The Royalty Forum ©

Investors Financing Businesses With Royalties

What's Right and What's Wrong
What's Fair and What's Unfair

Issues and Disagreements:

Why royalties are better for investors?

Advocate: Royalties are better for investors as they provide a return on capital as soon as the company has revenues, thereby reducing the risk. Royalty owners are not concerned with the declared profitability of the company as they only own the agreed percentage of revenues, which they hope will increase dramatically.

> **Skeptic: If the company doesn't generate any revenues then the royalty holder has no way of recovering any part of the investment. There is no assurance that revenues will be generated and buying stock in the company could be better as then there would be some ownership of the assets, as they might have a value even without there being revenues.**

Why business owners should use royalties?

Advocate: Business owners using royalties to finance their businesses retain full ownership and are not under investor pressure to declare ever-increasing quarterly profits so the investors can sell the stock they hold at higher prices than they paid for the stock. It is easier to raise the money through the sale of a royalty, as there is less risk to the investor.

Skeptic: The agreed royalty "comes off the top" line of revenue and is never a part of the company's cash flow. The royalty is due even when the company is operating at a loss. Royalty holders are only interested in the growth of revenues, not profits. The greater the revenues the more money the royalty investors receive.

How much information about the operations of a royalty issuer should be made available to the royalty owner?

Advocate: The more the royalty investor knows about the company issuing the royalty the better will be the position of the royalty investor to help the company. The amount and timing of information will be both determined by the terms of the Private Placement Memo and the issuer's attorney reflecting security-offering requirements.

Skeptic: As the royalty holder is not an owner of the business, why should confidential business disclosures be made to royalty holders? How do we know the royalty investor getting our information won't make it available to others? If the royalty investor is only interested in revenues why give more information than about revenues?

Is it possible for a royalty issuing company to subsequently offer securities or do other financings?

Advocate: If the royalty issuer uses the funds received for the sale of a royalty effectively, then the company will be better positioned in terms of likely valuation for a subsequent financing. Royalties can be made redeemable so they can be terminated at a known maximum cost including the royalties, which have been paid. The terms of a royalty can also be modified subject to the closing of a future financing.

Skeptic: Those considering investment in companies having outstanding royalties will recognize that a portion of revenues is deducted upon receipt and is not available to the company. They will also recognize the burden of royalty payments will continue until the maturity or redemption of the royalty.

What kind of companies should use royalties?

Advocate: Only those companies having a substantial margin of profit should consider the sale of royalties as royalties are deducted from revenues upon receipt. The advantage to the owner of a business of a royalty is that a financing providing growth capital can be accomplished without reducing the owner's interest in the company.

Skeptic: The existence of a royalty can limit the company's attraction to an acquirer or to an underwriter considering a public equity offering unless the royalty can be redeemed.

What are realistic target goals for investors buying royalties?

Advocate: It all depends on the balance in the investor's mind between risk of capital versus the reward of significantly increased revenues from which the royalty owner benefits. Most investors in early stage companies need to see at least a 20% Internal Rate of Return over the course of the royalty payment period.

Skeptic: In normal private company equity investments there is a direct correlation between the level of return and capital risk. However, in royalties paid at the time of revenue receipt there is an effective risk reduction with each royalty payment and so the risk is more predictable and is limited to revenue growth.

Are there minimum characteristics for royalty issuing companies as to projected profit margins and revenue growth projections?

Advocate: For an investor to find the potential of a royalty investment appealing, the royalty issuing company should have a pre-tax profit margin of in excess of 20% and realistic reasons to project annual revenue growth at more than 10% during the royalty payment period.

> **Skeptic: The privately owned companies, which can predict pre-tax profits of more than 20% and a 10% annual growth of revenues for a long period, are rare and hard to find.**

What kind of investors should own royalties?

Advocate: The ideal investor in a royalty fund is a non-taxable trust, foundation or institution, which requires growing royalty payments and limited capital risk. This is because royalty payments are considered a return of capital until the investment is recaptured and thereafter are ordinary income to the recipient.

