Terms Successful Business Owners Want in a Royalty ©

Arthur Lipper

Most owners of businesses like the idea of being able to get additional capital without having to sell stock in their companies.

The reality of business, especially in these times of banks being able to get virtually interest free deposits, is that commercial banks have little incentive to make term loans to privately owned companies. This is true even for those companies, which have an excellent credit record. This is even more the case in China where there are vast numbers of profitable privately owned companies which are forced to pay interest rates to the shadow banking community of up to 40% annually.

The first question asked by the business owner is "What will it cost me, using the sale of a royalty, to get the money"? The answer is dependent on the profile of the company and the realistic prospect of there being significant future revenue increases, based on the availability of the capital. In other words how much better will the company be able to do if it had more money?

The next question the business owner will want to know is "How do I terminate the royalty payment obligation if and when I want to?" The answer to that question is though exercising a redemption right provided in the royalty agreement.

Let's assume that it is understood the REX procedure of royalty collection occurring whenever revenues are received by the company and that critical assets of the company have been used to assure contractual compliance by the royalty issuing company. Also, it should be understood that investors in royalties issued by established companies are going to require an Internal Rate of Return (IRR) of more than 15% over the course of the royalty payment period. Therefore, the investor is going to be focused on the revenue projections made by the prospective royalty issuer as it is increasing revenues, which will allow royalty payments to be attractive to the investor.

The website calculators REXRoyalties.com, REX-RiAR.com and REXdebt-shareRoyalties.com have been created to facilitate royalty

negotiations and understanding the impact on royalties of the projected revenues being achieved.

As will be seen in using the calculators the longer the term of the royalties the lower can be the royalty rate for the investor to achieve a target IRR, if the revenues are increasing. Investors should know and be willing to discuss their target IRR objectives. This allows royalties to be structured so the target rate can be a minimum.

Royalties are or should be negotiable contracts and the royalty issuing company or any other interested party can attempt to acquire a royalty from the original investor at any time and on any terms. Therefore, the royalty issuing company can make contact with any royalty owner and propose whatever bid they wish. The royalty issuing company may also make a tender offer to all of the royalty holders on the same terms. Alternatively, the tender can be on a Dutch-auction basis where the company establishes the amount of money available to buy the amount of royalties wanted, with the purchases to be of the lowest cost royalties, until the amount of available funds is exhausted.

Assuming that a redemption clause has been negotiated as a part of the royalty agreement then the terms of the redemption are established and can include some of the following terms. Redemptions can be only triggered after an agreed cumulative amount of royalty payments have been made. If the sale of securities is contemplated by the royalty issuing company then the redemption can be for cash and/or an exchange for the securities to be offered to others, but on preferred terms to the royalty owner. Redemptions can be restricted to within maximum periods of time.

Also and most importantly, the redemption price can be inclusive of the royalty payments made previously to the same royalty owner. Therefore, a redemption right providing that at anytime within 10 years of issuance the royalty can be redeemed for 10 times its cost providing, if at the end of the 10th year, a 25.9% IRR, would only require the royalty issuer redeeming the royalty to pay the difference between the royalty payments made and the 10X agreed result.

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

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