Thoughts for portfolio managers of Royalty Income Funds ©

By: Arthur Lipper

The magic of royalties, from the perspective of the investor, is the fixed and contractual linkage to revenue growth. It is the anticipated growth of revenues, which permits the investor to accept a relatively modest return in the early years of a royalty payment period.

Having been involved in the ownership of businesses as well as having been a corporate advisor, board member and investment banker, I know that not all privately owned companies wishing to grow their revenues have the inherent ability to do so.

The financing of an increased sales effort is not an assurance that there will be sufficiently greater revenues to offset the cost of the increased effort. Many privately owned companies reach a level of balance and sufficiency within a customer universe based on the owner's personal relations, pricing and the significance of the product or services being offered.

If a company is already serving a significant percentage of the company's customer universe is the effort to grow in that universe warranted? If product pricing is the revenue growth retarding challenge is it likely that anything other than reducing prices will attract the non-customers? Is it good business to reduce prices to increase sales if the same price reduction, as is likely, will have to be applied to the existing customers? Should a royalty be purchased from a company, which will not assuredly benefit from the increased operational capital?

Can the company expand its revenues by either seeking to offer additional products or services to existing customers or to identify another universe of customers? First, are the new product offerings sufficiently beneficial to either the existing or new customers to be assured of acceptance? Second, is there evidence that the new products can be acquired or produced at a price to provide margins justifying the added marketing expenses? Should royalties be purchased from royalty issuing companies having low or shrinking profit margins, even on a larger sales base?

Although, royalties are wholly revenue rewarded the wise royalty investor will want to be comfortable that the royalty issuer is benefiting from the additional capital being made available.

What are the ages, health, level of ownership and motivation of the royalty issuing company's owners and managers? Many of the same factors in the buying of growth-oriented equities are valid considerations for a royalty purchaser.

How likely is the sale or acquisition of the royalty issuing company? Certainly, increased revenues will make such an event more of a possibility. This is an important consideration when structuring a redemption clause in the royalty payment agreement.

The royalty purchaser should have an understanding of the factors impacting the industry in which the company operates. If the outlook for the industry is difficult to bleak there should be a recognition that price increases and unit sale expansion will be difficult. The royalty purchaser should have a clear view of the industries which are and which are not positive. Similarly, the royalty purchaser should have a view as to the relative attraction of the present and possible areas and jurisdictions of activity. The opportunities for growing companies in China is great, but does a royalty purchaser want to have a large percentage of the business to be China-based?

Having established that it is better for the investor to buy and own royalties from companies in certain industries and locations these preferences should be used in determining the areas of deal research and focus. The greater the concentration of focus the greater the need for expert opinions, advice and insight.

So, in summation, what are the royalty portfolio manager and investor seeking? Companies having the characteristics associated with significant revenue growth, in industries and locations with positive outlooks and having good and possibly growing profit margins. This is not because royalties are rewarded with increasing profits but because companies with increasing profits will usually invest successfully in growing their revenues and that is what the royalty investor invests for.

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