Larry and Barry Discuss The Cost of Royalty Funding

Arthur Lipper

Larry: I like everything about the royalty deal for giving us the money we need to increase our revenues and therefore profits. Now some people, who know little about royalties, tell me the money is too expensive.

Barry: It is so simple that it shouldn't need explaining. The royalty buyers have a great deal if our revenue projections are achieved as they get an agreed percentage.

Larry: Right and we retain all of the ownership of the company, the value of which will be so much higher after we produce the revenues.

Barry: The word "if" is important for both the royalty buyers and we to understand. We may be overestimating the revenues we have projected, as even with the new money there may be problems we are unable to envision.

Larry: Yes and I love the way the right-hand column on the REX websites that shows the Business Value, which we are owning as much of as before getting the royalty money.

Barry: Well the Business Value is a bit too simplistic as it only takes our projected revenues, estimated Net After Tax profit margin and multiplies the result by the Price/Earning Ratio we suggested as being fair, based on comparable companies. But it will do for our internal purposes, as a rough, preliminary estimate.

Larry: So it doesn't take into consideration the money we might owe and have to be repaid before there is a residual value for the company owners.

Larry: Sure, and the royalty buyer has only limited liquidity if and when he wants to sell and we, being a privately owned company, with no plans on going public, only reward the investor with a share of revenues.

Barry: Right, the longer the investors maintain their royalty the more money they get and they have probably recaptured their investment in 5 years or so; the rest of the holding period is without capital risk.

Larry: So in the end the deal is we give up a bit of revenue, which is an even bigger share of profits, depending on how we report profit, for the growth capital.

Barry: Yes, and the royalty payments we make are tax-deductible.

Larry: So in the end it all comes down to how much it will cost us to terminate the royalty agreement.

Barry: That's why the redemption right we insisted on is so important. Each dollar paid in royalties is a pre-tax dollar of profit.

Larry: The exercise of the redemption right is our worst case cost as we can try to buy the royalties back from the holders in direct negotiation or we can tender for them on terms less favorable to the investors than would be were we to use our redemption right.

Barry: Remover that we thought the 10 times cost in 10 years, less royalty payments they suggested was so very high that we'd never use it.

Larry: Yes, but then we really were not sure that the revenues we were projecting could be achieved.

Barry: That 10 times in 10 years gives the investors more than a 26% Internal Rate of Return, which is a damn good investment.

Larry: So we have gotten much richer holding on to our ownership than would have been the case if we had sold equity, and the investors have had a good deal as a result of believing that we would succeed.

Barry: Yes, it is probably the case that most royalty issuing companies will want to buy back the royalties they sold before achieving the revenue increases the royalty money made possible.

Larry: So royalty money isn't expensive, as it allows us to benefit so much more than any other way of financing.

Barry: Right, it's a win/win.