Consumer Brands as Collateral: Opportunities for Asset-Based Lenders

By Gerald Sherman, Michael Fine and Jonathan Gurwitz

Consumer brands, while not the most obvious collateral, can embody significant value.

The origins of asset-based lending began with the financing of accounts receivable. Over time, albeit with appropriate reservations, inventory and equipment also became generally accepted forms of collateral. Some asset-based lenders have embraced less traditional assets for lending purposes; as a whole, however, the industry remains reluctant to do so. This article explores the use of consumer brands as an acceptable form of collateral and suggests that their judicious use as collateral can expand an asset-based lender's opportunities.

Understanding a Consumer Brand as an Asset

Defining a Consumer Brand

The International Trademark Association defines a brand as "a trademark (or combination of trademarks) that, through promotion and use, has acquired significance in distinguishing the source or origin of the goods or services offered under the trademark from those offered by others in the marketplace." Beyond that, a consumer brand will include many, but not necessarily all of the following:

- Patents, copyright designs and trade secrets required to produce a particular product, group of products, service or group of services
- Contracts, licenses and other third-party agreements including endorsement agreements, distribution agreements, marketing agreements, sales representation agreements, manufacturing agreements
- Customer information including all databases and contact information

Taken together, the collection of rights, intellectual property and business relationships represent the potential to generate revenue and profits.

Why Consumer Brands Matter

"If this business were to be split up, I would be glad to take the brands, trademarks and goodwill and you could have all the bricks and mortar—and I would fare better than you," said John Stuart, chairman of Quaker Oats from 1922 to 1964.[1]

Clearly, the value of a consumer brand has been understood for many decades. In today's economy, a consumer brand can represent either a standalone business entity or a profit center within a larger company. From a marketing standpoint, brands matter because they can connect with consumers both rationally and emotionally. Ultimately,

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the consumer's familiarity with the brand and his or her willingness to buy repeatedly can help create above-average profitability for the owner of the brand.

Clearly, a brand can offer benefits to its owner or licensee. Lenders interested in collecting on a loan need to ask what individuals or business entities might buy a brand and why. Essentially, an established brand can gain a company access to a particular market segment. Or, an established brand can help a company improve its profitability within an existing business segment.

Access to a New Niche

An importer and marketer of footwear was ending a relationship with a joint-venture partner. As a result, the company was losing several product lines that had represented a significant percentage of total sales. The company was offered the opportunity to license the rights to a leisure footwear brand with about $6 million in annual sales. The new license enabled the footwear company to project out about $2.4 million in gross profit for the coming year due to sales of the licensed brand. This enabled the company to cover its basic overhead requirements and also to anticipate significant growth potential for the future.

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By licensing the brand, the company gained instant access and recognition in a new niche. In addition, the company could scale down operations after the end of the joint venture without reducing staff. The footwear company could have sold the same products without the brand name but would have generated significantly lower sales without the branding.

Improved Performance in Existing Markets

As it grew from a regional discounter into a national chain, Target began competing more directly with Wal-Mart and Kmart. So Target adopted a strategy of "cheap chic" to differentiate itself. The sale of established brands became a linchpin of the cheap-chic strategy. Initially, Target acquired brands that had declined in value, such as Cherokee and Merona, and revitalized them to connect with the mass-market consumer. Subsequently, Target developed new brands through collaborations with well-known designers such as Isaac Mizrahi and Michael Graves. These steps further cemented customers' perceptions, transforming Target into the fashionable "Tar-zhay." The 30-year evolution of Target into a source for affordable hipness and fashion led to increased operating margins on a sustained basis.

The Market for Consumer Brands

Consumer brands represent customer awareness. For the manufacturer, importer or retailer, customer awareness represents opportunity: the opportunity to develop and maintain both market share and higher profit margins. Over the past 20 years, more and more companies have recognized this opportunity, and the market for consumer brands has exploded. Several companies now specialize in the business of buying, managing and licensing brand names. For example, Iconix, Inc., is now publicly traded. In addition, major U.S.-based asset disposition companies, Gordon Brothers Companies and Hilco, among others, have become very active buyers and sellers of the brands of distressed businesses. And a number of firms are in the business of appraising and marketing brands.

As the result of these developments, a very active market for brands exists. There are regular bidding wars for major brand names. Sharper Image and Circuit City are just two well-known brands sold out of Chapter 11 bankruptcy during 2008 and 2009. Even at relatively small dollar values, activity has increased significantly with transactions occurring for as little as $25,000.

