Larry and Barry Consider Both investing In a Royalty Income Fund and Selling a Royalty to Raise Growth Capital ©

Arthur Lipper

Larry: Someone I know and trust is advising me to invest in a royalty income fund. He tells me the fund's quarterly distributions will be much higher than other investments in which there is much greater risk of loss.

Barry: Is your friend earning a commission or getting a fee to get you to invest?

Larry: He tells me that over and above a relatively modest initial and fixed annual fee he will participate in an annual performance fee, which has a reasonably high hurdle rate, which has to be exceeded each year.

Barry: So the managers of the fund believe the royalties they buy for the fund will be yielding substantially more than the hurdle rate. Won't this prompt them to make risky investments?

Larry: They won't have to because the royalties are a percentage of a company's revenues and they only buy royalties from companies expected to have significantly higher revenues in the years when they are able to use the funds obtained from the sale of the royalty.

Barry: What happens if they are wrong and the companies do not increase their revenues? Predicting anything is tricky.

Larry: I asked him that and he had two answers. The first was that it was possible there would be investor disappointment in the level of the return. The second point was that it was possible for the royalty issuing companies to guarantee minimum payments. The fund also has a right at the end of

60 months to require a refund of the amount paid for the royalty, if greater than that of the royalties received.

Barry: **What kind of companies do they buy royalties from and why would these companies sell a percentage of their revenues?**

Larry: **They only buy royalties, in this fund, from companies having increased their revenues in each of the last thee years and which can realistically project that the money received for the royalty will allow projected revenue, which result in higher revenue payments.**

Barry: **So we care about the company continuing in business but not about how much or how little profit they earn?**

Larry: **Yes and the really good part is that the companies will have a redemption right allowing them to buyback the royalties at multiples of the initial cost. They are likely to do that if they want to sell or go public or achieve their projected revenues and start paying a lot of royalty money, all of which could be pre-tax profit as it "comes off the top".**

Barry: **I assume this buyout would be very good for us.**

Larry: **Yes. It could produce a return of much more than the 15% Internal Rate of Return (IRR) over the course of the full royalty payment period, which is the minimum expected.**

Barry: **Ok, but what about you and I having our company sell a royalty? We would qualify by our revenues increasing in each of the last three years. If we had a serious bunch of new money we could both buy our major competitor and expand the business even faster.**

Larry: **Yes but you always were against us taking in partners or borrowing money.**

Barry: **Yes, I didn't want to be a fiduciary for people I didn't know and didn't want to optimize profit reporting as I thought it better that we invest more in the business to make it grow as**

it has. I still feel the same way but as you describe it the royalty fund only cares about revenues and all we owe them is an honest count of revenues.

Larry: They seem to have a process which is fair and efficient.

Barry: Then we should talk to them, as I particularly like the part about being able to buy back the royalty if we change our ideas about a public offering or selling out.

Larry: The fund has a whole lot of safeguards, some of which will cost us something but none which are deal breakers.

Barry: What are they?

Larry: They want us to transfer to a mutually approved party our intellectual property and other assets. The third party is like a trustee and until an agreed time or event lets us use the transferred assets without paying anything. If the company got into trouble and had to be reorganized the Asset Holding entity would be able to continue the royalty with the new company. At an agreed time the assets are transferred back.

Barry: How much information about the company do we have to give them?

Larry: Quite a bit including a Private Place Memorandum and audited financials. It might be possible to only disclose to them a balance sheet and an audit of revenues. They have a process of collecting the agreed royalty immediately on our receipt of revenues. It's called a lockbox and it is a service many banks offer.

Barry: So effectively they know our revenues as soon as we know them. Why do they need the audit?

Larry: Because the managers of the fund are fiduciaries and have to protect the interests of their investors.

Barry: It sure sounds better than borrowing money, which we can 't do without a personal guarantee and sharing ownership which would require changes in our personal lives and what we charge as business expenses.

Larry: Ok, we can explore both possibilities being investors and royalty issuers. Both make sense.

Arthur Lipper, Chairman **© Copyright 2017 British Far East Holdings Ltd.**
British Far East Holdings Ltd. **All rights reserved.** **May 13, 2017**