What Do Royalty Investors Interested In Pre-Revenue Companies Really Want? ©

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Investors in technology-focused, high potential, high risk, early stage companies are a different breed from investors simply buying royalties to benefit from the royalty issuing company's growth of revenues. Of course, if the early stage company is successful it will usually have created more social value (jobs) and a greater return on the investor's capital put at risk than investing in an already established company's revenues.

Investors seeking increasing income as a result of a company's increasing revenues are attracted to royalties because revenues are easier to project than profits, and because of the greater safety reflected in the way we recommend royalty agreement contracts be written. They want less risk and more income than alternative investment opportunities. They will be generally pleased with an Internal Rate of Return of more than 15% annually, over the course of the royalty payment period. We believe it reasonable to structure established company royalties which, based upon the royalty issuing company's projected revenues, produce superior returns.

The more adventurous investor in early stage companies understands the risks are greater and possibly total. These investors are really speculators and seek to buy royalties from companies which expect to have a product or service which, if deliverable when predicted, has a potentially astronomical rate of revenue growth once the product is available.

The enemy of these speculators is not so much the possibility that the product or service will not be able to be created, or even that the sales growth will be less than anticipated. The enemy of enormous royalty issuer success is the issuer's right to redeem the royalties sold at a price which does not adequately reflect years of continuing royalty payments.

However, to be fair to royalty issuing companies we recommend that a redemption right be always present in royalty agreements, which do not reduce the royalty rate through the initial use of debt. Therefore, the negotiation is over the terms of redemption, not if a redemption right is present. We include an Internal Rate of Rerun (IRR) table in each of the website calculators we have developed for the negotiating parties to review.

In many cases I initially suggest a redemption right of 10 times the cost of the royalty in 10 years, less the cumulative royalty payments which have been made in the period. This would result in a minimum of a 25.9% IRR. The multiple and the number of years can be negotiated. Of course, the deal can be staged to provide an incentive for the company to exercise the redemption right earlier, thereby increasing the IRR.

Royalty issuers can also terminate royalty payments by acquiring the royalties held by investors through a directly negotiated agreement or by tender. The tenders can be either for a fixed amount for all of the royalties or using a “Dutch auction” approach, for a fixed amount, buying the lowest priced royalties offered by the royalty owners.

Investors should have an understanding and positive view of the company’s industrial focus. This view should be based upon the growth prospects of the industry, the competitive situation and a belief the company is raising enough money to, at the very least, to be successful in creating a proof-of-concept model. The risk to the royalty investor is not the traditional new company shareholder risk of equity dilution. It is that the product is not produced to the point where others will be motivated to obtain marketing rights, etc.

It is important to understand that we recommend the royalty agreement would be secured by the intellectual property of the royalty issuing company, as the bet is on the demand for the product, more than it is on the company developing it. This is one of the great strengths of royalties when financing exciting early stage companies.

The royalty investor must be aware that in some cases the technology-creating early stage company issuing the royalty may be acquired before there any revenues are recognized. Therefore it is

important that the terms of the royalty be secured by the intellectual property. This can be done in a number of ways.

As portfolio diversification lessens risk, I suggest the early stage company investor enthusiast buy royalties from a number of companies, perhaps in different areas of activity focus. However, if the initial area of focus is really understood and has excellent prospects, then owning royalties of several companies competing in the same area makes sense. In the end, it is a numbers game and there is no good reason to be solely dependent on only one company for the investor's overall success.

The early stage, pre-revenue royalty investor wants truly significant potential to offset and justify the added risk of the company not yet recognizing revenues, which demonstrate a demand for the product. Management and a large market demand have to be impressive. In the end, the investor has to be convinced that the promised product will be developed with the funds being invested.

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