For lenders, this market activity makes it possible to dispose of consumer brand collateral in ways that are similar to methods used to dispose of more traditional collateral. The asset can be appraised; the asset can be marketed to prospective buyers that would use it; and professional buyers are in the business of acquiring and remarketing distressed brands. With the development of this marketplace, a lender can advance against consumer brand collateral with the confidence that a ready market does exist if the brand needs to be liquidated.

Brand Value Considerations

Establishing a Brand's Value

Just as with a business entity or other asset whose value is not easily determined, consumer brand collateral should be appraised by a highly experienced professional. At the same time, it's important to have a fundamental understanding of the techniques the appraiser will use to develop the valuation.

Not surprisingly, the typical approaches to valuing a brand are the same as those used to value a freestanding business or business unit: the income, market and cost methods.

- **Income method.** The income method establishes a value by developing an estimate of future net income and then calculating the net present value of this future stream of income by discounting future period income. The discount rate selected reflects what would be considered an appropriate rate of return for the level of risk associated with the brand.
- **Market method.** The market method establishes value by identifying the value of similar brands that have been sold within a reasonable period before the time of the valuation. For example, if a brand of women's wear sold into the discount clothing market with annual revenue of $100 million was recently sold for $20 million and a very similar brand with annual sales of $50 million were being valued, the appraiser might come to a value in the general vicinity of half the value of the recently sold brand, with some discount to value applied for a smaller market share.
- **Cost method.** The cost method totals all costs associated with creating a brand. This would include creation of trademarks, product designs, advertising materials and associated professional expenses.

For active brands, either the income or market method will typically be most appropriate. In contrast, the cost approach will be more appropriate for brands that have either achieved little market penetration or been inactive or dormant for an extended period.

As with any appraisal, judgment and experience are crucial to determining a realistic value. Often, the value of a brand will be greater than a pure analysis suggests. In other instances, however, the realistic value may be less than analysis alone suggests. The market for the brand, its competition and—perhaps most important—the managers of the brand all significantly affect the actual value of the brand.

Key Risks Associated with a Brand's Value

Every form of collateral contains risks. Receivables may not collect. Inventory might not sell. Equipment markets may turn quickly. Consistent with this, the collateral value of a consumer brand has distinctive risks that should be factored into a lender's decisions. Of particular importance are the following:

- Certain categories of consumer brands are particularly vulnerable to rapid declines in value. For example, the value of a food brand can plummet overnight as the result of food safety problems. While not as vulnerable as food products, fashion-oriented brands also can decline quite rapidly.
- A consumer brand requires consistent financial support, marketing focus and continued success to maintain its value. When a company becomes distressed, the value of its brand or brands is likely to decline rapidly.
- All brands are vulnerable to declines in value over time as the result of consumer trends or poor brand management.
- There is no reliable method for predicting how or when the value of a consumer brand might change. In comparison, the value of a piece of equipment will typically decline in a predictable way over time, and a particular borrower's receivables will typically collect similarly to its historical pattern.

Lending Considerations

The Opportunity

In 2007, Kmart/Sears raised capital by securitizing a number of its brands, including Craftsman and Kenmore. In return for about $1.8 billion from investors, Kmart/Sears promised investors an annual return based on the earnings of these brands. It has become somewhat common for larger, more valuable brands to be used as collateral for raising substantial sums—sometimes in excess of $100 million. Transactions of this type require significant expertise in the area of consumer brands and involve a relatively small fraction of the total number of U.S. consumer brands. Accordingly, the more substantial opportunity in terms of number of transactions is with brands valued between $10 million to $50 million, where borrowers often need additional liquid resources. For such borrowers, the value of their brand or brands has the potential to be the final piece of a collateral package that will make it possible for a lender to provide needed funds.

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From the lender's standpoint, brand value has the potential to justify a financing program that provides for advances beyond what a borrower's traditional collateral—receivables, inventory, *etc.*—would support. The use of a consumer brand as collateral may allow a lender to stretch beyond traditional lending parameters while still extending financing in a prudent fashion. In the past, asset-based lenders sometimes provided advances that lacked support from traditional collateral classes (air balls). The judicious use of consumer brands provides a potentially sound basis to support such advances.

Given the reticence of asset-based lenders to use consumer brands as primary collateral, lenders willing to commit to this type of collateral have opportunities to develop a distinctive business niche. Such lenders would likely be able to justify higher rates and fees for the portion of their lending program secured by a brand or brands.

Determining a Brand's Suitability as Collateral

When evaluating a consumer brand's suitability as collateral, lenders must first determine the likelihood that the brand could devalue quickly. In terms of brand value, the most significant issue is the likelihood that a product could cause harm to a person. Accordingly, given the potential for contamination, food, beverage and drug brands are not suitable for use as collateral. Other products, for example, toys and automobiles, bring some risk and must be evaluated on a case-by-case basis.

