The Profitability of Responsibly Managing a Royalty Income Fund for Investors ©

Arthur Lipper

The investment management of other people's money has usually been a great fee-generating business. Frequently investment managers have been able to consistently produce net investment performance results that are superior to that what investors could achieve for themselves.

As royalties sold to investors by companies seeking to grow revenues without equity dilution can be structured to produce a superior risk-related return, it is logical that investors would be attracted to invest in a royalty income fund to benefit from portfolio diversification.

In the creation of a royalty income fund a number of decisions have to be made. The decisions are:

> Form and structure of the fund, with investor tax and liquidity consideration being critical
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> Services to be performed internally by the fund or by its management entity or contractually outsourced include:
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> > Investment management - both selection and structuring,
> > Balance and diversification of the fund's holdings,
> > Minimum and maximum size of any one holding,
> > Registrar and Transfer Agency functions,
> > Royalty collection and royalty distribution,
> > Investee information collection and distribution, and
> > Contractual compliance arrangements.

The requirements for investment management will reflect the investment policies of the fund as to characteristics of royalty issuers, industrial and geographic areas of focus preference and exclusion, and target investment rate of return.

The investment manager can be an individual or a committee and it can also be a company. Depending on the method of funding used to create the capital to be invested in royalties, there may be marketing needs or regulation as to the experience of the investment manager.

The necessary expense required to manage a royalty income fund will be dependent on the decisions made regarding the functions to be performed internally as opposed to through outsourcing.

As there are additional costs required for each investment opportunity researched, the size of assets under management and diversification policy of the fund will influence the need for personnel. There will also be a necessity for the fund to have continuing contact with investee royalty issuing companies.

It should also be noted that in the case of royalties there are two distinct decisions to be made. The first is the determination that the prospects for continuing revenue growth and company sustainability are positive and that therefore a participation in the revenue growth is desired. This decision will require both credit and securities analysis experience. The second area requiring, at least initially, a different decision-making process in the structuring and negotiation of the royalty. In part, the structuring will reflect the policy of the fund and the target returns desired. However, all deals are different and there is no "one-size fits all" format which is workable in all situations. Deal structuring options of royalty financing include, but are not limited to, the amount and duration of royalties to be paid, the potential combination of debt, with interest rate and term, the right of the company to redeem or terminate a royalty and the conditions under which redemption may take place.

The annual expense of managing a royalty income fund is likely to be in excess of 2% of the assets under management, with some of the expense paid by the fund investors and issuers. Of course, the smaller the fund the relatively higher will be the cost of management. I advise that to perform as a fiduciary and provide the investor with the risk-reducing benefits of portfolio diversification, $50.0 million is the smallest target amount of assets to be under management.

The fee for managing a pool of capital of $50.0 million which I believe to be fair and reasonable, is a fixed annual fee, paid quarterly, of 2% of the assets under management. In addition, a performance fee of 20% of the royalty distribution in excess of an agreed hurdle rate is also fair and reasonable. Therefore, were the hurdle rate to be 8% or $4.0 million in the case of a $50.0 million fund, the performance fee would be $700,000 were the annual distribution to be 15% or $3.5 million, before fees, over the hurdle rate. This would be mostly profit, as the $1.0 million received in fixed fee would be mostly used for expenses. Clearly, the potential profit in managing a larger fund(s) would increase disproportionately.

Arthur Lipper, Chairman
British Far East Holdings Ltd.

April 27, 2016