Royalties Are Not Dividends
and
Dividends Are Not Royalties©

Arthur Lipper

Although companies pay both royalties and dividends to investors, the two are conceptually, legally and technically different and reflect a polar distinction.

Companies are formed and managed to earn profit for the company and therefore the owners of the company. The greater the sustained profitability of the company, the greater its value.

Traditionally, especially in manufacturing, mining and railroad companies -- the majority of companies traded on public exchanges prior to the advent of service and technology companies -- there was an expectation that roughly 40% of after-tax earnings would be paid to shareholders in the form of dividends. The balance of the company's profit would be used to develop and expand the company.

For U.S. companies and shareholders, dividends were doubly taxed, first through corporate income taxes on the profit of the company and second on the income of shareholders, reflecting their receipt of the dividends. Recently, some companies have found using excess or borrowed funds in share repurchase programs a better way of increasing the value of share ownership.

Today, a great many profitable companies do not pay dividends at all; for example, Apple and Microsoft, two of the largest companies in the S&P, only recently declared their first dividends, and Warren Buffett refuses to pay any dividend at all on Berkshire-Hathaway. These companies find that they benefit shareholders more if they largely channel their profits back into organic growth of their business, or to strategic acquisitions.

As dividends are paid from declared profits there is stress between the interest of the managers of a company wishing to have the maximum amount to use in the building of the company and the owners of the company wishing to have for their own use some of the company's profit.

It is the Board of Directors, elected by the shareholders, that determines the amount and timing of dividends.

On the other hand, revenue royalties, as issued by a company in exchange for capital from an investor, are a company's contractual obligation to pay to royalty owners an agreed percentage of the company's defined revenues for an agreed period of time. Royalty payments are tax deductible for the royalty issuer, and incur no tax liability to the investor until their original principal is recouped.

It is just that simple -- the payment of the agreed percentage of revenues, for the agreed amount of capital, has nothing to do with the profitability of the company. Neither the Board nor shareholders has any decision over whether to pay the committed royalty, when or how much. Owners of the royalty have no ownership interest in the company and therefore are neither benefited nor penalized by changes in the valuation of the company.

The current value of a royalty is determined by the present value of the future cashflow from the royalty -- the remaining period of payment entitlement based upon projected revenues. Investors will make their own determination as to the appropriate discount to apply to the revenues projected by the royalty issuer.

We have developed and made available website calculators which assist both investors and business owners in understanding the impact of projected revenues. The websites, which are specifically useful in valuation determination, are REXRoyalties.com and REX-PV.Com.

We believe royalties are the better way of investing in privately owned companies because of their simplicity and predictability. There is no need for the royalty investor to be concerned with the complexity or motivation in the determination of a privately owned company's profit, declared or otherwise, and therefore no concern about whether a dividend is paid. The royalty investor just needs to be comfortable with the mechanics of knowing, collecting and distributing the agreed percentage of the revenues of the royalty issuer.

In the U.S. patented approach we recommend, the agreed royalty percentage payment is deducted and transmitted from the royalty issuer's bank account immediately, at the time revenue is received. This could be daily depending on the type of business issuing the royalty. The royalty payment is then collected and distributed to the royalty owner quarterly.

Royalty payments are ordinary income -- the same as dividends -- after the cost is recaptured.

We recommend royalty-issuing companies provide investors with an annual audit of revenues, and possibly a full audit.

In the patented approach, we recommend a process for assuring the royalty issuing company's contractual compliance through the transfer or assignment of critical assets, without which the company would not be able to operate should royalty payments not be made in a full and timely manner.

Royalties are the better way of investing in privately owned companies.

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