> **Skeptic: The really big investment returns have traditionally been made in equities, commodity futures and options when the selection of specific investment has been accurate. Investors may be well rewarded by investing in royalties but are not likely to make quantum returns in shorter periods.**

How easy is it to sell a royalty?

Advocate: Royalties are like any other contractual asset producing projectable periodic revenue. The valuation is based upon a discounted present value and is calculated at the website REX-PV.com. Royalties are easier to sell after a period of revenue growth and regularly scheduled royalty payments.

Skeptic: Royalties will have to be sold by the original investors to accredited investors should they wish the liquidity. Projecting revenues and associated royalties will be necessary to develop a present value for the royalty and even with a record of several years that may not be easy.

How should the royalty be structured?

Advocate: One of the greatest advantages of royalties is their inherent flexibility. Royalties can be structured to meet the sometimes-unique needs of either or both investors and issuers. Royalties can include minimum payments, capped returns, issuer assured results, accruals of due payments and debt as an element of a royalty structure. The best result for many early stage companies is a combination of debt and a royalty.

Skeptic: The problem with royalties is they are an obligation of the company and assets of the company frequently secure that obligation. Therefore, the company has less flexibility in addressing problems in difficult times.

Should the royalty issuing company have a right of redemption?

Advocate: Many business owners feel a need to have the ability to terminate the royalty payment obligation in order to implement either a sale of the entire company or a public offering. If the redemption right is based on a fair return to investors, including royalties already paid to the investors the investors will accept the feature of the royalty offering. As a guide investors will reasonably require a result, which is more than a 20% internal rate of return for the period the royalty, was held.

Skeptic: The idea of the royalty issuing company having the right to terminate a royalty doesn't seem fair, even if the result is the payment of a reasonable return to the investor.

Is there an advantage to the business owner to offer guarantees?

Advocate: If a business owner feels confident in the issuance of a guarantee of some minimum result for the investor in return for a lower royalty rate it seems a reasonable deal. It has to be noted that a guarantee of a minimum result includes that paid in the normal course of events. Therefore, it is only an incremental payment, which is being guaranteed in order to get a better original deal.

> **Skeptic: The problem is that when a business owner's guarantee has to be honored it comes when things have not gone as well as had been expected.**

How to give the business owner an incentive to be conservative in making revenue projections?

Advocate: in the website calculator REXScaledRoyalties.com there is a facilitation of an approach where if the projected revenues are exceeded, during an agreed period, by an agreed percentage there will be an agreed reduction in future royalties. The website also calculates the amount of royalties which were to have been paid in the period based on the original projected of revenues. The website does not suggest a penalty for missing by an agreed percentage the revenue projections.

> **Skeptic: It is too easy for a business owner to project revenues, which he is sure of exceeding by the necessary amount to get a better overall deal. Yes, if the projections are too low investors will not be attracted to the opportunity.**

Why might a business owner agree to provide a minimum royalty payment result?

Advocate: The reason to make a royalty more attractive to an investor is to get the investors to accept more favorable terms.

Skeptic: How good is the business owner's guarantee?

How can the terms of a royalty be enforced?

Advocate: As a part of the royalty agreement, critical assets of the royalty issuer are assigned or transferred to a trustee-like agent of the investor who grants the royalty issuer an exclusive international right to use those assets without cost for so long as the issuer is in contractual compliance with the investor. The assets are transferred back to the issue upon completion of an agreed level of royalty payment.

Skeptic: What happens if the royalty issuer goes bankrupt? Won't other creditors also want the same assets? What happens if the assets are not in the U.S.?

Are royalties more or less risky for investors?

Advocate: Risk is measured by and relative to reward. In many cases it is far less risky to own a percentage of a company's revenues than a minority equity position or even traditional debt.

Skeptic: There are risks of the company not being able to generate any revenues or less revenue than projected. Sure, it is better to have an interest in revenues than ownership when a company get into trouble, but isn't there still some risk?

