since the first valuations were conducted, brand valuation has matured as a business tool. Many variations have been developed and tested over this period, but there is general agreement now that any valuation method must at least conform in two areas: it must measure the cash-generating power of the asset by using discounted cash flow, and the base profit must be isolated from the “super profits” by some common approach. This allows variations in other components of the methodology, but means that wherever a brand

<table>
<thead>
<tr>
<th>Brand Category</th>
<th>Percent</th>
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<tbody>
<tr>
<td>Exterior Paint</td>
<td>71</td>
</tr>
<tr>
<td>Weekly Newspaper.</td>
<td>88</td>
</tr>
<tr>
<td>FMCG — Frozen Foods.</td>
<td>82</td>
</tr>
<tr>
<td>FMCG — Spreads</td>
<td>71</td>
</tr>
<tr>
<td>TV Station</td>
<td>70</td>
</tr>
<tr>
<td>Parastatal.</td>
<td>54</td>
</tr>
<tr>
<td>Insurance.</td>
<td>51</td>
</tr>
<tr>
<td>Ready-Mix Concrete</td>
<td>49</td>
</tr>
<tr>
<td>Bank</td>
<td>61</td>
</tr>
<tr>
<td>Athletic Shoes</td>
<td>71</td>
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is valued and by whom, some degree of harmony and consistency can be expected. Our approach uses a version of the well-known Delphi technique and our data collection therefore differs from others, but our final quantification is in line with how this is commonly achieved. We test our valuations against a hybrid of the approaches used by Interbrand and Brand Finance and find that we are invariably close to what we think they would have produced.

Second, the demand for brand valuation is increasing as its applications expand from the original in brand financing and accounting to marketing, strategy, franchising, income tax, and trademark protection and defense. Anecdotally, we are told that since brands are so critical to a company’s health, and yet most boards are unaware of the monetary value vested in them and have no risk management procedure in place to protect them from calamity, they have attracted the attention of the King Commission into Corporate Governance.

Analysts are already following brand management as a vital variable in evaluating the worth of companies and, as has been described in this paper, the accounting profession is re-examining its stance on brands on the balance sheet. We are in discussions with major international companies who are examining our methodology with a view to using it to compete in this market. Reports to-date have compared us extremely favorably with the other approaches available.

If the BrandMetrics methodology is to compete globally it must, in certain regards, conform to what is becoming the norm. The use of Discounted Cash Flow and the manner in which the brand asset is carved from the “super profits” is now best practice from which we should not, and see no cause to, diverge.

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