Beliefs and Truths About Using Royalties to Invest in Private Companies ©

Arthur Lipper

The revenue growth prospects for many privately-owned companies are outstanding and the risk and inevitable and inherent conflicts of interest in investing in privately-owned companies are largely mitigated by the approaches we have developed. We believe that royalties are the better way of both investing in and financing of privately-owned companies.

Royalties are a new and unproven means of separate parties benefitting from the success of a venture.

> **Royalties are one of the oldest means of trade, originating in pre-Biblical times. Barter is the only means of trade which might have been an earlier means of exchanging one thing for another, with valuations determined by the parties to the trade. Royalties, which are simply a revenue sharing in whereby one party receives a share of the revenues generated by another party. Royalties are unrelated to the profit or loss generated by the party using the asset owned by the other. Royalties are a percent of revenue rent for the use of an asset. Sharecropping, franchising and intellectual property asset licensing are effectively royalties. The concept of revenue sharing pre-dates the existence of money. It is a "you use my property and we will share the revenue". In other words, "use my money or other assets and pay me a percentage of what you receive".**

Investing in the equity of privately-owned companies is risky, as investors are never really sure if the profits reported are accurate due to tax payment strategies. Also, what are the company's controlling shareholder's policies regarding executive compensation and other profit impacting decisions?

> **Royalty investors are wholly focused on revenues and not on reported profits. Royalty investors are the beneficiaries of transactions which benefit the royalty investors when revenues increase, irrespective of the profits earned or reported. Royalty**

investors own an agreed percentage of revenues, for an agreed period and subject to agreed terms of the royalty agreement.

Investing shareholders in privately-owned companies do not know how well the company is doing, unless the company wants to tell them and then shareholder reports can be long delayed.

Using our patented approach terms, the agreed royalties are collected for the royalty investors, immediately at the time the royalty issuing company receives any revenue. The royalties are distributed to investors quarterly. The royalty issuing company will also issue a brief advisory of likely revenue change in the following quarter.

There is really no way of an investor knowing if a privately-owned company will do what they promise to do when attempting to entice investors.

One of the terms of the royalty agreement we recommend requires that the controlling shareholders of the royalty issuing company and the senior managers personally attest that all defined revenues of the company have been deposited in royalty-investor approved banks. There will either be a "lockbox" agreement with the bank or other arrangements made to facilitate the immediate deduction of the agreed royalty for payment to an investor designated account. There will also be an independent annual audit, of at least the revenues, of the royalty issuing company.

The most potentially attractive companies, where the present owners are convinced the company will dramatically increase in value over the coming years, will want to limit the term of the royalty agreement

The royalty agreements we recommend contain a right of redemption clause permitting the royalty issuing company to redeem all outstanding royalties for an agreed multiple of the investor's cost, less royalties paid, if the redemption occurs within an agreed period. For instance, as an example; 5 times cost if redeemed in 5 years or 10 times if in 10 years. The specific terms are as negotiated and agreed by the parties. The

royalty issuing companies may also, through either direct negotiations with specific investors or by making a tender to all investors, seek to reduce all or the desired number of royalty units outstanding at any time. The royalty issuing companies will always be the most logical buyers of their outstanding royalties. New financings, going public or selling the company will naturally trigger redemptions. The more the founders and present owners of the royalty issuing companies believe in the future increase in value, if they receive adequate funding, the more they will embrace fairly-priced, non-equity dilutive royalties.

There is very little an investor can do to protect their investment in a privately-owned company.

In the royalties we design and structure there are a number of investor protections. Also, in the case of a diversified portfolio of royalty holdings, such as in a royalty income fund, assurance of the return of invested capital may be available.

No matter how successful a privately-owned company is there is no way an investor can benefit until the company goes public or is purchased by another company.

A flow of quarterly royalty payments will always be found attractive by other investors and most of all by the royalty issuing company, as they will like to terminate future royalty payments. Each royalty payment is a pre-tax profit payment for the royalty issuing company.

Indeed, royalties are the only way, other than by either selling their holdings at a profit or receiving dividends, that an investor can profit, regardless of the success of the company.

From the perspective of the business owner, expanding their business without having to borrow or diluting share ownership is most attractive.

The use of royalties in the financing of expanding privately-owned companies benefits investors, company founders and owners,

employees, company suppliers and customers and the communities in which the companies are located. It is also clear that successful and expended privately-owned companies benefit all of us

Royalties are a winning funding and investment strategy for all concerned.

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