Companies From Which Investors Should and Should Not Buy Royalties ©

Arthur Lipper

Successful investing in the revenue sharing royalties sold by privately owned companies requires correctly assessing the royalty issuing company's future revenues. The investor is concerned to a lesser extent with the reported profitability of the company.

Increasingly investors are also concerned with the social and business values of the company issuing royalties. The development of Impact funds and the focus on Benefit Corporations and Program-Related Investments illustrates the changing values of longer-term investors.

Positive Characteristics

The product or services offered by the company benefit the customer.

The company has or will have a substantial and sustainable margin.

The company's controlling shareholders are seeking revenue growth.

The non-equity dilutive funds raised by the sale of a royalty will be used to increase revenues.

The company's products or services generate measurable benefits to the community and to society as a whole; this may make it more likely that the company's anticipated revenues will be attained.

Management of the company has been successful in prior endeavors and the company has already experienced increasing revenues, over at least the previous three years.

Customers of the company both confirm product or service satisfaction and either have reordered, or plan on reordering.

The company has good labor relations and has been relatively free of disputes and litigation.

The company's projected revenues are reasonable to those who have knowledge of the industry in which the company competes.

The terms of the royalty agreement provide protections to investors and are fair to the royalty issuing company.

Negative Characteristics

The company is engaged in socially undesirable or controversial activities.

The company is in a low profit, low-margin industry.

The company has a history of disputes and litigation.

Intellectual property of the company is difficult to protect and therefore of little security value to the royalty investor.

The owners of the business are not focused on the long-termfuture of the operating company, but instead may be interested in "flipping" and a quick exit.

Relationships within the company are stressful and employees do not believe that the company's success will benefit them.

The revenue growth projections are not sustainable, given the history of the company, or in the judgment of knowledgeable industry advisors.

Company customers primarily base their purchase decisions on the terms of trade, or just on price.

There is a concentration of customers, and special relationships account for a significant percentage of revenues.

The business is overly dependent on a single individual.

There are existing minority equity shareholders or Board members who may not wish new investors to have the advantages of revenue royalties, and may oppose revenue financing.

There are existing debt holders with covenants that must be sought for approval of a royalty contract, who may oppose a royalty transaction.

Conclusion

There are fewer questions which need to be answered in successful royalty investing than with equity investing. There is a natural gravitation to good businesses, requiring growth capital. There is also a reasonable preference for royalty issuers owned and controlled by people believed to have good personal and social values.

The virtues of royalty investing are clear and it should always be better to have a revenue entitlement in a company where full ownership retention is important to those in control. It is reasonable to be wary of those willing to accept a dilution of their ownership at a significant discount to what they proclaim will be future results.

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