Introducing The Concept Of Creating A Range Of Royalty Income Funds

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Royalties used to provide growth capital to companies that wish to avoid equity dilution must agree to terms attractive to investors.

Investors seeking long-term increasing income through the ownership of royalties, entitling quarterly payment of a percentage of defined revenues for an agreed period, must accept limited liquidity until there is a positive history of royalty payments being received.

There is a need for the creation of royalty income funds to meet the needs of both business owners and investors who seek the risk-reducing benefit of portfolio diversification. Royalty income funds can have differing investment focus as to industry, country, maturity, company size and other areas of interest to investors.

Investors will benefit from increasing income tied to the revenue growth of royalty-issuing companies. Business owners will benefit from the availability of non-equity dilutive capital. Communities and society will benefit from increased employment and commercial activity. Managers of royalty income funds will benefit from both fixed and performance fees based on the level of royalty payments paid to fund participants.

Assumptions include the continuing demand for growth capital, which entails the payment of agreed percentages of revenues for agreed periods, the ability of investment fund managers to successfully identify companies that can reliably demonstrate sustainable, likely significant growth of revenues over a period of years, and the ability of investment fund managers to structure and negotiate the terms of royalties meeting the needs of the parties.

The funds will need to perform, or outsource, administrative capabilities in the areas of registrar service, transfer agency, custody, investee information distribution, royalty collection and distribution. There will also have to be an acceptable asset holder for the critical assets of royalty issuing companies for securing contractual compliance.

If the fund manager wishes to participate substantially in the projected revenue growth of a royalty issuing company in the face of portfolio concentration limitations, the fund can arrange to syndicate to other funds or investors.

There is a current market need for such funds, as the demand from privately-owned companies for term loans is great and the supply is limited. Commercial banks often require some combination of personal guarantees, restrictive negative covenants and asset assignment, and are generally not interested in other than revolving loans to privately-owned companies.

The investment management of a royalty fund is different from typical equity fund management, as the assessment and prediction of enterprise valuation is not required -- the royalty investor participates only in the gross revenues and has no direct interest in per-share profitability.

The royalty, to be attractive to the owners of a company, should include a right of redemption. It is logical to believe that companies will wish to redeem their outstanding royalty obligations at some point after they have become highly successful, since a dollar of royalty payment is effectively a dollar of pre-tax profit. The redemption right will also become necessary should the company become involved in an acquisition or wish to enter the public equity market.

Royalties should only be bought from companies with substantial, defensible profit margins, and can be structured to achieve anticipated minimum IRRs of 15% or more over the course of the royalty payment period. In the case of established companies with a current track record of revenue growth, the capital risk to the investor can be reduced at the same time as the company generates revenues. This is the case, when using our U.S.-patented approach, which provides arrangements for royalty collection at the time of revenue receipt.

Another feature of the patent is the option of the royalty issuing company's critical assets to be transferred or assigned to a mutually acceptable asset holder. The asset holder conveys an exclusive, international right of use without charge for so long as the company is in contractual compliance by paying the royalty as revenues are received.

Finally, the management fee of a royalty income fund should be both fixed and performance-based. If the returns are as anticipated, then a significant fee would be justified for returns over an agreed hurdle rate. There is the potential for creating high-level risk-adjusted value for all concerned.

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