What can go wrong for investors in royalties?

Advocate: Companies can fail. Business owners can do bad things. Companies can make bad judgments. Lots of things can go wrong but the terms negotiated for royalty investors should be sufficient to provide some protection of capital. Also, it must be remembered that with every quarterly royalty payment the level of capital risk is reduced.

> **Skeptic: Yes, but is it possible for an investor in a royalty to lose money?**

Why should business owners be careful in negotiating the terms of a royalty?

Advocate: Business owners should be represented in a royalty negotiation by experienced counsel. The essence of any negotiation is the shifting of risk away and of reward to the negotiating parties. Although it is generally thought to be easier for a business to project revenues than per share profits the terms of a royalty should be fair to both the investor and the issuer. Royalties are not perfect, but they are a lot better for all concerned.

> **Skeptic: If the royalty owner gets paid every time there is revenue and the company never has control over those funds, doesn't the royalty investor always come out better in the case of problems than owners of the business?**

Should royalty payments be due if a royalty Issuing company is operating at a loss?

Advocate: The profitability or lack thereof is not the concern of the royalty investor. Does the electricity company or landlord expect to be paid regardless of profitability? The royalty investor provided the company issuing the royalty with capital

in the purchase of the royalty. The royalty investor wants the company issuing the royalty to succeed and enjoy increasing revenues. However, the royalty investor has no ability to influence the management of the company and nor does the royally investor benefit from increased earnings or valuations of the company.

> **Skeptic: Is it fair for royalty investors to receive royalty payments when those payments add to the loss of the company? Is it possible the contractually required royalty payments be accrued or modified?**

[When should royalty payments be made?]

Advocate: Using the U.S. patented approach we recommend, the royalties are collected simultaneously with the receipt of revenues by the royalty issuing company. The royalties are distributed quarterly to the royalty investors.

> **Skeptic: What happens if the company changes its mind and does not pay upon the receipt of revenue so that it has more cash flow?**

[What has to happen if a royalty owner wants to sell the royalty owned?]

Advocate: For an original investor of a royalty who wants to sell their royalty they have to find a qualified buyer. This can be done by the investor or by an agent of the investor acting as a broker. The website calculator REX-PV.com provides a useful facilitation for both secondary royalty investors and the original investors.

> **Skeptic: Even though royalties may be a great investment and produce high levels of income there still is not a developed secondary market for royalties.**

[Does the royalty owner have any rights to advise the company issuing the royalty or to attend any meetings of the company?]()

Advocate: A royalty owner has no vote and no ability to influence the management of the company issuing the royalty.

> **Skeptic: It is easy to say that royalty owners have no ability to influence successful companies but if a company is in trouble and needs to negotiate royalty changes with investors the investors have lots of ability to influence management.**

[Who represents the royalty owner once the purchase is made?]()

Advocate: Royalty investors will, for the most part, be members or shareholders in a royalty income fund and it is the responsibility of the fund managers to represent the interests of the investors. Those who independently purchase a royalty from a privately owned company will have to arrange for the services offered by fund managers re monitoring the performance of the royalty issuer and enforcing the agreed terms of the royalty agreement. I would not recommend that individual investors attempt to negotiate royalty agreements with companies as it is too complex a task and if done amateurishly too likely to end in disappointment.

> **Skeptic: It is clear that someone must represent the interests of investors versus the interests of the owners of royalty issuing companies.**

[Who negotiates the terms of the royalty for the investors with the business owner?]()

Advocate: the can be a lead investor or an investment banker who has the primary responsibility for negotiating terms of a royalty agreement with the owner of a privately owned company.

Skeptic: Being sure the company issuing the royalty does what it has agreed to do is a job for a professional and should not be undertaken by inexperienced individuals.

How can the royalty owner be sure the business is being conducted as promised?

Advocate: There must be an annual audit of the royalty issuing company's revenues and possibly a full audit. There has to be an agreement with one or two banks acceptable to both the investor and the company into which the controlling shareholders of the company personally attest that all revenues are deposited in these banks. Then there must be a "lockbox" agreement with either the bank or an independent party empowered to deduct immediately on deposit the agreed royalty percentage of each and every revenue deposit re transfer to the account of the investor.

