Larry and Barry Explore "What's Wrong With Royalties" ©

Larry: Ok, all the people we talk to seem to agree that royalties fit their needs. So let's explore the downside and see the problems of royalties.

Barry: An unusually good idea. Let's do it.

Larry: First they are illiquid even though negotiable and can't always be sold whenever an investor wants to sell them.

Barry: I see that as being like saying "we can't find a buyer for our royalty at our asking price. Royalties are income-producing assets and therefore will have a market value based on a combination of the yield of the last period, say a year, and the prospect for the royalty issuing company's revenues in the remaining years of the royalty.

Larry: Yes, if the royalty payments have been as expected and the outlook for revenue growth good there should be lots of investors who, at a price, would buy the royalty.

Barry: Right and the price will be a function of the presently assumed yield on the price paid and the royalties to be paid and the longer-term outlook for the revenues of the company to increase with a proportionate increase in the royalty payments.

Larry: Ok, so it's a matter of finding a way of letting investors know of the availability of the royalty and then negotiating a fair price.

Barry: Yes, that's what brokers and bankers do, find counterparties.

Larry: Of course, the best answer would be specialized market for royalties such as we are being told is in the plans. If there were one or more exchanges, which traded royalties, we could sell more easily and other investors could find their yield providing vehicles quicker and easier.

Barry: the next biggest problem is that most royalties will be issued by privately owned companies and investors do not know a lot about the individual issuers of royalties.

Larry: Sure, that is true but in most cases there is going to be an investment banker involved in vetting the company offering the royalty.

Barry: And, don't forget that using the patented approach of the collection of royalties every time the company receives revenue in their bank account we know what the revenues are minute by minute. Also, the company is required to give us an annual audit of revenues and may even give us a full audit of their financial condition.

Larry: Yes and we get to meet the senior executives once a year and might even develop a relationship with them where we can help them increase revenues, which is our only area of interest.

Barry: Also, before we bought the royalty the Private Placement Memo or prospectus gave us a lot of information about the company and the deal terms.

Larry: Yes, you are right and come to think about it how much do we really know about publicly traded companies, except what they want to tell us.

Barry: Ok, that covers the marketability of royalties once we own them and the fact that the issuers are privately owned companies.

Larry: Which is why we are getting such a good deal as they do not want to raise money by selling shares or ownership interests in their companies and we have only bought a percentage of their revenues.

Barry: What about what happens if they want to go public or sell out and therefore want to terminate the royalty?

Larry: That's ok as in the redemption clause giving the company the right to redeem the royalties there is a formula for the price the company would have to pay to terminate the royalty payment obligation if they feel it necessary to attract investors or get a better deal if they are selling out.

Barry: Sure and they can come to us directly and bid for the royalty or tender for all of the royalties.

Larry: We are worrying about an eloquent problem that should only occur.

Barry: What if their revenues decrease instead of increasing as they and we have expected?

Larry: Then we would have less in royalty payments than we expected, unless there was a minimum royalty payment agreed to originally.

Barry: But, of course, with every royalty payment we receive our investment in the company's royalty is that much less and after 5 to 7 years we should have had royalty payments equaling all of our money back and all the future royalty payments would be profit.

Larry: What else can go wrong?

Barry: This idea of royalty income funds is great. They have the expertise and relationships we don't have.. Also, we have to remember that even with these problems, which seem to be non-problems, the reason we got involved in owning royalties, through the royalty income fund is because we can't get as high a return and an increasing return anywhere else.

Larry: Yes, and the fund does the work of selecting the companies from which to buy royalties, collecting the royalties, sending us a quarterly check and generally making the process painless for us.

Barry: I agree and even though they get a high performance fee, they earn it.

Barry: I think that's it, but we also have to recognize that when royalties become traded like convertible bonds or stocks that investors will extrapolate the trend of revenues and be prepared to pay a premium price for the royalty based on their projection of the total value of the anticipated royalty payments.

Larry: That will or should be some windfall for us as we will be offered a fancy premium and have been well paid in the meantime.

Barry: Those guys who started the early royalty income funds sure did us a favor and themselves as once royalties become better understood and used and traded the companies will not have to pay such a high percentage of revenues to attract the capital and existing royalties will have a sharp appreciation.

Larry: Yup. We bought the royalties for good and increasing income and got a big gain to boot. Not a bad day's work.

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Lawrence (Larry) Lion and Bernard (Barry) Beaver have been used by Arthur Lipper to illustrate the reactions of typical growth oriented entrepreneurs. Larry and Barry first appeared in the monthly column of Arthur Lipper, as Chairman and Editor-in-Chief of Venture, The Magazine for Business Owners. Arthur Lipper's latest book is The Larry and Barry Guide to Entrepreneurial Wisdom has also been published by CITIC in Chinese and has sold well in China.