Changing the Terms of a Royalty–What's Better?©

BY ARTHUR LIPPER

In my prior column I describe the reasons why royalties are the better way of both investing in and financing of privately owned companies. The website calculator recommended for structuring the terms of a royalty is REXRoyalties.com. Now, using the same projected revenues, I introduce REXComparator.com, which allows users to compare and modify two different royalty structures and be able to study the results and impacts of the difference in terms.

When originally creating the website calculator, which is used in the assessment and negotiation of royalties my challenge was to show the results of using the variations of the terms side-by-side while maintaining the projected revenues as a constant. REXComparator.com accomplishes the objective as will be seen in reviewing the 4 Sample cases.

Let's consider what can easily be varied as to terms.

First, the amount of money paid for the royalty, which is a separate decision than if any investment is warranted by the scope of the business opportunity. As you would expect the business owner, whose company is offering the royalty, will consider accepting less than originally sought for the same percentage of revenues. The less paid for the same asset the better. However, the royalty issuing entity should not reduce the amount to less than is required to achieve the company's immediate goals. Terms other than the amount paid for the royalty can be more easily addressed.

The company assuming the terms and completion of the deal being considered should estimate the Pre-Tax and Net-After-Tax earnings of the company. Also, the user can enter the Price/Earning Ratio of comparable companies, as these factors will impact the Business Valuation, which is calculated by multiplying the Net After Tax profit by the P/E. Of course, this does not include debt.

The initial and subsequently reduced, if any, Royalty Rates are then entered for each scenario. It is also possible the parties will agree that when a specified level of cumulative royalty payments has been reached, usually within a specified time period, the Royalty Rate will be reduced or the royalty may be terminated. This is the case in the CappedReturn sample. This is also addressed more fully in REX-RIAR.com, which will be the subject of a future column.

It is also possible the parties may wish to assume a different than initially suggested Compound Annual Growth Rate for the revenues and the calculator can readily accommodate and reflect the royalty payment and other analytics as will be impacted by the changes in terms

The Analytics tabular presentation shows the results of the entered data on a two deal, side-by-side basis, including the differing IRR's and Business Value.

The first of the charts show the Projected Net Revenues and Royalty Distribution and the second chart shows the Pre-tax Profit, Royalty Distribution and Business Valuation for each deal.

The FastRecap, MoreEarly and DoubleDown samples each show how a different set of deals would workout. The usual trade-off being the investors wanting a faster return gets a smaller Internal Rate of Return than the longer staying investor, as it is optimistically assumed the revenue projections, which are ever increasing, are actually achieved.

REXComparator.com is a wonderfully helpful website and allows for an evaluation of relative risk and reward. It is such an analysis, which is the basis for successful investing as well as successful business management, all of which goes back to why I have created and chosen the Balanced Wisdom scale at the top of this column as my personal logo.

Arthur Lipper, Chairman, Chairman@REXRoyalties.com, British Far East Holdings Ltd.