“Always Seeking a Hedge” and What About Leverage? ©

As the ever logical and mostly successful Mark Cuban says: he is always seeking a hedge to protect his assets. This is a reasonable approach as relating to assets, which have only a point-to-point objective of acquiring at a price today, with the hope of selling at a higher price in the future.

This is sensible, because there are so many factors which are beyond the control of both the investor, such as markets and the investee company’s competition, operational issues and subsequent dilutive financings.

Preservation of capital while seeking increasing income is the objective of royalty investors. They are focused on the longer term by definition, and expect to continue holding their contractual position providing for quarterly percentage of revenues, which they hope will increase.

In particular, royalty income fund participants, due to portfolio diversification, are not concerned with the unlikely prospect of a royalty issuing company suffering an unexpected cessation of established revenues. Can a royalty issuing company suffer a revenue decline? Of course, revenues can both decline and increase. However, in the case of established companies, especially those with the additional capital the sale of a royalty will produce, it is more likely there will be revenue increases. Price inflation also works for the royalty investor.

The investor’s bet on a company’s increasing revenues is far more reasonable than basing the value of an investment on future per-share quarterly reported earnings.

It is also more reasonable for a royalty investor to consider the use of leverage, especially in times of lower interest rates, as a means of increasing returns. If the tax-deductible cost of borrowed money is no more than half the ordinary income return from a royalty, then the net

return for the investor will be enhanced. It is also probable that some royalty income funds will have the right and possibly practice of leveraging their royalty investments.

In some cases, it may be possible for a royalty investor to buy a contract, for a fee, assuring the payment of a minimum royalty level. Indeed, the royalty issuing company itself might be the seller of such a contract.

Arthur Lipper, Chairman
British Far East Holdings Ltd.

February 13, 2016