Where The Value In A Trademark Lies

by Zareer Pavri, Senior Manager, Price Waterhouse
edited by Richard Wise, FCA, Richard Wise & Associates

Trademarks, often valuable assets, pose rather difficult but nevertheless interesting valuation problems that business valuators and appraisers must address whenever a transaction involves their purchase, sale or assignment. So let's look at some of the more baffling of those problems and at the methods for solving them.

In nearly every area of tax law, acquisitions and divestitures, the problem of valuing property occurs. Patents, copyrights and trademarks are no exception. Whether property is being purchased and depreciated, or sold, a proper valuation is crucial. The question of value is one of fact and can be answered only when all the particulars and circumstances are known.

In general, the valuation of intangibles such as trademarks is founded directly on earning power. Where little or no income history is available, however, imagination, common sense and experience may be the best guides, in addition to studies of the industry in which the trademarks will be used or the products marketed, market surveys of probable sale prices and expected profits, and opinions of industry experts.

Companies generally take years and spend a fortune developing each new product and marketing it under its own trademark to win and maintain widespread demand. In fact, conventional wisdom has it that in the United States it costs, on average, about $50 million to research, develop and market a new product. After all this, does a trademark have any value? And if it does, what is the value should it change hands?

Trademarks are bought and sold for a variety of reasons. For example, in early 1982, Procter & Gamble Co., Cincinnati, purchased the international prescription and non-prescription drug business of Morton-Norwich Products Inc. of Chicago for $371 million cash, or about 17 times the division's 1981 pre-tax earnings and 24 times its 1981 after-tax earnings. Procter & gamble wanted a major entry into the pharmaceutical business; Morton-Norwich wanted cash to repurchase a block of its shares to protect itself from any unfriendly acquirers, and to invest in areas it considered potentially more attractive.

In 1980, Dow Chemical bought Richardson-Merrill's prescription drug division for $260 million worth of Dow shares. The price was calculated at 25 times that division's pre-tax earnings, and twice its net worth. Dow Chemical wanted to expand its prescription drug business and was impressed with the potential of Richardson-Merrill's products still in the research stage. For its part, Richardson-Merrill found its prescription drug operations too small to support the research and development needed to exploit its products commercially in the long term and chose to sell rather than expand by acquisition.

In both these cases, the price tags represented large premiums over tangible assets and reflected the perceived value of intangibles assets, namely, goodwill, expertise, products at the research stage, patents and trademarks. How much of the price in the examples mentioned could be allocated to trademarks per se is unknown. Experts, however, have "generally accepted" approaches for valuing businesses with valuable trademarks. The final price is usually the result of one or more of those approaches and, in the final analysis, some hard-nosed bargaining between the two parties.

What's in a name?

The Trademarks Act defines a trademark as:

> "(1) A mark that is used by a person for the purpose of distinguishing or so as to distinguish wares or services manufactured, sold, leased, hired or performed by him from those manufactured, sold, leased, hired or performed by others; (2) a certification mark; (3) a distinguishing guise; or (4) a proposed trademark."

The act also defines a trade name as the name under which any business is carried on, be it a corporation, partnership or individual. A trade name must, however, be attached to a business; it cannot exist *in vacuo*; that is, independent of the business enterprise.

A trademark differs from a trade name, then, in that it is used in association with vendible commodities or services, while the latter is more properly applied to a business' goodwill. Trade names may be applied to or used in association with goods, but only to indicate the marketer's or trader's name from whom those goods emanate. In other words, a trade name might also be a trade mark – Coca Cola, for example. A trader may use more than trademark, but goodwill of his or her business is represented by a single trade name, which remains constant.

To illustrate this difference, here are examples of some well-known trademarks:

- "Your money's worth and more." (Sears)
- "The quality goes in before the name goes on." (Zenith)
- "It's the real thing!" (Coca-Cola)

A company's success in establishing a recognized trademark depends to a large degree, of course, on its reputation for quality products or services. In most cases, however, trademarks can be developed and maintained through extensive and costly advertising.

While patents and copyrights are distinct in themselves (patents deal with the physical arts and sciences, copyrights with products of the intellect), they do have this in common: they both protect the substance of the article itself.

