 Agenda

• Economic Determinants of Royalty Rates
• How to Quantify Royalty Rates
• Where to Find Relevant Information
• Structuring and Adjusting Royalty Terms
Premise of Value

Premises of Value Include:

- Licensing
- Sale/Purchase
- Use-in-Place
- Joint Ventures
- Cross Licenses
Premise of Value
Transaction Context - Licensing

- Significant trademark rights conveyed
- Willing licensor
- Willing licensee
- Not direct competitors
- Expansion of brand into viable new markets
- Geographic or product

Premise of Value
Premise of Value
Summary of Negotiation Positions
Economic Methods

• Three Golden Rules of Finance
• Accounting Approach
• Appraisal Methods
Cost Approach

- Not often used when determining the royalty rate of an established trademark.
- Often used to value secondary trademark types.
- Lump sum
- Types of costs:
  - Concept development
  - Consulting expenses
  - Registration
  - Signage
  - Package designs
  - Advertising expenses
Market Rates

Sources of Royalty Rate Data

• Client company
• SEC filings
• Reported case decisions
• Business/trade periodicals
  – Licensing Economic Review
  – Trademark Reporter
  – Licensing Law and Business Report
• Surveys
• Licensing publications / Valuation books
  – Licensing Royalty Rates (Battersby)
  – Trademark Valuation (G.V. Smith)
Market Rates
Sources of Royalty Rate Data

- Proposed norms / lifetime learning
- Shopped term sheets
- ‘Seat at the table’
- Proprietary databases
  - Royalty Source
  - ReCap
- Consultants
Market Rates

Sources of Royalty Rate Data: SEC Filings

From the Form 10-Q Q LINCOLN SNACKS CO: EXHIBIT 10(b), 10/31/1997:

• “Agreement, dated the 6th day of October, 1997 between Nabisco Ltd and Lincoln Snacks Company…”
• “Whereas, Nabisco is the owner of the trademarks Planters, Mr. Peanut and the Representation of Mr. Peanut, together with associated logos, trade dress, packaging appearance and claims to copyrights… in Canada.”
• “Whereas, Licensee (Lincoln Snacks) desires the right to use the IP on and in connection with the manufacture, distribution, advertising and sale of its Fiddle Faddle branded snack food products…”
• “Nabisco hereby grants Licensee a royalty free license for use of the IP on the Products in the Distribution Channels in the Territory for the First and Second License Year…”
• “In the Third through Fifth License Years, Licensee shall pay Nabisco a royalty in each such License Year of (i) one percent (1%) of annual Net Sales… and (ii) two percent (2%) of annual Net Sales of Products in the Distribution Channels in the Territory with respect to sales in excess of 500,000 Equivalent Cases of Product…”

“(i) one percent (1%) of annual Net Sales… and (ii) two percent (2%) of annual Net Sales…”
Market Rates
Sources of Royalty Rate Data: RoyaltySource Database

License to Austin Powers Related TMs:
Royalty Rate High: 10%
Royalty Rate Low: 10%
Upfront Fee: $30,000
Retailers will receive a break, paying a royalty fee of 5 percent on Disney Denim instead of the 10 percent they usually pay to sell apparel with Disney characters.
Market Rates
Sources of Royalty Rate Data: Valuation Publications

Licensing Royalty Rates by Gregory J. Battersby and Charles W. Grimes

Market Rates
Sources of Royalty Rate Data: Valuation Publications

Trademark Valuation by Gordon V. Smith

<table>
<thead>
<tr>
<th>TYPE OF MARK</th>
<th>Commercial</th>
<th>Industrial</th>
<th>Consumer</th>
<th>Product</th>
<th>Consumer</th>
<th>Service</th>
<th>Food Apparel</th>
<th>5.1</th>
<th>Toys/Games</th>
<th>5.0</th>
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<td>Institutional</td>
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<tr>
<td>Corporate/Prod</td>
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<td>4.6</td>
<td>3.2</td>
<td>5.1</td>
<td>6.9</td>
<td>5.0</td>
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<tr>
<td>Fashion</td>
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<td></td>
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<td>5.5</td>
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<tr>
<td>Celebrity</td>
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<td>10.0</td>
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<td>Character</td>
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<td>College/Sports</td>
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Licensee's Use of the Trademark

FIGURE 7.8 Royalty Rate Analysis

Source: Trademark Valuation, Gordon V. Smith, John Wiley & Sons, 1997
Market Rates
Analysis of Comparability

• Profitability
• Risks
• Awareness and strength of the mark
• Degree of trademark protection
• Exclusivity
• Geographic reach
  – Local
  – Regional
  – Global
• Industry
• Market size and characteristics
Market Rates
Analysis of Comparability

