Managing a Portfolio of Royalties ©

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Professionals with the responsibility of managing the funds of others are currently reviewing the advantage to their clients of creating a royalties income fund (RIF).

There are a number of key considerations that govern the formation of a RIF; some of them are unique to the revenue royalties asset class.

First there has to be a decision made as to the nature of the fund. Should the RIF be leveraged to increase its yield? This is very tempting due to current interest rates and the structurally non-volatile and risk- reducing nature of royalties.

Should royalties be purchased from companies only in certain industries, including those which may be have social impact, or is portfolio diversification and therefore risk reduction a more appropriate objective?

What should be the level of investment concentration be, as a percentage of the planned RIF? Also, there should be an Internal Rate of Return (IRR) objective for the portfolio as a whole and individual portfolio holdings during the course of the royalty payment period?

Following are the investment decision areas which need to be focused upon by a manager of a RIF.

Amount to be invested in the purchase of an individual royalty - Sustainability is of primary importance and there should be a realistic belief the royalty issuing company will be in business for the royalty payment period. There also must be a belief the company, its products and management, have the potential to deliver a minimum compound annual growth rate (CAGR) of revenues sufficient to achieve the target IRR.

There is a correlation between the period of capital employment and level of return: Royalty Payment Period. The shorter the term of the royalty the higher must be the royalty rate percentage of revenue paid to the investor. We believe that 20 years is usually the most appropriate period, as then the level of royalty rate can be more reasonable for the company using the sale of a royalty as the basis for obtaining growth capital. We also believe that royalties should be redeemable on negotiated terms so the royalty issuing company can terminate the payment obligation for the payment of a known amount, including that paid in royalties. The terms and basis for redemption will be discussed later.

A set of calculators is available to the portfolio manager, to facilitate discussions and negotiations with royalty issuers. Some or all of these may be used in each case:

Using the www.REXRoyalties.com website calculator the parties can easily determine the royalty rates which must be paid from the projected revenues to result in the royalty payments necessary to achieve the investor's target IRR objective. Therefore, the achievement of the projected revenues is vital for the royalty and the portfolio manager must believe the projections to be realistic.

Using the www.REXScaledRoyalties.com website calculator the parties can negotiate royalty rate reductions if revenues during an agreed Selected Adjustment Period of years exceed those projected by an agreed percentage. Also, in the case of revenues not achieving projected levels by an agreed percentage, penalty royalty payments can be agreed upon.

The website calculator www.REXComparator.com allows a comparison or results between two royalties of different financial terms, using the same projected revenues.

The website calculator www.REXdebt-shareRoyalties.com is used when there is a loan of up to five years, at reasonable interest rates made to the royalty issuing company, with a long term royalty, at a modest royalty rate commencing on the repayment of the loan.

The www.REX-PV.com website calculator allows users to understand the level of payment necessary for buyers to pay the original investor so the target IRR is achieved, and the likely investment experience of the buyer based on the royalty issuer's projected revenues.

Compliance Assurance – As royalty payments, using our approach, are paid by the company's bank or a designated agent having a limited power of attorney on the company's bank account, immediately on receipt of the revenue, there is need for a mechanism to assure company compliance with the terms of the royalty.

Such assurance can take the form of a transfer of the ownership of the company's critical assets, without which the company cannot operate. The transfer can be to an agreed party who will grant the company the continuing exclusive, international, right to use the transferred assets, without cost, for so long as the company is paying it royalties as agreed. The assets are fully returned to the company on the completed compliance of the company. There can also be full or partial return of the assets at earlier stages in the contract, as negotiated by the parties.

There can also be third-party assurances of company compliance.

There are administrative details, which are necessary for the manager of a RIF to arrange. These administrative services can be internalized or outsourced.

That is all there is to it. The portfolio manager has to identify companies seeking financing which will be able to achieve increased revenues with additional funding. Then, using the indicated website calculators, the negotiation process and determination of fairness can easily by achieved.

Royalties are the better way of both financing of and investing in private companies.

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