Will Venture Capital Firms Ever Embrace Royalties ©

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An associate has suggested to me that if the venture capital (VC) firms understood the benefits of royalties they would use them in their investee companies.

VC firms are usually limited partnerships having an 8 to 15 year life. The General Partners (GP) usually charges their Limited Partners (LP) a significant management fee, frequently 2% of assets plus 20% of profits. Sometimes there is a hurdle rate or minimum level of profits to be achieved before there is a sharing between the GP and LP's.

The form of VC investment is typically a Convertible Preferred stock, which votes as if converted into equity and has a liquidation preference, assuring that its holders will receive a multiple of their investment on the sale or liquidation of the company.

The VC's have a sweet deal. They own a substantial part of the company, on highly preferential terms versus the equity holders, and frequently require board of director representation.

The VC's believe they have the experience and contacts, which will be of benefit to the company and to themselves as regarding the company in which they invested.

In most cases, the VC's buy into a company in the expectation of being able to arrange a sale of the company or "liquidity event", through which they expect to profit. Therefore, their focus is on being able to sell their shares sooner rather than later and for substantially more than they paid for the stock.

As an important owner of the company the VC's wish to be involved in corporate decisions and can become the blocking, if not controlling, members of the Board.

Royalty investors are very different as to expectations and general approach. Royalty investors do not want to sell their positions in a successful company as the percentage of revenues being paid to the royalty holders increases as the revenues of the company increases.

Royalty investors do not own any part of the company except for the percentage of revenues purchased, as relating to an agreed period.

Royalty holders do not vote or have any ability to influence the owners or managers of the company having sold the royalty.

Royalty holders do not have an interest in the valuation of the company, either at the time they buy a royalty or at the time the owners want to sell the company.

The royalty investor must believe the company from which a royalty is purchased is well managed and has a sufficiently good profit margin enabling the company to be sustainable.

The royalty investor must also believe there are good reasons why the revenues of the royalty issuing company will grow. Fortunately, it is easier to predict a trend of revenues than it is future levels of per share, net after tax, earnings.

Therefore, a company which grows its revenues consistently but manages its finances so there is little growth in profits, and therefore taxes, would be of little interest to the VC's but is exactly what the royalty investor seeks. VC's want companies to be managed so taxable profits are maximized as they are focused on selling the company.

Of course, the successful business owners will want a method for terminating the royalty payment obligation and royalties can be redeemable, as well as being repurchasable, either by direct negotiation or tender.

A familiarization and study of the samples in the website calculators: www.REXRoyalties.com, www.REXdebt-shareroyalties.com, www.REX-PV.com and www.REXScaledRoyalties.com will provide a full understanding of the royalty process.

The VC's have a great business and they are not likely to support an approach which allows privately owned companies to raise capital on fair and non-equity diluting basis. VC's benefit *from* business owners and royalty investors' benefit *with* business owners.

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