Should a Royalty Investor Use Leverage To Increase the Return? ©

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To answer the question as to the degree of leverage the royalty investor should use, one has to know the characteristics of royalties purchased and the number of royalties in a portfolio.

If the royalties purchased are issued by established, profitable and revenue-increasing companies then a relatively high degree of leverage may be justified, drpending on the investor's overall objectives and risk tolerance. Note the use of the word "companies", as the aggressive investor needs portfolio diversification to minimize the possible significance of default by a single issuer.

If the investor is only purchasing a royalty from a single company then a credit analysis similar to that of a lender should be undertaken. This would be especially important were the issuer an early stage company.

However, the requirements for analyzing royalties used by companies that already have revenues are very different from those of a term lender, as the royalty investor receives the benefit of reducing the principal risk, with periodic increasing royalty payments.

If the royalty, based on the royalty issuer's projected revenues, is structured to return the capital used in buying the royalty in 60 months, the risk to the royalty holder is reduced to zero during the 60 months. The greater the portfolio diversification of the investor, the less likely there will be an overall loss.

Indeed, British Far East Holdings Ltd., the U.S. patent owner of the approach developed for the use of royalties, which I chair, would be pleased to provide Royalty Payment Assurance to investors holding a diversified portfolio of royalties. Investors that have the comfort of being assured against capital loss should be willing to accept a lower royalty rate and ultimate Internal Rate of Return (IRR).

Therefore, a royalty structured on a cash investment basis to achieve a minimum 15% IRR would be significanrly enhanced especially in the current interest rate environment, if only modest leverage were used.

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