What's Good and Bad About Revenue Royalties©

By Arthur Lipper

Revenue Royalties are a percentage of a company's revenues, paid by the issuing company to an investor for an agreed period. They may be negotiable, redeemable, convertible, and have either or both minimums and caps. Royalty payments can be paid by the royalty issuing company daily, annually or at any selected interval. Royalties are exclusively revenue-focused and do not either increase or decrease as a result of declared profits.

Good

Royalties are more predictable and safer for the investor than shares, because revenues are inherently easier to predict than profits.

Royalties are revenue-dependent and are not reduced by possible company losses.

Royalty contracts can be bought and sold to and by "accredited investors", although they are not registered securities.

Royalties may benefit from inflation, as they are only revenue focused, and revenues tend to increase in times of inflation.

Royalties produce increasing payments as the revenues of the issuer Increases.

Royalties are less volatile than stocks and are safer to borrow against.

A purchaser can sell royalties profitably once there is a history of increasing issuer revenues and increasing royalty payments.

Revenue royalties can be collected automatically, on receipt of royalty issuer revenue, in a separate account controlled by a trustee-like service provider acting on behalf of the investors. Royalties should not be vulnerable to discretionary or reduced payment by the issuer.

The royalty payment agreement can be simpler and more quickly negotiated than the documentation regarding acquiring an ownership interest or one involving debt.

Personal guarantees are not usually required in royalty contracts.

A royalty investment may be tax deductible to the royalty issuer if the funds raised are used to expand the business.

Royalties received may be deemed to be a return of principal, and therefore not subject to income tax, until the amount received equals the initial cost of the royalty.

Royalties do not require business managers to make the same disclosures, as is the case with equities.

Royalties do not constrain executive compensation, charitable contributions, pension benefits, employee benefits or bonuses, as may be the case with shareholder-financed companies.

An audit of a company paying royalties may be simpler, quicker and less expensive than a full financial audit, since the audit of royalties is focused on full and accurate reporting of revenues received only.

Royalty payment amounts are not fixed, as they reflect the level of revenues. The amount of royalty payment adjusts automatically as the revenues change.

The detailed covenants and possible penalties of a loan, and the ratchet-based penalties of convertible preferred stock if certain agreed levels of revenues or profits are not achieved, do not usually apply to royalty contracts.

Securing performance on a royalty contract does not encumber physical or financial assets of the company. Performance is commonly assured through the use of key assets of the company, such as trademarks, intellectual property, customer lists, which are transferred or pledged to royalty investors and licensed back to the company at no cost for its exclusive use.

Since payments on a royalty contract normally begin immediately upon receipt of an investment, the investor’s possible loss decreases with each royalty payment received.

When the royalty contract is concluded, either by running its natural term or through an early redemption, all contractual compliance assuring obligations by the issuing company is terminated; there is no debt to pay off, and no equity dilution.

Bad

Royalties are not yet traded publicly and therefore have limited liquidity.

Royalties may not be as big a winner as stocks in the event the royalty issuing company is highly successful and either is bought or goes public.

Royalty payments reduce the profitability of a company until the funds received for the sale of the royalty can be effectively employed.

The royalty payment plan of payment on receipt of revenue allows the royalty holder(s) to immediately know the revenues of the royalty issuer.

A company with an outstanding royalty obligation may be less attractive to a potential acquirer or to an underwriter of a public offering, unless and until the royalty can be redeemed.

Most revenue royalties in private companies are offered to accredited investors only, and may be sold only to those similarly qualified.

Determining the fair market value of a royalty is a challenge, since there is no established methodology for doing so and no public market as yet. Formulas based on last-sale, trailing or future revenues, are a matter of negotiation between individual buyer and seller.

In a bankruptcy, the position of the royalty holder (which holds no debt and owns no equity) may be in conflict with senior debt holders, with holders of common and preferred equity, so recovering funds if the company goes bankrupt may be difficult.

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