What Can Go Wrong for a Royalty Issuer? ©

Arthur Lipper

Assuming that a business owner finds attractive the prospect of receiving growth capital in exchange for a percentage of future revenues, allowing the owner to retain his full equity position, what can go wrong?

There are three things which can go wrong.

The first problem is the profit margin of the company declines to a level where the agreed royalty coming off the top makes the royalty payment untenable. Of course, this would also be the case with rent and salaries. Only companies having a healthy profit margin should consider selling royalties, and investors should analyze the likely profitability of the royalty issuer.

All contractual obligations can be changed with the approval of the parties to the contract and it is not in the royalty holder's best interest for the issuer to fail. Therefore, relief in the form of a delay in making royalty payments is possible for an incentive as are other modifications of the contract.

The second thing which can go wrong from the perspective of the royalty issuer is the business has grown faster and become even more profitable than was the case when the royalty terms were negotiated and established.

Whether or not a redemption right had been negotiated as a part of the royalty agreement, the company or its owner can always seek to purchase from the investors their royalties. The purchase negotiation can be directly between the parties or can be in either a tender to all royalty owners of a Dutch auction -- in which the purchaser sets the amount of cash or some other consideration available to purchase X number of royalty units. The result would be a competition between the royalty owners in the form of the price or terms, which were acceptable. The buyer would be required to purchase the royalties offered on the most attractive terms.

Were there to be a redemption right the issuer could simply redeem royalties on the basis of the terms agree initially which would include the royalty payments already made to the royalty owners. Therefore, if the redemption terms were 10 times the original cost of the royalty if activated within ten years the issuer would have to pay the difference between the amount paid in royalties and 10 times the amount received for the royalty. The Internal Rate of Return for 10 times in 10 years is 25.9%, a pretty good investor result.

The third reason for an issuer to want to terminate a royalty is the opportunity for the company to be acquired on terms considered favorable, or to make a securities offering. In such a case the issuer could exercise their redemption right or offer to exchange the royalty for a portion of the expected receipt of acquirer's shares or whatever was received from the acquirer. The investor could also have negotiated a clause in the royalty agreement requiring the issuer to offer the royalty owners an agreed share of that received in an acquisition.

Also, in the case of a public offering on agreed minimum terms, the royalty owners could have a right to accept equity or some other security at some relationship to that being offered to the public offering price, in exchange for their royalty.

So there it is, the three things which can create a desire on the part of the royalty issuer to terminate the royalty: shrinking profits, being acquired, or making a public offering. Two of the three things are elegant problems for the investor, and the distress of the issuer can be restructured to the investor's advantage as the investor has the leverage of the contract and whatever critical assets of the issuer held to assure contractual compliance.

Royalties are the better way of both investing in and financing of privately owned companies. The investor is well protected and compensated while the business owner continues to have the full benefit of control and ownership of his business.

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April 27, 2016