Business Owners Using Royalties Should Seek More Funding Than Believed Required - But From Where? ©

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The norm with entrepreneurs and many business owners selling equity to raise capital is to try to seek the smallest feasible amount so as to limit their equity dilution. This is unfortunate, as it should be understood that most new projects cost more and take longer than anticipated.

The usual result is the need to seek additional financing prior to the originally projected results being achieved. This frequently desperation-financing effort is likely to be on highly dilutive and on terms otherwise unattractive to the business owner, regarding cost and control of the business.

Of course, the greatest advantage of using royalties to finance a business is that they are non-equity dilutive and confer neither an ownership interest nor a vote. The cost of the royalty to the business is the agreed percentage of revenues, paid for an agreed period to the royalty investors. Royalty payments will adversely impact profit margins until the company has had time to utilize the funds in either an acquisition, technological development or increasing the staff and marketing effort, so there should be careful attention to gross profit margins, to ensure that the company's ability to pay its bills its no impaired by the required royalty payments.

On the assumption that we agree there could be a greater need of capital than originally believed, the question is where might it come from? Possibilities include selling more equity, more debt or a combination of the two and an additional royalty.

My thought is the original royalty investor has a clear interest in the sustainability of the royalty issuing company and is therefore a possible provider. Also, there is an ever-present reality that investment returns are calculated on the amount of capital employed to achieve the desired return and therefore there is an interest in the quickest possible return of provided capital.

So if the royalty was sold for 50% +/- more than the company's anticipated need to achieve cash flow breakeven or a revenue measured level, the overage could be banked, even at the current very low interest rates.

Alternatively, the company could make royalty payments after an agreed period discretionarily, or required in excess of the contractually agreed revenue percentage. The royalty rate could be adjusted on a capital-employed formula basis with the effect of the royalty investor offering an incentive to the royalty issuing company to return the amount paid for the royalty more quickly.

For an issuer of a longer term royalty the savings in royalty payment rate could be significant, while still producing excellent levels of income and a less risky initial investment.

It is also theoretically possible for another royalty investor to be interested in acquiring the overage royalty for a lower fee than the original royalty investor, as there could be less risk due to the prior utilization of the original amount.

All royalty negotiations are different and the flexibility of the non-equity dilutive approach is on of the distinct advantages. An experienced investment banker can guide the parties to a fair and mutually advantageous transaction.

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