Trademarks, in comparison, protect only the device or symbol attached to the goods, not the goods themselves: the goods are open to the world. The trademark's owner is entitled only to prevent it from being used to make purchasers believe they are buying his or her goods when, in fact, they are buying those of a rival.

Furthermore, patents and copyrights in Canada have limited legal lives. A copyright's term is for the life of the author plus 50 years, while a patent's life is for 17 years. But a trademark, once registered, may be renewed at 15-year intervals, without limitation, on payment each time of the necessary renewal fees.

Valuation methods

Two methods are commonly used to value intangibles: (1) the residual technique (where identifiable intangibles such as patents have a finite economic life) and (2) the excess income method (where identifiable intangibles such as trademarks and unidentifiable intangibles such as commercial goodwill have a perpetual economic life). In other words, the single most important element affecting a trademark's value or other intangibles with indefinite economic lives is the property's earning power.

The adoption of the excess income method implies the use of the dual capitalization approach, which recognizes that a different level of may be attributed to tangible asset backing than to intangible assets, such as goodwill, which is represented by earnings in excess of a fair rate of return on net tangible assets. While this method recognizes that an intangible property's earning power is essential in establishing value, it does not enable a valuator to segregate value between identifiable and unidentifiable intangibles. This segregation is often required because identifiable intangibles are often purchased, sold or assigned independently of the business enterprise owning them.

Given that limitation, one of the approaches used more commonly to value trademarks per se is the relief-from-royalty approach. The idea here is that, by owning a trademark, a company is relieved of the necessity of having to pay someone else a royalty for its use. It follows, therefore, that anyone wanting to obtain the right to this trademark would have to enter into a business arrangement with the original owner. Such arrangements, akin to the licensing of patents, usually entail a royalty payment, generally a percentage of product sales. The percentage will vary depending on a trademark's strength and visibility and, more specifically, on:

- The product's opportunities in the market.
- The product's integrity: Does it do what it claims to do?
- The security, if any, afforded by a patent, recognizing that most products in the development stage or in a yet-to-be established market have patents to guard against their unauthorized use by competitors.
- The security of supply of raw materials.

Furthermore, the royalty rate depends on the frequency with which new, acceptable products enter the market. Generally, the less frequent the entry, the more a market is considered to be a licensor's market. Ultimately, the selection of an appropriate royalty rate will take all of the characteristics mentioned into account, since the trademark's user is expected to benefit immediately from a competitive standpoint.

According to experts in trademark valuations, trademarks closely identified with consumer products will generally command high royalty rates – much higher than those for goods and services in the industrial sector.

Under the relief-from-royalty method, trademark valuation computations generally include consideration of the present value of the annual after-tax stream of revenues – the result of not having to pay royalties – and of the present value of future income tax savings resulting from claiming capital cost allowances on a specified portion of a trademark's cost; that is, the tax shield.

To determine the present value of this after-tax stream of future revenues, certain assumptions are generally made regarding the annual estimates of revenues associated with the trademark product, the royalty rate, the company's tax rate and a reasonable rate of return, normally based on the risk involved in realizing the projected revenues when considered in relation to the type of trademark product being acquired.

Where a business arrangement stipulates that the trademark is to be used for a definite term and then phased out, its value will gradually diminish over the finite life of the product. For instance, a purchaser might enter into an agreement with a vendor for, say, a five-year term, to use an established trademark. This will allow the user to benefit immediately from a competitive standpoint. Implicit in such an arrangement, though, is the need for the purchaser to have a well-defined marketing plan to replace the existing trademark with another to prevent the erosion of its market position and share. As the new trademark becomes more familiar to the market, the significance of the old one will fade.

It follows that when such an arrangement is used, the relief-from-royalty method should, in addition to the factors mentioned, reflect the estimated rate of decline in the old trademark's recognition and significance – a purely judgmental and subjective factor.

Under Canadian income tax law, a trademark is treated as an eligible capital expenditure. As such, any valuation preceding an arm's-length taxable transaction should include both a purchaser's and a vendor's perspective of value.

