The Natural Enemies of Royalty Financing ©

Arthur Lipper

An imagined dialogue between a professional private company "Shark" investor in an off-the-record discussion with a curious "Journalist."

Shark: I sure hope this royalty-financing thing doesn't catch on, because we have had it so easy up to now.

Journalist: What do you mean?

Shark: Well, most private company owners are not able to borrow from banks at commercial rates without providing a collateralized personal guarantee, which many cannot do -- and none want to do.

Journalists: What else?

Shark: The banks want the borrower to prove how profitable they really are and why they really do not need the money. To do so they will frequently have to show the bank why their company's income tax filing declares lower profits than they could have shown, if their accounting had been done differently.

Journalist: So how do you, as a professional private investor, profit from the problems the business owner has in getting capital on commercial bank terms?

Shark: Well, first of all -- our loan rates are much higher than the bank's and we require much tighter controls on how the company operates than do the banks. Also, we might be able to take a percentage of revenues off the top and/or options to buy shares of the company as sweeteners to the loan. When the banks won't make a commercial loan to a privately owned company, we are set up to profit -- at a much greater cost to the company.

Journalist: What else can you do?

Shark: We can provide less money than we know the company will need, forcing them to come back to us for additional credit. These follow-on rounds of financing are the most profitable for us, because the companiy has limited alternatives at that point. Their need for more capital could put them in default of some of their original loan covenants.

Journalist: Then what can happen?

Shark: We then can dictate the terms of the needed financing, frequently gaining control of the company. In some cases, that may have been our original, unstated objective.

Journalist: What sort of deals other than loans can you do?

Shark: We can buy convertible preferred stock in the company, which has liquidation preference (requiring payment of a multiple of our cost before any other investor gets anything in the event of a liquidation). The preferred can also be granted voting rights based on the shares under the unexercised option and we can require the ability to appoint a sufficient number of members of the Board of Directors to assure the company cannot do anything with which we disagree. In many cases, we acquire negative control of the company as soon as they accept our money.

Journalist: What more can you do?

Shark: Well, equity deals are similar in some ways to lending -- companies tend to ask for considerably less money than they will ultimately need because they want to avoid excessive dilution, and in subsequent rounds of financing, when we control the terms of the deal, we make our greatest gains by enhancing our equity position in the company.

Journalists: Is there more than you can do?

Shark: Yes, we can require that outside consultants be retained by the company, some of which can be friends of ours. We can effectively control executive compensation, and hiring and firing of executives. Once we invest, it is really our company if we choose to make it so.

Journalist: So why are you so opposed to royalty-based financing?

Shark: Because they are too beneficial for the business owner and we are no longer the only alternative. Also, because the royalty holder does not vote or have any control over the management of the company. Many royalties are written so they can be redeemed on agreed terms, There are no negative covenants and control of the company does not change. Royalties are just too damned fair to the business owner, and they can produce superior returns for investors too -- with less risk if the company's revenue projections are achieved.

Journalist: You mean that with royalties, business owners preserve their most precious asset -- their equity -- and still get the capital they need, in many cases in a single round calculated to get them to significant profitability so they can spend their time building their business instead of constantly raising money. Also, royalty investors get paid whenever the company receives revenues and they do not have to wait until some future date for an exit event, like an acquisition or IPO.

Shark: These are just a few of the ways that royalties are better for both investors and for companies – and they will certainly make my job harder and less profitable when they become widely understood and used.

Journalist: Thank you. Sure seems so.

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