Skeptic: Being sure that agreements are honored is a both a matter of mechanically setting up a procedure and monitoring it on a continuing basis. This is not a job for someone who is without experience.

What sort of annual returns should a royalty purchaser expect over the course of the royalty payment period?

Advocate: The level of return is a function of the level of risk assumed in any investment. A professional fund manager should be able over the course of the royalty payment periods to generate something more than a 15% Internal Rate of Return from a portfolio in which there was a high level of diversification.

Skeptic: The level of return for royalties is likely to be slower growing during periods of economic hardship as the

revenues of the royalty issuing companies will likely be less than were projected.

What can a business owner do if the business is much better than anticipated and the royalty payments are far larger than expected?

Advocate: The redemption right feature of royalties will allow the royalty issuers to pay the owners of royalties an agreed premium to be allowed to redeem and therefore terminate a royalty. The royalty issuing company can also tender for all or a portion of the outstanding royalties. As most of the royalties will have a 20-year term we expect that the more successful companies will pay premiums to terminate the royalties prior to maturity.

Skeptic: If a royalty issuing company is so successful that it will pay the agreed premium to terminate the royalty and the return is what was greed that's great. However, what about the companies which fail to reach their projected levels of revenue and therefore royalty payment?

How does the royalty owner know the company is depositing all revenues in the approved banks?

Advocate: We recommend that in negotiating a royalty agreement with the owners of a privately owned company that each of the controlling owners personally attest that all deposits have been made as agreed. We also recommend there to be an independent audit of at least the revenues of the royalty issuer and that the amounts deposited and paid in royalties was appropriate.

Skeptic: One of the problems is being sure the company issuing the royalty does not set up other companies and accounts to avoid paying the agreed royalties. This is a problem, especially when dealing in developing countries.

[Will the presence of a royalty impede a company from going public or being acquired?]

Advocate: The valuation of a company with a significant royalty payment obligation will be impacted and it is likely the redemption right will be used or another means found to terminate the royalty.

Skeptic: The possible acquisition or public offering is an elegant problem for a royalty owner.

[What happens to the royalty payment obligation if the royalty issuing company is acquired?]

Advocate: Companies with royalty payment obligations are acquired all the time. Most oil and gas companies pay royalties, as do most publishers and entertainment companies. The acquirer simple continues to make the required royalty payments.

Skeptic: Again, an elegant problem to contemplate.

[Can the terms of a royalty agreement be modified, changed or even terminated?]

Advocate: A royalty, as is the case with any contract, can be changed, modified or terminated as the parties to the agreement agree. There will usually be an agreement with the investor group regarding the percentage of approvals necessary and what arrangements are made with those not approving the changes.

Skeptic: It is important the interests of investors are protected and professionally advised in the event agreements are to be changed.

What are the tax consequences of royalties for either investors or royalty issuers?

Advocate: For investors royalty payments received are a return of capital until the amount invested in the royalty are received back in royalty payments. Thereafter, for most investors, the payments are ordinary income. For royalty issuers there is not an all-inclusive answer and business owners and managers of companies selling royalties are advised to seek the advice of their attorneys and accountants.

> **Skeptic: There are different tax consequences for investors in different jurisdictions and circumstance.**

Summary: It is my wish to increase and improve the understanding of how using royalties is truly a better path for both investors and business owners considering investing in and financing private and early stage companies. This booklet is intended to be a primer. The following free website calculators and the Writings section of PacificRoyalties.com are for a more serious and detailed study of the approach.

www.REXRoyalties.com
www.REXComparator.com,
www.REXdebt-shareRoyalties.com
www.REXScaledRoyalties.com
www.REX-PV.com
www.REX-RIAR.com

I am available for consulting and possibly other assistance and can be reached using Chairman@REXRoyalties.com.

Thank you.

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