From the purchaser's viewpoint, the fair market value would include an estimate of the present value of tax savings resulting from claiming future capital cost allowances. The vendor, on the other hand, would estimate the net proceeds of disposition, after taking the relevant tax costs into account.

Suffice it to say that, in an arm's-length transaction, the fair market value would likely range between the value from a purchaser's perspective and the after-tax proceeds in the vendor's hands. The ultimate value would be established, of course, through negotiations between the two.

In a tax-free transaction involving the Income Tax Act's elective rollover provisions, the purchaser generally assumes the adjusted cost base of the trademark being acquired. In this case, a deferred tax liability would arise in the purchaser's hands. What then has to be considered is the present value of such a liability which, in most cases, may not be material, assuming the purchaser will own and use the trademark for some time.

Secondary valuation approaches

Where possible, the primary approach to trademark valuation should be supported by one or both of the following: (1) carryover benefit of past advertising costs, or (2) gross profit margin differential.

Carryover benefit of past advertising costs

As mentioned earlier, a recognized trademark is often developed and maintained through extensive and costly advertising. This approach, which tries to compute the after-tax worth of future savings in advertising costs, is based on the following premises:

- The estimated cost of recreating the position enjoyed by the trademark's owner at the valuation date. (Remember, although advertising costs are usually a material and essential element in developing and maintaining a product trademark, there are exceptions. For instance, in the pharmaceutical industry, product advertising costs are minimal, but recognition and the significance of product symbols are maintained by a network of salespeople in direct touch with doctors).
- The product symbol in question is established and reliable.
- The establishment, albeit on a purely judgmental basis, of an estimated rate of decline in a trademark's recognition and significance in consumers' minds. Implicit in this approach is the assumption that advertising ceases immediately at the valuation date and that, without further advertising, the prominence of a recognized product in the minds of consumers starts to decline progressively.

Since this first approach is essentially a cost-based one (based, that is, on the estimated cost of recreating the position presently enjoyed by the trademark's owner), a prudent, knowledgeable vendor and an equally knowledgeable prospective purchaser would recognize that, in assessing the carryover benefits of past advertising costs, and, hence, a trademark's value: (1) advertising costs expended over the years by the vendor are, in effect, after-tax advertising dollars due to their tax-deductible nature; (2) on the sale of the trademark, only 50% of the gain over the cost base of this asset would be taxable for Canadian income tax purposes, the balance would be tax-free; and (3) funds that would normally have been earmarked by the purchaser for promoting the product protected by the trademark need not be spent on such promotion but may instead be invested in potentially more lucrative areas – in increasing the business' operating capacity or asset base.

Gross profit margin differential

This approach compares the gross profit margins of a product with an established trademark to a similar "no-name" or generic product.

The gross profit margin differential is a function of a trademark's reliability and public acceptance, which depends in turn on the product's quality. Generally speaking, the greater the public acceptance, the larger the differential. Since the advent of generic products, however, particularly in the food and pharmaceutical markets, consumers have shown strong resistance to the often substantial costs associated with maintaining trademarks (through promotions, advertising and so on).

It can be misleading to compare the reported gross profit margin of a generic product with that of a trademark product, since costs associated with maintaining the trademark are generally excluded in computing the gross profit and resulting margins. The gross profit margins of trademark products would necessarily have to be substantially higher than those for generic products to cover these costs; therefore, it is only by deducting them from the gross profits of trademark products that a realistic, comparable differential can be derived.

The adjusted gross profit margin differential, when capitalized using appropriate multiples, would likely approximate the trademark's value. The multiples in such situations would obviously be lower than normal earnings multiples and would reflect the pre-tax nature of the differential and the product's expected life. The latter, in turn, would normally be a function of the risk of a new and more acceptable product entering the market, resulting in the possible erosion of public acceptance and the significance of the old trademark.

The problems involved in both of these secondary approaches are quite evident. All that can be said here is that any attempt to value a trademark must be based on a study of its earning power. The secondary approaches should be used, where possible, merely to support the conclusions arrived at using the primary approach – the relief-from-royalty method, for instance.

While these are good bases for trademark valuation, remember there are no generally accepted rules of thumb. As is often the case with intangibles, experience, common sense and reasoned judgment may be the best guides.