- Growth outlook for relevant products
- Channels of distribution
- Barriers to entry
- Company structure
- Timing
- Duration
- Scope and status of legal protection
- Terms of agreements (e.g. field of use restrictions, payment structure, etc.)
Market Rates
Analysis of Comparability

• Other IP needed

• Functions
  – Research and development;
  – Product design and engineering;
  – Manufacturing, production and process engineering;
  – Product fabrication, extraction, and assembly;
  – Purchasing and materials management;
  – Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;
  – Transportation and warehousing; and
  – Managerial, legal, accounting and finance
Profit Based Approaches
Amount of the Income Stream

Revenue Drivers
- Market size
- Market segmentation
- Market growth rate
- Market share
- Product pricing

Expense Drivers
- Manufacturing costs
- Capital investments
- R&D requirements
- Operating expenses
- Tax rates

LESS

= Total Income
Profit Split Methods

- Excess Earnings
- Residual Earnings
- 25 Percent Rule
Profit Split Methods

**Excess Earnings**
Profit on Branded Product
Less: Benchmark for “Normal” Profit on Unbranded Products
Equals: Profit Available to Pay Royalty

**Residual Earnings**

**25 Percent Rule**
### Profit Split Methods

**Excess Earnings**

<table>
<thead>
<tr>
<th></th>
<th>Branded</th>
<th>Unbranded</th>
<th>Premium</th>
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</thead>
<tbody>
<tr>
<td>Average Unit Price (AUSP)</td>
<td>$100</td>
<td>$70</td>
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</tr>
<tr>
<td>Incremental Cost / Unit</td>
<td>80</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Incremental Earnings / Unit</td>
<td>$20</td>
<td>$10</td>
<td></td>
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</table>

Excess Earnings / Unit

Excess Earnings as a % of Branded AUSP

Excess Earnings may be used as a starting point for determining a royalty or a brand “earnings rate.”
Profit Split Methods

**Excess Earnings**

**Residual Earnings**
Profit on Branded Product
Less: Required Return Associated on all Assets (Except TM)
Equals: Value Attributable to Subject TM

**25 Percent Rule**
Profit Split Methods
Residual Earnings

Determining Profits Attributable to the Subject IP Rights / Trademark
## Profit Split Methods
### Residual Earnings

<table>
<thead>
<tr>
<th>Anticipated Operating Profit</th>
<th>$302</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Charge for Fixed Assets</td>
<td>Less: $139</td>
</tr>
<tr>
<td>Less: Charge for Working Capital</td>
<td>Less: $7</td>
</tr>
<tr>
<td>Equals: Earnings Attributable to Intangibles</td>
<td>Equals: $156</td>
</tr>
<tr>
<td>Less: Charge for Other IP and Intangibles</td>
<td>Less: $90</td>
</tr>
<tr>
<td>Equals: Earnings Attributable to Subject TM</td>
<td>Equals: $66</td>
</tr>
</tbody>
</table>

### Implied TM Earnings Rate

If total revenues equal $4,500, then the implied trademark earnings rate would be calculated as $66 / $4,500 or approximately 1.5%.
Profit Split Methods

Excess Earnings

Residual Earnings

25 Percent Rule
Profit on Branded Product
x 25%
Equals: Royalty Starting Point
Profit Split Methods
25 Percent Rule

Profits Related to Other Risk Factors / Assets

Profits Related to IP

Licensor

Licensee
Structure of Royalty Payments

• **Contingent**
  – Percent of revenues
  – Per unit
  – Percent of profit

• **Fixed Amounts**
  – Up-front lump sum
  – Per annum or other time period

• **Other**
  – Minimum
  – Milestone payments
  – Option payments
Adjustments to Royalty Rates
Determining Profits Attributable to the Subject TM

- Global Ownership and Use
- Global Licensing
- Regional Licensing
- Non-Exclusive Regional Licensing
Adjustments to Royalty Rates

• Royalty base
  – Accounting measures defined (i.e. sales)
  – Scope of products included

• Risk factors not addressed in royalty calculation

• Exclusive v. non-exclusive royalty rates
  – One study suggests 5:3 ratio
  – Other, similar, rule of thumb is 2:1

• Option Fee
  – 5 to 10 percent of expected annual mature royalty level

• Up-front fees
  – 5 to 10 percent of deal NPV
  – One year’s mature royalties
  – May or may not be credited against future royalties

• Minimum royalties
  – 25 to 50 percent of anticipated earned royalties
Deal Structuring
The Negotiation Process

Develop Valuation Model

Evaluate Position of Other Party

Establish Negotiation Position
The fine print...

• The views expressed in this presentation are solely the author’s and not those of CRA International
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