by Connie Loizos
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Arthur Fox, Godfather of Royalty-Based Finance, on What VCs Are Missing

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Earlier this week, Seattle entrepreneur and investor Andy Sack debuted **his newest startup**, a revenue-based financing company called Revenue Loan, which will lend startups money in return for a 3x-5x repayment whenever feasible.

Sack isn't the first person to try out the model. Rather, Boston-based entrepreneur-investor Arthur Fox says that he's "kind of the godfather" of the methodology, and that he's been applying it — successfully — for nearly 20 years.

Fox co-founded several companies in the '80s — Octek Computer Technology, Lexidata Corp. and Medicel — before starting Royalty Capital Fund in 1992, whose "royalty-based" approach entailed buying the right to a percentage of a company's receipts, and whose two funds' IRRs, says Fox, were both north of 50 percent. Now he's partnering with a Dallas-based group, **Cypress Growth Capital**, to create a new fund and preparing to raise another Boston-based vehicle, next year.

We talked yesterday about his approach, and why more people haven't embraced it thus far.

What's the sweet spot for revenue-based finance, based on your experience?

The sweet spot is $1 to $3 million or $4 million in companies that are doing between $3 million and $10 million in revenue every year. The reason I think so is that the risk goes up the smaller the company is. Also, in the capital markets, irrespective of the structure, there seems to be a lack of capital in the $1 million to $5 million range because it's big for angels and small for VCs. It's kind of like a black hole.

And how is what you do different than offering a high-interest loan?

Conventional lenders require that you repay them over a time schedule and with fixed dollar amounts that aren't related to whether you have the cash or you don't. With a royalty-based structure, there are no minimums. If a company has erratic cash that comes in so that one month they have a lot and the next month they don't, they don't owe us anything. It's like

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month they have a lot and the next month they don't, they don't owe us anything. It's like someone who gives you money and says, "It's okay to pay me when you have it and if you don't, then don't have to worry about it."

So your biggest risk is that a company will go out of business before you're paid back.

Right, my concern is getting it to survive, opposed to speeding it along, and the advantages to that strategy are numerous. Let's say you're an entrepreneur who can manage a company to $5 million a year but beyond that you'd have to be replaced if the idea was to take company to next stage. Let's also say that you want to keep company at scale that you can adequately manage. Well, VCs would consider that a lifestyle company that they wouldn't want to touch. But a lifestyle company can be a nice company to be an employee or an entrepreneur of, and we don't insist that they put their foot on the accelerator.

But obviously, if the company becomes a breakout success, you miss out on that upside.

Well, as part of our standard structure, we take a warrant on a small amount of stock, typically between 1 to 3 percent of the company, so if they do get to be big, it's a significant kicker.

Also, as you're getting paid back the capital, it exposes you to a company over a period of time, so if they do a subsequent round of equity and you're there to be a part of it if you'd like, you can invest with a lot more knowledge about the company.

Is that a common practice for you?

It isn't, though it has happened. As an atypical example of what a spectacular success might be was in a multimedia software company called Andover.net. From our first small pool of capital in 1993, we gave the company $100,000. Within 18 months, we'd gotten our money out, but the company subsequently did another round of financing with an angel, and he wanted us [involved]. We said, we'll take the royalty cap, which is 5x the capital, and we'll cut it in half to 2.5x the capital in exchange for some stock. Ultimately, we gave up $250,000 in profit but the value of the stock turned out to be $15 million. [Andover.net, which had gone on to create a network of news and discussion sites including Slashdot.org, went public in December 1999. It was later acquired by VA Linux.]

Are there other advantages to revenue-based finance?

Sure, obviously, I've never lost 100 percent of my capital in any company, because they immediately start paying you back the month afterward. That's one of the reasons that the investor rates of return on the royalty structure are as strong as they are. Another is that if you do a discounted cash flow analysis, if you're getting paid month by month, the IRR rate is a lot higher than if you get a lump sum after a several year period, as the traditional model works.

And there's a tax advantage of this structure to the company receiving the financing. We get paid until we receive a certain multiple, typically 5x. If we put out $100,000, when we get back $500,000, that marks the end of the deal. So in the example, the gross cost of the transaction isn't 5x capital but 4x capital because $100,000 was our own initial capital coming back. And that 4x is entirely tax deductible by the company, whatever their tax rate is, so the subsidy is quite strong.

If they are in the 40 percent corporate tax bracket, then 40 percent of the 4x is actually being paid for by the tax savings. So the net effect is that in a 5x royalty deal, the true cost is .6 x 4, or 2.4x over the return of our capital. That's the cheapest form of growth and risk capital that a company could possibly raise, so it's a terrific option for a company and it's a good deal, of course, for the investors.

If it's such a good deal, why aren't more people doing it?

I have a lot of friends who do VC and I do a lot of angel investing so I know that area, but my VC colleagues can't stand the fact that I'm capped out. And that's another way of saying, they can't stand not having a runaway success as their goal. And that's another way of saying that they find my portfolio boring. They want to be able to talk about the hottest company they've got. They're addicted to the big hit and they're temperamentally not suited to the idea, even though my returns are as good and better than theirs are.

Tags: Arthur Fox, Royalty Capital Management

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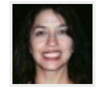

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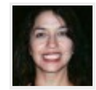

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