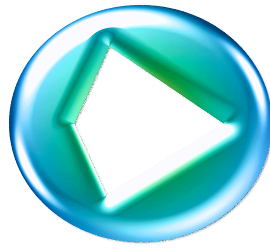


Royalties

a new way of participating
in the growth of a company

A Primer

from Pacific Royalties

1. The Investor's Mind

Place yourself for a moment in the mind of a business investor. You have money you wish to invest, and you want to earn more than a savings account or government bond. There is a growing private company that interests you, and you understand that the risks and rewards of that path are significant.

Naturally your first thought is -- you want the greatest possible reward for the lowest possible risk.

2. Basic Options

To achieve your goal, you might lend money to the company -- but your return will be limited by the interest rate you can charge. Your risk is that the company somehow can't make the payments, and you could be forced to seize the collateral you took on the loan -- the owner's house or car or life's savings -- or lose your entire investment. That risk goes down slowly each time you receive a loan payment, but your reward, especially in a low-interest rate economic environment, are modest for the risk you take.

On the other hand, if you buy stock in the company, you become a minority owner. You hope that the company's value will increase, that one day someone will buy your stock for more than you paid. You also hope that the company will one day be profitable enough to pay dividends -- a share of the profit. Again, your risk is that the company may not prosper or even survive, and then you could lose your entire investment.

With a private company, you may wait many years for a possible acquisition by another, strong company -- or for your company to enter the public market. It is a long path with no guaranteed outcome, but the reward, if you make the right investment at the right time, at the right price, can be huge.

3. A Third Option

A different approach, more balanced between risk and reward, may be to own a share of the company's revenues -- a "revenue royalty." An investment of this kind entitles you to receive a percentage of the company's total sales for a period of time. That's it, very simple -- the essence of a royalty is three key items: the amount you invest, the percentage you receive, and for how long.

Your initial risk is the same -- that the company will survive to pay you the royalty promised. But that risk goes down, perhaps faster than with a conventional loan, with each royalty payment you receive. As the company increases its revenue, even modestly, your reward for the risk taken increases. You don't have to wait in the shadows for an indefinite period like a shareholder, hoping the your ship comes in.

You as an investor start receiving income right away, possibly at a higher rate than a standard loan, and you don't have to hope for dividends to be declared, or wait patiently for someone to buy your stock, one sunny day in the future.

4. The Company's View of Royalties

A royalty can make good business sense for the company, too. It's similar to many regular operating costs the company has to pay. For example, the company pays the power company for the electricity it uses; the faster the meter spins, the higher

the bill. It doesn't matter whether the company is profitable or not -- the electric bill has to be paid.

Other examples of variable operating costs include office supplies, overtime to hourly workers, fuel costs, shipping, research and development, postage, marketing -- all these are recurring expenses, different from month to month depending on how much you use, and they all contribute in different ways to the company's productivity.

Royalty payments are also a variable cost of doing business -- but the difference between a royalty payment and an electricity bill is that the royalty investment makes it possible for the company to thrive, grow, compete and expand -- and pay all the other bills.

A royalty is the cost the company pays for the capital it needs to expand its revenues.

The arithmetic is simple; a typical 5% royalty means that investors receive $5 out of every $100 that is deposited from sales.

5. Many Directions for Royalties

Naturally, lawyers, accountants, bankers and creative business minds will find ways to make simple things more complicated, and more interesting.

For example, royalties can pay investors a minimum or maximum amount, or both. The rates can change automatically over time, or when investors have received

twice or three times their investment. Royalties can be secured by the assets of the company, by a third party, or not secured at all. They can be convertible into shares of the royalty issuer, or into a long-term loan. They can be made part of a standard loan initially, as an incentive to increase the lender's return. They can be bought and sold; they might one day be traded like stocks or bonds, once a Royalty Exchange is established. A company might pay a lower royalty rate if its revenues exceed projections, or a higher rate if it falls short.

Royalties can also be combined together into a professionally-managed royalty income fund or limited partnership. Royalties can be re-purchased by the company, at an agreed price. They can be used as security for a loan or line of credit. This is just a partial list of what can be done with royalties.

But in their simplest form, an investor pays an amount of money in advance, in exchange for a percentage of a company's revenues for an agreed period of time. That's it.

6. What is a Good Deal?

How much is fair to pay for a revenue royalty, for what percentage and for how long? That is easily calculated, if you have a conservative projection of the company's sales. There's an online interactive model you can use, which explains this and shows you how, at http://www.rexroyalties.com

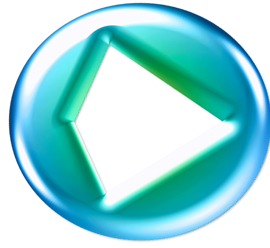
7. Summary

From the company owner's point of view, he receives the capital he needs to grow without surrendering a share of ownership or control, and without going into debt. The disadvantage: his profit margin is lower, because royalties come "off the top". If the owner uses the royalty investment wisely, that "top" revenue will increase -- through efficiencies from increased marketing efforts, new technology, better economies of scale or competitiveness made possible by the investment, his profit margins will expand to compensate.

The investor participates directly in a company's growing revenues, without regard to the profitability or valuation of the company. The company acquires capital without surrendering equity or incurring debt, and without having to report everything they do to shareholders.

Royalties put investors and owners on a more even playing field, and help resolve the conflicts that may arise as a result of differing goals and objectives. Everyone is focused on the same goal: increasing revenues.

Royalties represent a new, potential win/win relationship between investors and business owners.



http://pacificroyalties.com

Arthur Lipper, Chairman

www.REXRoyalties.com

with the participation of Michael North

© 2014 British Far East Holdings Ltd.
All rights reserved