How to Create Virtually Riskless Royalties

First, financial risk must be defined. Investopedia has the simplest and most relevant definition: “Risk includes the possibility of losing some or all of the original investment”. Mike Lipper’s “Monday Morning Musings”, weekly blog #581 discusses relative portfolio debt risk. Also, to be added to the definition of risk is the loss of the amount which could have been earned on the lost capital.

In any and all cases, risk must be assessed relative to the anticipated benefit of the investment. In the case of debt, the benefit is the interest earned and repayment of the loan. The only possible profit is receipt of the interest earned and availability of the principal at maturity of the obligation.

In the case of royalties, an agreed percentage of a company’s revenues, the only risk is the royalty issuer’s possible failure to meet the agreed terms of the royalty and to make the contractually required payments. When the royalty payments have totaled the amount paid for the royalty there is zero capital risk and all future royalty payments are profit. The level of profit will either be greater or less than anticipated, based on the pre-investment, originally projected revenues. However, once the invested capital has been recaptured there is no capital risk possible and the issuer’s revenues could be greater than projected.

In our recommended structuring of royalties there a number of inherent investor risk protections. It is also possible that an independent entity guarantees the investor against capital loss through the receipt of at least the amount invested.

Such a guarantee would be paid for by the royalty issuer as a means of justifying the negotiation of a lower royalty rate due to the elimination of capital risk, if the guarantor performed if, as, and when required.

Therefore, the concern, possibly viewed as a risk by the investor, is if the royalty issuer's revenue projections are not achieved and therefore the investor's anticipated royalty payments are not made, at least to the minimally expected level. This risk can be addressed by the royalty issuer's undertaking to pay a minimum level of royalty, regardless of the level of revenues, for agreed periods. The shifting of risk from the investor to the issuer will be used by the issuer to justify a lower royalty rate.

The negotiation of the terms of a royalty is risk/reward tradeoff. "The less risk the less reward" is the natural and reasonable rule of the market for all transactions.

In the case of royalties, it is possible to create terms which balance risk and reward resulting in royalties which meet the needs of both investors and royalty issuers. Specifically, we believe it possible to create a portfolio of royalties which will generate returns significantly in excess of other alternative classes of investments, with far lower levels of potential capital risk.

More information on royalties can be found at www.Royalties.Website.