Changing the way the world invests

in privately-owned and early-stage companies ©

By: Arthur Lipper

The logo above is intended to represent the investment decision-making process required to balance the possible risks and rewards of investing, when viewed through a telescope that allows an accurate view of future events. This is what successful investing is all about -- balancing risk and reward in light of what is to come.

After more than a half a century of both advising and observing professional equity investors, I offer the following observations: Investment management success is achieved by portfolio diversification and an analysis of data applied to long-term objectives.

The importance of individual investors continues to diminish, as both equity and debt investing are increasingly done by professional portfolio managers, especially those associated with organizations that deploy a successful marketing effort.

The primary concern of most investment managers is that of personal career risk -- incurring losses in investments not currently in favor in the investment community. As in many other situations, the risk to the fiduciary of under-performing is greater than the reward for over- performing. This leads to a concentration on companies and industries found attractive by others.

The portfolio focus and concentration on issues broadly believed to have a favorable financial future, and therefore already selling at price/earning levels that anticipate continued similar success, leaves those positions vulnerable to reported disappointing results. So the company's success is in the price of the stock, but not that of a less than generally expected result.

Only a small segment of investment managers has been able to consistently generate a record of significant competitive success, as measured against the most common benchmark, the S&P. Equity investment managers and investors have benefited from the inflation experienced in much of the period since WWII, but their total results have often been disappointing, net of inflation and fees.

There are vast amounts of funds not invested in equities and at the same time, there are fewer areas for investment in which the current price and most recent results favor investment. In other words, the investment manager is being forced to look further into the future to justify the employment of funds and meet his clients' expectation for performance.

The most dramatic gains in corporate results and the price of stocks have been in younger or early-stage companies, often privately-held. Of course, these have also been the most likely to result in investor disappointment, because of heightened expectations.

So what do the above observations indicate? Only a relatively few professional investment managers have been able to competitively excel for a consistent period; there will be an increasing amount of capital available to to invest in early-stage companies; and it is more difficult for investment managers to invest comfortably in publicly traded equities and still meet or beat the benchmark.

In part as a reflection of the foregoing, the concept of financing the growth of companies through a purchase of a royalty, or a share of their gross revenues for an agreed period, has been developed.

If one believes that it is easier to predict the trend of a company's revenue growth than to predict the level of future per-share earnings the company may report, buying a percentage of revenues makes sense.

Also, in the case of many privately-owned companies seeking growth capital there is a reluctance to report maximum profits and therefore pay maximum taxes. Therefore, a strictly revenue-focused royalty is attractive to both the royalty issuing company and to the investor since revenues are a more transparent measure of company performance than declared profits.

In royalty investing the negotiation between the investment managers of a royalty income fund (which we believe will be the next important development in world finance), and the business owner or manager, will focus on the following:

Amount to be paid for the royalty.

Percentage of defined revenues on which the royalty is based.

The number of years in which there is a royalty payment obligation.

The collateralization or means of assuring the royalty issuer's contractual compliance.

The credibility of the company's projected future revenue growth, based on past performance, management quality and conservative planning,

The amount paid for the royalty should be sufficient to assure the royalty issuer of achieving a positive cash flow, including recognition of the royalty payments.

The royalty rate or percentage of revenues should be sufficient to attract investors and be something close to an Internal Rate of Return (IRR) of 20% per annum over the course of the royalty payment period, based upon a realistic projection of revenues.

The payment period can be adjusted to meet the needs of the parties, but the shorter the period the higher the royalty rate must be, for the investor to achieve the investor's objective.

The more comfortable and secure the investor is regarding the assuredness of receiving the contracted for payments, the more favorable will be the terms of the royalty. Royalties and debt can be combined.

Royalty rates and royalty payment periods can reflect the cumulative levels of royalty payments received by the investors.

Royalties can also be redeemable, convertible into equity, guaranteed by third parties as to either or both minimum levels of royalty payments to be received periodically or cumulatively, and can be capped as to the maximum amount to be received in any period.

Royalties are collected immediately upon receipt of revenues, by a trusted third party such as a bank, insurance company or other fiduciary. They are treated as an operating expense, and never become an account payable.

Investors in royalties typically do not own any part of the company issuing the royalty and usually do not have voting rights or other means of influencing management.

Royalty issuers can be encouraged to be conservative in their revenue projections by using a "Scaled Royalty" approach in which there is both a benefit for over-performance and a penalty for under-performance, in the revenues actually achieved versus the projected amounts.

For American taxpayers, royalty payments are tax-free during the period of capital recapture. The income from royalty payments becomes "ordinary" income once the amount paid for the royalty has been recaptured.

Royalty payments are tax deductible by the issuing company. The approach we recommend to both investors and business owners is that which we were able to patent and which is generally described in this writing.

To accommodate the large supply of capital seeking investment in early-stage and privately owned companies. a corps of trained business analysts capable of both assessing the sustainability of a royalty issuer, and an industry-experienced assessor of the revenues projected, will be required.

There will also need to be experienced commercial bank loan officers, recognizing that additional royalty-based capital acquired by privately-owned companies having significant growth potential also makes them good prospects for term loans on fair terms.

Finally, there will be a need for institutional investors, probably pension, retirement, annuity, endowment and other tax-exempt or tax-deferred funds, prepared to buy royalties from original investors after their performance has been proven. These royalties will increase significantly in value, based on a Net Present Value calculation, once their capability to deliver growing revenue streams, to meet their projections and honor their contractual obligations, has been demonstrated. The terms under which these “seasoned” royalties may be acquired will be attractive to both the original investor and to the new institutional investor.

Eventually, royalties will be traded on registered public exchanges, much as securities are currently. That is our ultimate intent and expectation.

Royalties could become a major force in the international financing of companies, creating millions of jobs. increasing the overall vitality of economic growth, and providing stable, attractive long-term returns to investors.

Arthur Lipper, Chairman
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with assistance from Michael North, Pacific Royalties