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# The flight of fancy

Christof Binder

All blown up: Stand-alone valuations that are not based on fundamentals won’t stand the test

The Kingfisher Airlines brand valuation exercise is often cited as a case for all that can go wrong with the process. Here are some lessons.

The Kingfisher case is bad for both the brand valuation profession and for brand-backed financing. There are some lessons to be learned immediately from the case.

Multiples and other comparable data are used in all different kinds of valuations. Comparables are easily available for brands as well, and it is time to make use of them in brand valuations. Such comparables cannot replace the valuation as such or the valuer. But they provide useful guidelines for mean values and a usual bandwidth and distribution of values within which the subject case can be positioned based on its particularities. No valuer should do, and no auditor or bank should accept, a valuation without using comparable data.

Don’t trust a brand valuation based on excessively high revenue growth in the future. Such growth is typically based either on expected market growth or on sizeable brand investments that are not yet paid or even known. Neither has anything to do with brand value as it stands on the date of the valuation. They are, rather, goodwill (or hope). If helpful for finance purposes, the brand can be revalued regularly in the future to include actual sales growth.

Profitability is a prerequisite for the existence of brand value. The sanity check of the good old profit split method is more important than ever. It is mostly impossible to justify any brand value under enduring losses. Temporary losses require strong arguments for the existence of intangible assets. Valuation methods based on historic cost, reconstruction cost, or replacement cost — instead of methods based on future earnings — should be considered in situations of weak profitability.

Beware of stand-alone brand valuations. Brand is only one of many different assets that make up a business. Sometimes, as in the Kingfisher case, brands are valued “stand-alone.” Sometimes, brands are valued as part of purchase price allocations where the sum of all assets amounts to the enterprise value of the business. Here, all different assets are valued separately and relative against each other, to arrive at the given enterprise value. Stand-alone brand valuations tend to neglect the value of other assets pertaining to that business (i.e., customer relations and goodwill and, in particular, landing rights and concessions in the case of airlines) and overestimate the value of the brand.

Comparable royalty rates from brand extension licensing must be treated with care. Often, value drivers and margin structures in the core business or territory of the licensor are much different from the licensee. The trademark royalty rate reflects either of the two or a mixture of both. For comparability, it is important to understand which one. As we have seen in the Kingfisher case, royalty rates for beer and airlines are not the same.

Brands are anything but infinite. Often, they can perish much faster than real estate or machinery, especially in distress. Brand valuation needs to consider useful life and risk more seriously, especially for brands that hold less than a No. 1-to-No. 3 position in their market. A good indicator of brand persistence by industry is whether brands are replaced post-acquisition or whether they are kept and maintained.

In most industries (except traditional consumer goods businesses), brands are extremely difficult to sell without the underlying business, like in insolvency. Lenders have to take this into account when they accept brands as collaterals. The valuation and the grant should include a fall-back position based on replacement value (cost of rebranding) or reproduction value. Further, the loan agreement should include automatic provisions in case of default, such as, for example, options to convert the loan into equity. Overall, brand-backed loans are more risky than the average interest rate they reflect, not necessarily for the general risk of brands, but for the average risk of businesses seeking to pledge their brand.

Full independence of the valuer from their client is of utmost importance. Independence should not be limited to independence from follow-up business. It should also include independence from client briefings. Almost all valuations carry an explanation that they were done for a specific purpose and in a specific situation.

The firm that valued Kingfisher also refers to this explanation today, when it states the valuation was appropriate in the context of when it was done and the purpose for which it was done.

Of course, situations may change, and purposes as well. But, if situation and purpose are major determinants of value, the result of the valuation is not an objective, realistic value but rather a value based on the client's briefing and desires.

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