Brands that have a fashion component—clothing, footwear, certain types of consumer electronics—also can decline quickly in value. While brands in these segments are not likely to devalue as quickly as food or drugs, one or two bad seasons can dramatically reduce a fashion brand's value.

In addition, the brand should be examined just like any class of asset, as follows:

- **Market size.** What is the size of the market for the brand? This includes total dollars' value of market, number of key participants in the market, breadth of potential buyers for the asset.
- **Market conditions.** How do industry and market conditions affect brand value? This includes current industry performance, future industry prospects, industry liquidity, industry volatility.
- **Time to sell.** How long would it take to sell the brand? In addition to the factors listed above, the time to sell could be affected by issues such as any imperfections with respect to registration of the brand and the brand's market position.
- **Cost to sell.** What would be the costs of selling the brand? Costs associated with the sale of the brand would include brokerage and/or investment banking and the costs associated with brand registration issues.

Another key consideration is the condition of the borrower itself. The performance of a distressed borrower is very likely to lead to a reduction in the value of its brand. In comparison, the value of more traditional assets like receivables and inventory would be less vulnerable.

When performing a brand appraisal, it's important to select a professional with deep experience in brand valuation. The primary focus should be on net forced liquidation value, which represents both the lender's worst-case scenario and the most likely result when a brand being used as collateral is being sold.

Establishing Appropriate Advance Rates and Minimum Asset Values

The use of a consumer brand as collateral brings special challenges that should be reflected in advance rates. When considering appropriate advance rates for a consumer brand, lenders should take into account a number of factors:

- The fashion orientation of the brand
- The longevity of the brand
- The financial stability of the owner of the brand
- The likely devaluation of the brand once its owner becomes financially distressed

Given these considerations, the appropriate range of advance rates is likely to be between 10 percent and 25 percent. This relatively low range reflects the speed with which brands can devalue when a borrower becomes distressed. A fashion-oriented brand would be at the lower end of the range; a longtime brand with more stable characteristics owned by a financially sound borrower would be at the higher end.

Brands with values under $500,000 may not be meaningful to potential buyers, so the minimum size of a brand suitable to be used as collateral is likely to be around $10 million. At that level, even with significant devaluation, there could still be a viable market of buyers.

Monitoring and Managing Consumer Brand Collateral

Asset-based lenders monitor and manage their collateral exposure with every asset they lend against and this should be no less true for a consumer brand. Generally, a consumer brand acts most similarly to real estate collateral in that its value tends to change over time—and can change either positively or negatively. One critical distinction, as opposed to real estate, is the fact that a brand's change in value will not necessarily track its overall market. As just one example, in the 1990s, Nike was growing rapidly. At the same time, Converse, a competitor in the same market, fell into bankruptcy.

To manage the risks associated with consumer brands, every lender should take five steps:

- **Amortize brand value over a reasonable period.** Availability based on a brand's value should be amortized over a reasonable period, perhaps four to six years.
- **Include annual investments in the brand in loan covenants.** Annual investments in brand support and development should be included in loan covenants. This will help to assure that the brand will have the best opportunity for continued success.
- **Monitor brand value regularly.** Sales should be tracked monthly and appraisals of brand value should be updated annually, with the possible exception being when the brand exceeds preestablished benchmarks for superior performance.
- **Plan for the forced sale of the brand.** Prior to closing the loan, develop a plan for the forced sale of the brand, including the following information:
  - List of potential buyers
  - List of potential intermediaries to market the brand
  - Maintenance of current due-diligence information on prospective buyers
  - Maintenance of a list of other borrower assets needed to effectively market the brand
  - Maintenance of a plan for monitoring the brand during the sale process in order to help assure that key customer and vendor relationships are preserved
- **Update the forced sale plan regularly.** The forced sale plan should be reviewed and updated no less than annually.

Opportunities for Forward-Looking Lenders

Consumer brands can be a viable form of collateral for asset-based lenders now that it is possible to efficiently liquidate them. As with any class of collateral, lenders must understand numerous nuances related to valuation, advance rates and loan management. Given the asset-based lending industry's general reluctance to use intangibles as collateral, the lender willing to commit to the use of consumer brands has the opportunity both to gain market share and to improve profitability.

Endnotes

[1] Steve Rivkin and Fraser Sutherland, THE MAKING OF A NAME: THE INSIDE STORY OF THE BRANDS WE BUY (New York: Oxford University Press, 2004), at 8.