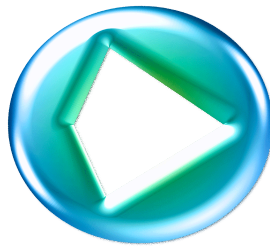

Royalties

a new way of participating
in the growth of a company

A Process Description

from Pacific Royalties

1. The Professional Investor's Mind

The professional investor is by definition a fiduciary when managing client assets, as other people's money is being exposed to risk in search of reward. The professional investor is in the business of seeking the highest return available, with a level of risk that is acceptable when considering the prospective return. The professional investor is paid to employ client capital; just the purchase of conservative government bonds does not meet the needs of most investors, as increasing income and wealth enhancement are natural goals.

If there were a growing private company with the potential for significant increasing revenues, the investor's natural goal would be to find a way of benefiting from the company's growth without being exposed to the same risks as the owners of the business.

2. Basic Options

The professional investor might seek to benefit by making a loan to the company. However, that benefit would be limited to the interest rate charged, which is highly competitive and based on factors largely beyond the investor's control. The risk is of possible borrower default. Lending to privately-owned companies requires credit analysis skills based on information provided by the company, which must be verified. The most qualified borrowers are unlikely to be willing to pay higher rates of interest as their company's revenues increase, which is what happens in the case of a royalties.

The other major option -- buying stock in a privately owned company (if the owners are willing to share ownership) -- results in the future value of the investment being based on earnings and declaration of profits. In many cases, it is believed by the controlling owners of private businesses that it is in their best interest to use all legal means to report the least amount of profit, and therefore pay less in taxes. On the other hand, if the owners of the company plan on selling shares to the public, then they may employ accounting practices that optimize reported earnings. It is also possible that privately owned companies will opt to pay dividends to their shareholders, but this decision will be made by the controlling shareholders and not by minority shareholders.

In all these cases, investors, as minority shareholders in a private company, must accept limits on the transparency of information provided by the company about its profits -- yet this is exactly the information that the investor needs to accurately forecast risk and reasonably assess opportunity.

3. A Third Option

Revenue sharing, through a financial instrument known as a royalty, has the benefit of entitling royalty owners to a percentage of the royalty issuing company's revenues, without regard to profits. Therefore, as the revenues of the royalty issuing company increase, so do the royalty payments. Royalties can also include minimum payments, if contractually agreed. The revenue of many companies will increase as a result of inflation, while profits may or may not. Inflation will tend to favor royalty holders, but not the purchasers of private company debt. In this sense, royalty investing may be seen not only as an inflation hedge, but as providing, in some cases, an inflation benefit.

Investor risk when purchasing royalties is that of the ongoing, continued ability of the royalty issuing company to meet its contractual obligation in the payment of the agreed royalty. The royalty investor's principal risk is reduced with the receipt of each royalty payment, and there can be arrangements where assets of the royalty issuing company, and possibly others, reduce the risk and provide assurance to the royalty purchaser. The requirement of the royalty being collected on a daily basis also reduces the royalty owner's risk.

When a royalty is purchased from an established company, royalty payments commence immediately and are not discretionary with the controlling shareholders or management of the company, as in the case of dividends. Also, it is likely that the rate of return to the royalty holder will be higher than with a loan of the same amount to the company.

4. The Company's View of Royalties

The primary advantage to the royalty issuing company is the availability of funding, which may not be available from banks or conventional funding sources,

on terms which are acceptable and do not require an equity dilution. Many companies seek additional growth capital, but are unwilling to sell equity to investors due to the initial and continuing financial disclosures which would be required. Such disclosures, even if cloaked in confidentiality with private investors, are very competition-sensitive with companies in high-growth industries, where information about suppliers, partners, customers, technology and profit margins are critical.

Once there are equity investors in a company, the directors and controlling shareholders find themselves in the position of being fiduciaries, as all corporate actions must be intended to benefit all of the shareholders. This may constrain management's options, when considering immediate, short-term profit reducing investments that are necessary to the growth of the company, for example in research-and-development, strategic marketing, and major customer discount accommodations.

Royalties are treated, from an accounting standpoint, as a variable ordinary expense to the royalty issuing company, to the extent that they are a fixed percentage of revenues. Some royalty payment rates may change in stipulated periods, and in such cases the accounting would be adjusted.

5. Many Directions for Royalties

As royalties become more common in the financial landscape, business professionals -- including lawyers, accountants, auditors, investment bankers, angel and venture financiers, private equity firms and underwriters, will evolve many creative ways they can be employed.

For example, royalty payments can have either an agreed minimum or maximum amount or both. The rates can change automatically over time, or may be based on the achievement of certain milestones of total investor return, or internal rate of

return. 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. They can be made part of a standard loan, as an incentive to increase the lender's return. They can be bought and sold; they might be registered as publicly tradable securities, through a new kind of securities exchange specialized to deal with royalties. This opens up the possibility of writing options and futures contracts based solely on a publicly traded company's gross revenues, which is not currently possible.

