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THE COSTS OF BRAND LICENSING INCURRED BY THE LICENSOR

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SUMMARY

When talking about royalty income from brand licensing, most people and even some valuation experts think that this is easy money representing net profit. This could be the case, but in most cases is not. What most people forget is that brand licensing requires resources, efforts, time and sometimes investment. As a result, the net profit resulting from licensing can vary between 95% of royalty revenues and as little as 0%. The following contribution discusses some issues of costs, cost structure and profitability in brand licensing.

BOTTOM LINE PROFITABILITY

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STRATEGY

There are very different strategic approaches to brand licensing, resulting in differing importance of profitability and financial results of the licensing initiative.

Some licensors engage in brand licensing to earn additional revenues and to improve their financial results. In this setting, licensors are usually cost sensitive and try to minimize expenses related to licensing. On the other hand, some licensors do brand licensing to enhance brand value. Their brand alignment and licensing functions are more intense and strict, and they accept to re-invest substantial parts of their royalty revenues into the activity. Some licensors do brand licensing simply to protect the trademark in other classes or territories and thereby prevent third parties from free riding or counterfeiting the brand.

For instance, cigarette and liquor brands installed brand licensing activities in order to bypass advertising bans in their core categories. Their goal was to enhance brand value, not to earn additional money. Similarly, designer brands reinvest most parts of their revenues from licensing to run their “core business” which is haute couture, fashion shows and PR.

Some companies have centralised, others have decentralised management structures; this is a question of management philosophy, and the same can be found in licensing. The centralised licensor tends to control its licensees and their brand related activities—at higher cost, whereas in decentralised licensing the licensees operate rather independently and non-aligned with the business of the licensor—at lower cost.

BUDGETING

The method of establishing budgets may influence the cost of licensing. While some licensors base their budget decisions on effective functions and their effectiveness, others base it on “usual ratios” as percentage of revenues. In the latter case, a profitability ratio of more than 50% - which is quite typical in licensing—can be suspicious to controllers, and it can be impolitic as against other divisions with much lower profit ratios. In such cases, cost budgets and expenses of the licensing office might be increased to get profitability down to more normal levels. As a result, licensing functions may become inefficient.

LICENSING FUNCTIONS

Licensing functions can be broadly split into two different areas: acquisition and ongoing management.

During the acquisition phase, functions include: searching potential partners, due diligence, negotiating deal points, negotiating contract. Sometimes, licensees simply drop in by chance. Usually, acquisition takes not only time (between 6 and 18 months), but also substantial legal support, while revenues from that license relationship are still far away in the future. The costs to initiate and acquire a contract can range from 5% to 50% of the total lifetime cost. Thus, acquisition is an important cost driver.

During an ongoing contract, the licensor’s functions include: business strategy/planning, product management, trend previewing, product design guidance, graphics, photo shoots, new product and marketing approvals, marketing and sales programs, auditing and compliance, reporting, collecting royalties, and contract renewal. Trademark protection is not a function in itself, but may still be very costly.

Major cost drivers are the product innovation rate, the extent of common marketing initiatives, and the number of common customers/sales channels to be coordinated. I.e. fashion licensing is cost intensive because of product innovation (hundreds of new products every season) and point of sales integration (shop-in-shops integrating different categories). By contrast, food licensing with fewer products and less innovation can be managed at much lower costs.

The licensor's time to manage a brand licensing contract is not less than 10 mandays of a license manager. For important, large contracts this figure can increase up to 200 mandays. 35 mandays is a good approximation for an average figure.

IN-SOURCING OF FUNCTIONS

Some licensors require their licensees to buy selected services from them, or even in-source selected functions of the licensee. The payment for such functions can be by unit prices and effective use (i.e. for photo shoots), or by a percentage of sales (i.e. central marketing or sales). As a result, the licensor has additional revenues. As the licensor does not make profits on such functions, his profit margin (as % of revenues) will decrease.

Some licensors, i.e. Ralph Lauren, go even a step further and provide centralized advertising and/or sales functions for their licensees. The cost for such centralized services is either invoiced directly to the licensee, or compensated through an additional percentage on licensed revenues. Again, this part of the value chain is "not-for-profit"; all revenues of the licensor are expensed.

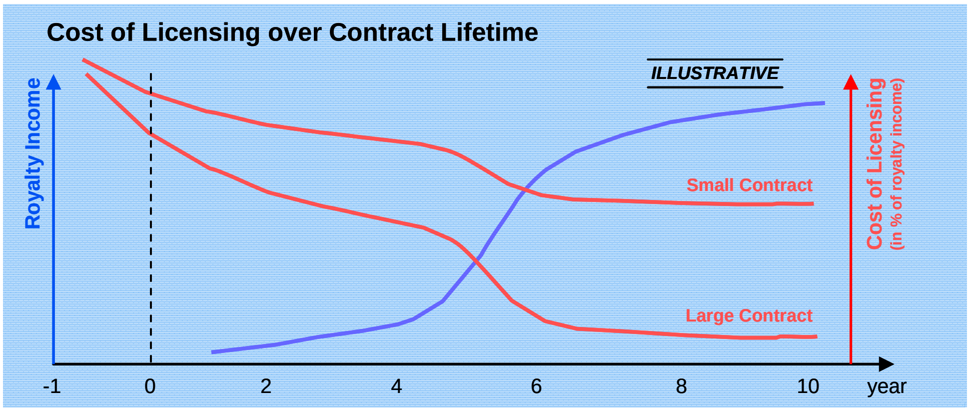
	Case 1	Case 2
trademark royalty revenues 5% on 1.000	50	50
advertising royalty revenues 3% on 1.000	-	30
total revenues	**50**	**80**
licensing expenses ½ of 50	25	25
advertising expenses	-	30
profit	**25**	**25**
profit in % of revenues	**50%**	**31,25%**

Such centralized functions do however change the profit margin of a licensing division quite substantially (see table). Assuming a trademark royalty rate of 5%, an advertising royalty rate of 3%, and an expense ration of 50% of trademark royalty revenues, the overall profitability drops from 50% (case 1) to 31,25% if advertising is centralized (case 2). The more licensing management is centralized, the lower is the profit margin of the licensor.

