Investment Manager Questions About Starting A Royalty Income Fund ©

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After studying and understanding the inherent investor advantages of participating in the growth of a company's revenues, those with investment management experience naturally begin to consider starting a revenue royalties income fund.

Here are some of the questions and their answers:

What are the industrial activity and geographic areas about which you feel most comfortable and have had the most experience?

> **The experience of the manager will determine the comfort level for the type and stability of the prospective royalty issuing company's projected revenues. The manager's prior success in investing in a similar investee profile will also be useful in marketing the fund to investors.**

What are the primary concerns of the portfolio manager of a royalty fund?

> **The investment manager is a fiduciary and therefore the sustainability of the royalty issuing company is of primary importance. However, the judgment area, which is most important in both structuring the royalty and deciding which company's royalty should be purchased, is an ability to determine the credibility of the revenues projected by the royalty issuing company.**

What should be the form of the royalty fund?

> **Funds can be registered in the U.S. or internationally. In the U.S., Limited Partnerships or Limited Liability companies are the norm. The manager's counsel and auditor should be involved in giving the manager advice and both will be involved in the necessary investor documentation.**

What is a fair compensation for the manager of a royalty income fund?

The traditional venture capital and private equity fund fee of a fixed annual fee of 2% plus an annual performance fee of 20% is fair if there is a minimum return to investors before the performance fee is applied. In the current market, I believe a 10% return is a reasonable hurdle rate. Due to competition and a generally poor investor return, other alternative investment approach managers have had to reduce these management fees.

Some innovative manager compensation formulas also involve direct participation in the royalties paid to investors. This may be considered when there are high-quality company revenues involved, with strong historic track record and a persuasive case for increasing long-term revenues, after application of the capital provided by the revenue royalties investors. It is prudent for fund managers to compare the risk-adjusted outcome of such a strategy, compared to the conventional 2/20 formula with hurdle rate.

What are the operational functions of a management entity for a royalty fund?

There must be a process for the initial assessment of royalty purchase opportunities. Most applicants for funding will not pass the test of investing the resources for serious due diligence. Next there must be an ability for due diligence focused on the ability of the company to remain in business with the amount of funding the royalty sale will provide, and with the load on top-line revenues -- and therefore profitability -- imposed by the revenue royalties obligation.

Then there must be an ability to assess the reasonableness of the company's projected revenues. A sound policy is to examine the pre-funding gross profit margin, compare it to the post-funding margin after application of the investment, and then assess how the capital provided may, over time, restore the pre-funding profit margins through capital efficiency, market

positioning, long-term supplier agreements, alliances and acquisitions.

Red flags in use of proceeds for a royalties investment are disproportionate payments to executives for sweat-equity contributions by founders, retirement of debt, stock buy-backs and other equity restructuring, payment of tax obligations and other expenditures that do not directly impact the company's top-line revenues.

There must also be provided or outsourced the functions of a registrar, a transfer agent, a custodian, a royalty collection agent, a royalty distribution agent and an entity to hold the critical assets of the royalty issuer to assure contractual compliance. Depending on the form of the fund there will be financial statements and income tax advisories, which will have to be prepared and distributed.

As revenue royalties become more prevalent in the market, it is expected that specialty management firms, familiar with the unique aspects of revenue royalties fund management, transfer, trust and remittance functions, will emerge.

The manager will also have to negotiate with the royalty issuer the amount and timing of financial information as well as maintaining a relationship with the royalty issuer, which can include providing professional advice.

Managers should develop and have good relations with both counsel and an auditor.

How is liquidity offered to fund investors?

In part this is a question for the attorneys as the royalty agreement is for a negotiable instrument with royalty payments being as received within an agreed period, such as the most recent quarter.

The challenge for the new investor is to find an accredited investor to purchase the royalty contract for the remaining period of the royalty payment agreement, at a fair price given the demonstrated income provided. The website calculator REX-PV.com provides the means of negotiating the amount of premium the selling royalty investor must receive in order to achieve its original targeted IRR.

The calculator also indicates the period necessary for the new owner to earn back in royalty payments the amount paid for the royalty as well as the IRR the new owner will experience if the projected revenues are achieved. If, as we recommend, the new royalty holder is a tax-exempt entity, the royalty will be of greater value, as the royalty payments will be tax-free. The royalty payments will remain tax deductible to the issuer.

The best and most logically interested buyer will be the royalty issuer, as most issuers will seek to reacquire the royalties sold through direct negotiation, tenders or exercise of the redemption right. Every dollar of royalty payment terminated is a pre-tax dollar, making the issuer itself the most logical of buyers when capital is available.

It is also possible the manager and other fund participants will be interested in acquiring royalties from investors wishing to sell them. The fund manager may also offer to provide a listing function for existing investors in the fund to buy or sell shares of the fund among themselves. After the fund has demonstrated satisfactory performance over a period of time, and depending on the total amount of capital involved, fund managers may consider filing a Registration Statement to list the fund's shares on a public securities market.

Can royalty funds seek additional capital?

Depending on the terms of the royalty fund purchase agreement, royalty income funds can take any legal actions approved by the investors as proposed by the management entity. This flexibility should be built into any fund manager agreement.

Royalty funds can do anything other collective investment vehicles can do with the consent of the investors. The advice of counsel and auditor should play an important role in the decision-making regarding structure or focus changes.

When do royalty income funds close?

This is a matter to be determined at the time of formation. The fund could be sold to a tax-exempt entity, it could be dissolved with investor approval, it could seek a public offering or it could raise additional capital and go on for many years of producing superior returns for investors and therefore managers.

What are the requirements of managers of royalty income funds?

There are no regulatory requirements for managing a royalty income fund. However, to be able to attract investment from sophisticated investors the experience of key managers will be an important consideration.

Clearly, the manager(s) should have a good understanding of business and securities as well as law and accounting. Ideal managers will have had experience of managing equity or debt portfolios, and will have experience with alternative assets

What is fair compensation for the managers of royalty income funds?

The compensation arrangement is part of the management fee negotiation as the expenses of operation, including management are expected to be covered by the fixed fee. As the performance fee has the potential for being so large, I believe it questionable if the investors should be concerned with how the management entity pays its leaders and staff.

Can royalty funds co-invest with others and if they are the originators of the opportunity can they take a fee from the other investors?

Sure, the fund can both co-invest and profit from introducing the other investors, given required broker-dealer certification that

allows sharing of fees. The profit can be a fee or different terms regarding the sharing of the performance fee.

Michael North, Co-Managing Member of Pacific Royalties LLC both edited and provided significant input to this writing. The business of Pacific Royalties is to advise and assist those involved in the management of royalty income funds.