Larry and Barry On the Stupidity of So Many Early Stage Private Company Investors ©

Arthur Lipper

Larry: I was just at one of those meetings for people supposedly interested in investing in early stage companies.

Barry: How was it?

Larry: Terrible; they were thinking just the way we were before we learned about royalties.

Barry: You mean they "allowed their wishes to become parents of their thoughts" and were about to make dumb "all or nothing" bets on the typically unrealistic projections of entrepreneurs who start many businesses, as we once did?

Larry: Yes, exactly -- the same as we were when we thought the essence of good dealmaking was getting the most equity possible for the least money invested.

Barry: We learned really quickly that owning a minority position in a privately owned company was foolish, if we could instead own a percentage of all the company's topline revenues.

Larry: Executive compensation, expense account policies, special deals with friends of the owners, actions taken to reduce reportable profits, amounts spent on research and why there was a need for newly decorated offices -- these are all expenses which reduce profits and therefore the value of our investment. If we could make a revenue royalty investment instead, then we no longer have to worry about these highly discretionary expenses.

Barry: Also, with royalties we don't care about the inevitable added dilution of the company's equity every time the company needs more money -- or the be concerned with stock option deals that management makes with themselves, or provides to new hires.

These might all be valid moves for those controlling the business to take as they build their company, but they are detrimental to our interests, if we're equity investors and only really interested in selling the stock we bought sooner rather than later.

Larry: Also, there was no realistic possibility of the companies paying us dividends, even if they become profitable, so our only shot at a profit was by selling our shares, some time in the indefinite future -- either to a buyer of the whole company on terms we couldn't control, or if the company went public. Not much of an exit strategy for us. Also the terms of a buyout almost always favor the owners and managers, not the equity holders.

Barry: Yes -- but using the REX approach we get paid every time the company receives revenues. We receive our revenue royalties immediately, as soon as deposits are made in a bank we have approved.

Larry: And we always have the ability to invest our quarterly royalty distributions to earn an even greater return from the royalty. The compound effect of such a reinvestment creates a much higher Internal Rate of Return than the minimum we established as a reason to do the deal. It is also possible the reinvestment of the royalties we receive can be into the royalty issuing company on predetermined terms.

Barry: Another thing that helps to control risk in royalties -- the REX approach of using critical assets of the royalty issuer to secure contractual compliance without cost to the issuer. That's a really good idea.

Larry: Especially if the company has to be reorganized for some reason in the future, and the newly reorganized company will be required to continue paying the royalty if they want to use the intellectual property and other assets of the original company.

Barry: Maybe the best part for us, the investors, is also something the royalty issuing company wanted for themselves: the right of redemption, giving them the ability to terminate the royalty on terms we agreed upon in advance.

Larry: Yes, and I like the deal we worked out where we can get five times our investment back, including the royalties paid to us, if the royalties are redeemed n five years, and ten times if they're redeemed in 10 years. If the company is very successful, so are we -- just like in more risky and deferred equity deals.

Barry: It's also a good deal for the issuer as they are only likely to exercise the right of redemption if they are being bought out, going public or making a lot of money, and they don't want to have the expense of the royalty anymore.

Larry: Of course, in they're very successful, the companies will probably try to buy back the royalties without exercising any right of redemption, either directly by making us a bid, or by them making a tender offer to all of the royalty holders.

Barry: The owners get to keep all of their ownership, and retain the prerogatives that go with owning a privately owned company. They continue to operate as they wish, without the burden of the often unwanted advice and operational restrictions imposed by VC's or Angel investors. This freedom is what the company owners like the most, of course -- as well as keeping all of their equity.

Larry: So they get many operational advantages, a reasonable cost of capital, an ability to exit from the deal -- and they get to keep their company.

Barry: And it is far easier to make a reasonable projection of a future trend in revenues, than it is for investors or the company to have the ability to predict or achieve projected profit points. With royalties and the straightforward incentive of increasing revenues, everybody knows the ground they stand on, in a simple, clear way.

Larry: I am sure glad that we learned about the benefits of royalties to investors -- and we're not the greedy and therefore dumb investors that we once were.

Barry: Me too. We should be congratulated.

Arthur Lipper, Chairman
British Far East Holdings Ltd.

September 1, 2017