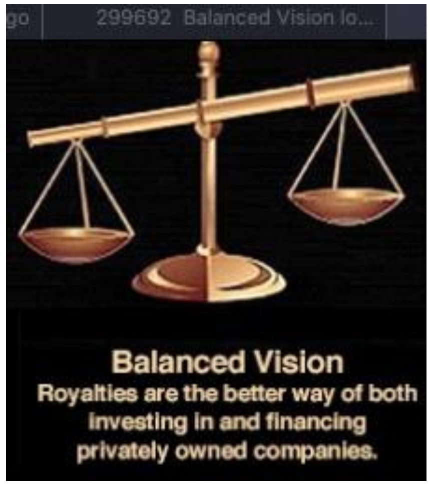

Venture Debt Versus Revenue Royalties

Early-stage companies are increasingly being solicited by aggressive lenders and enticed to borrow with payment terms including a multiple of the principal, based on a percentage of revenues received during an agreed period. I have heard that one of the deals being offered calls for the repayment of 200% of the principal by the end of 24 months and an even higher percentage if the repayment takes longer. Companies accepting these terms do so believing that the amount borrowed and agreed to be repaid is justified by exceptional developments that will be facilitated by the availability of this funding.

These multiple-of-cost-based loans can become truly burdensome for the borrowers if the events counted upon to justify the high cost of money do not materialize as expected.

These arrangements are not revenue royalties.

In comparison, revenue royalties are a contractual agreement whereby a company sells a percentage of its defined future revenues, for an agreed period of time, and on agreed terms. In order to induce the investor’s purchase of the royalty, there can be an agreed minimum amount of revenues, and therefore royalty payments, either within specific periods or cumulatively by the end of the royalty payment period.

It is also possible that the company issuing (selling) the royalty may pay a fee to an independent third-party guarantor to assure that the royalty investor will receive the promised amount of royalty payments, within an agreed period, in order to negotiate a lower percentage of company revenues which need to be paid to the royalty investor. The terms we recommend provide for the investor to receive at least the amount initially paid for the royalty in royalty payments by the end of an agreed period. Depending on the financial reliability of the guarantor or the terms of the guarantee, the investor may thereby be able to consider the transaction to be risk-free, with only upside potential remaining.

Since companies issuing royalties may want or need an early redemption of the royalty if the company is successful or if it wishes to be acquired or to refinance, we recommend that a royalty issuer's right of redemption should be included in the contractual terms of the royalty agreement. This redemption value should be calculated as an amount, including the royalties already paid to investors, which is a multiple of the investor's cost of the royalty.

The more successful the company, the more likely the company will want to redeem the royalty early. The negotiation of the redemption value depends on a range of factors and must be sufficient to attract investors, because the exercise of the right terminates and caps the investor's return. A redemption value of 5X (times cost) if exercised within 5 years or of 10X if within 10 years would respectively produce a minimum of 38% or 26% Internal Rate of Return. As it is probable that some royalty payments would have already been made and reinvested before this redemption, the rate of return for investors would actually be higher than this traditional point-to-point, straight-line IRR rate.

It should also be noted that a venture debt loan is a security transaction and that basic royalty agreements may not be considered securities in all jurisdictions. Also, royalty payments made by corporate issuers may be an income tax deductible expense, while in comparison only the interest payments on loans are income tax deductible by the borrower. Royalty investors do not have taxable income until they have received a full return of their cost of the royalty.

Revenue royalties can also be structured so that they have the benefits of debt for the investor due to a higher certainty of repayment of principal, and consequently they may provide a less expensive form of financing for the issuer since they offer the attraction of capital preservation to investors.

For a long time, we have believed that both company owners and investors would in time recognize the benefits of structuring transactions based on revenue growth rather than on profit engineering. So, I am now inspired to say, "Welcome Aboard".

Arthur Lipper, Chairman chairman@REXRoyalties.com
British Far East Holdings Ltd. 858 793 7100