Royalties can also be purchased by a royalty income fund, which might be designed to reinvest the royalty payments or to disburse them. Such funds could be focused on specific investment objectives, geographies or industries. Royalties can be redeemable by the company -- that is, terminated early by the company before they expire, at an agreed price based on discounted cash flow or other factors. Royalty investors can also have the ability to rescind the transaction at the end of a stipulated period. Royalties can be used as an added incentive 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 to the royalty issuing company, 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 what percentage and for how long? These factors can be calculated, if the company can provide a conservative projection of the company's sales over a period of time. There's an online interactive model one may use which demonstrates this, at http://www.rexroyalties.com

To complete the most basic model, it is necessary to enter only four items: 1. total investment provided to purchase the contract; 2. maturity or duration of the

contract in years; 3. the royalty rate (or rates, if variable rates are desired over the life of the contract), and 4. the first year's project revenues, with an estimated compound annual growth rate (CAGR) for the life of the contract (or rates, if different growth rates are projected in future periods).

The model also allows the company to enter three other items, to aid both the prospective investor and the company's managers in the position of understanding the impact of assumed factors: 1. the price/earning ratio typical for this type of company; 2. the company's estimated NAT (net-after-tax) income, expressed as a percentage of total revenues; and 3. the interest rate that might be received from a comparable investment in other companies similar to the company being analyzed, for benchmark purposes.

The REX Royalties model then calculates full information on the royalty investment's total return in both tabular and graphic form. It is possible to pinpoint critical breakpoints from this data, including for example the point in time at which an investor receives royalty payments equal to his cost, or when he doubles his investment; both the compound annual rate of return and the internal rate of return, and when each is projected to go positive; and an estimate of the increasing market capitalization of the company, if it receives the prospective investment and as a result performs on its revenue estimates over time.

The model makes it easy to change assumptions, rates, time periods and all other variables, to assist both the investor and the company issuer in achieving their objectives and arriving at an equitable agreement.

As a convenience, sample cases are presented which are intended to help those entering their own. There are just three steps needed to access this model:

1. Click http://www.rexroyalties.com/sign_up
2. Enter a username; our sample is "professional"
3. Enter a password; our sample is "investor"

4. Enter any of four different assumptions and three supplementary items if you wish, as described above; then click “Apply a CAGR”
5. To see the results, click “View Analytics”
After viewing the spreadsheet, you may click “View chart,” to see the information in visual format. You may also click “Print” to print the spreadsheet.
Click “View Calculator” to return to the data entry screen.

There is currently no charge to use this model. Users may create and store their models and data.

This model was conceived and developed by Arthur Lipper, Chairman of British Far East Holdings Ltd., the royalty approach patent owner and filer of a current related patent pending. Other websites may be useful for serious royalty investors and issuers; they include; hwww.REXComparator.com for comparing different terms with the same projected royalties and www.REXdebt-shareRoyalties.com, which provides an ability to study the impact of a loan followed by a royalty on the loan’s repayment, the royalty being at a lesser percentage of revenues than would be the case for a straight royalty.

7. Summary

From the company owner’s point of view, capital is provided for growth through royalty finance without surrendering any ownership or control, without incurring debt, and without having to report everything management does to shareholders.

The issuer’s potential downside: a decrease in profit margin, because royalties come “off the top.” If the issuer uses the funds received for the sale of the royalty wisely, then gross revenue will increase -- for example, through efficiencies from increased marketing efforts, new technology, better economies of scale or competitiveness made possible by the funds received for the royalty..

The investor participates directly in a company's growing revenues, without regard to the reported profitability or valuation of the company. In the case of a company having current revenues the royalty payments commence immediately.

Royalties will probably not produce the same amount of gain for those investors smart or lucky enough to buy stock in one of the few highly successful early stage companies which are able to achieve their profit projections, and then are either bought for a high price while still privately owned, or have a successful Initial Public Offering. However, royalty owners investing in multiple companies, perhaps through a royalty income fund for example, will almost certainly see a much better overall result than through either equity or debt investments.

The approach described for using royalties in the financing of businesses is reflected in US Patent Number 7813999; http://j.mp/royaltypatent. Pacific Royalties will be a licensee of this patent, and will be advised by Arthur Lipper, an experienced investment professional. Michael North, a Hawaii resident entrepreneur and business owner, will also be an advisor to Pacific Royalties, which he conceived and introduced to important members of the Hawaiian community.

Royalties define a new, more equitable and usually more profitable relationship between investors and business owners. They avoid the inevitable and irreconcilable conflicts of interest between investors and business managers that are present in most equity purchases.

Royalties are a win/win arrangement and are the better way of both investing in and financing of privately owned companies.

http://pacificroyalties.com
Arthur Lipper, Chairman, www.REXRoyalties.com
With the participation of Michael North
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