Structuring the Financing of a New Business©

Arthur Lipper

Entrepreneurs have a problem in deciding if they are better off doing a royalty-based deal or a traditional equity-related deal.

Their question is simply, "What if we are really going to be as successful as we are telling investors?"

If the projected results are achieved in the future, the value of the ownership interests being offered at that time will be far greater than the value at which they are being offered today. Yet today's equity investor discounts the company's profit projections, and negotiates based on a valuation model that gives them maximum upside if the business turns out well -- and takes ownership of the maximum amount of equity possible today.

If projections are realized, this will result in a natural regret on the part of the owner of the business, whose ownership has been diluted and who now owns less than 100% of the equity. It is not unusual for those conceiving and creating successful businesses to end up with a much smaller percentage of ownership in the company than anticipated, by the time multiple rounds of equity investors have each negotiated their share, and all preferences, ratchets and options for each round have been exercised.

Of course, with the surrender of ownership there is also the acceptance of investor "advice" and possibly collective control of the business by the minority shareholders. Investors buy only with a view to selling in the future, and the interests of investors and founding entrepreneurs, while agreeable today, will not necessarily always remain similar.

Paying too much for capital is a fear of all business owners -- offset by the fear of not getting the capital at all. Investors control the dialog, because they have the financial resources to do so. All of these limitations are accepted, grudgingly, by the business owner as the "cost of doing business."

Recognizing the foregoing, both business owners and investors should be aware of a logical and attractive alternative approach -- our patent pending REXdebt-shareRoyalties.com.

This approach begins with a term loan, at a fair below-market interest rate, with a modest royalty commencing on the repayment of the loan and continuing for an agreed number of years.

The loan is prepayable without penalty, and the royalty can be redeemable and thus may be terminated on terms agreed in advance.

Therefore, the business owner can know today the possible maximum cost of the capital he receives. He does not have to fear being too successful, and the regret that he sold too much equity, too soon. The entrepreneur retains ownership and control of the business -- no equity is transferred.

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

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