LIFE CYCLE

Royalty income is changing over the life cycle of a contract. During the acquisition phase, income is zero. The launch phase—between contract signing and availability on the shelves—typically takes 12 months, depending on product and development. After that, it takes 7 to 10 years to reach maximum sales (see graph).

Licensee acquisition costs occur during the phase of zero income. Ongoing management costs are quite constant over time. As a result, budgeting licensing costs as a constant percentage of royalty income is not really helpful. A flexible approach to budgeting costs according to the contract life cycle is needed.



CONTRACT SIZE

Another important aspect is the royalty income per contract. While costs to manage and control a specific contract do not depend on licensed turnover, royalty income does. Therefore, a contract generating higher royalty income can be managed at lower (relative) costs than a contract with low royalty income. Similarly, contract size must be considered in budgeting costs of licensing management.

CONTRACT PORTFOLIO

After all, it is the total portfolio of licensing contracts, their position in the life cycle, and their specific contract sizes, that determine the appropriate costs of licensing. A young licensing initiative requires a much higher cost ratio than an established program with many successful and experienced licensees.

IN PRACTICE

There is no statistical survey available on average expenses in licensing. The commissions charged by full service licensing agencies might serve as a first indicator. According to a study on “Best Practices in Trademark Licensing” published by EPM in 2003, agent’s commissions range from 10% to 40% of royalties, with the most common range being from 25% to 35%. Considering that “make” (having an inhouse licensing department) or “buy” (outsourcing the licensing activity to an agent) is often a question of size, critical mass and factor cost, agent’s commissions are likely to be higher than the cost of an in-house licensing function. However, even with the best agent, some functions and costs remain with the licensor, i.e. securing and defending the trademarks, design guidance, marketing and sales integration, some approvals, etc. Therefore, the range of agent’s commission cited above represents only 60% to 90% of total costs. As a result, costs of licensing could vary from 10% to 60% of royalty revenues.

In practive, the range is even larger. While a few licensors spend little more than 5%, others spend even 100% of total royalty revenues.

CASE STUDIES

Boxing brand Everlast is a good example for very efficient, low-cost licensor. Everlast was able to run 88 licensees in a global brand licensing program with only three licensing executives. The licensing program generated 13.4 mn US$ in licensing revenues at 0.9 mn US$ cost, or 7%. This could be achieved despite low average revenues of 150.000 US$ per contract. Cost per licensee is 10.000 US$. This figure covers the considerable efforts of Everlast to acquire new and replace old licensees.

Another efficient licensing program is Guess Inc., the US fashion brand. Guess Inc.'s revenues from licensing amount to 115 mn US$, Here, the cost of licensing is 10% of licensing revenues, or a profit margin of 90%. In this case however, the licensor's average costs per license amount to 650.000 US$ per year, or 65 times the amount of Everlast.

Ralph Lauren Inc., the US designer brand, ranks among the champions in brand licensing. Total royalty revenues reach 178.5 mn US$. Operating income from licensing was 108.3 mn US$, or 61%. Ralph Lauren spends on average over 2,5 mn US$ per year on each licensee, showcasing the level of management and support Ralph Lauren provides to its licensees.

The three cases discussed above show different profit margins, as well as different cost levels per licensee. Still, the profitability levels are very high in all three cases, as is typical for brand licensing divisions. However, these cases do not account for the original cost to build the brand; typically, licensing divisions get the brand “for free”. With this respect, Iconix Brand Group Inc. is an interesting case study. Iconix is a pure licensing management company with 27 brands, 1.400 licenses and licensing revenues of 333 mn US$. However, Iconix acquired all its brands (including some license agreements) from third parties, usually from insolvency situations. In contrast to the other three cases, Iconix is not in a position to use its brands “for free” but has to bear the cost of financing and depreciation for its acquired brands. Iconix operating expenses are 36% of revenues (similar to Ralph Lauren, but for a much larger number of licensees) or 85.000 US$ per licensee. In addition to that, other expenses for depreciation and interest amount to 20% of licensing revenues, adding up to a remaining profit margin of 44%.

Our last case is Camel. The brand owner, J.R. Reynolds, initiated a brand licensing program in the late 70ies as a counter-measure against the ban on tobacco advertising. The plan was to establish the brand outside cigarettes and to generate brand impressions from there. However, J.R. Reynolds never intended to make profit with its licensing arm. To the contrary, the revenues from licensing were expensed for licensing functions and in parts for the Camel Trophy.

CONCLUSION

As we have discussed before, there is no academic or strategic answer to the appropriate cost budget in brand licensing. It all depends— on the basic objectives of the licensing initiative. It is possible to run a brand licensing program at very low cost, but the serious licensor should at least afford the basic functions: positioning, brand alignment and quality control.

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