Comparing Royalty Financing to Debt and Equity financing

(by Marco Vangelisti)

Royalty financing, whereby investors receive a percentage of revenues, relieves the entrepreneur of the implicit pressure early equity investing creates to grow rapidly towards an "exit" and avoids dilution of the original owners. Royalty financing is more appropriate than debt in the early stages of a business since repayments are based on revenues and allow for better cash flow management.

This article further discusses royalty financing introduced in the prior article "A New Funding Structure for Slow Money Projects".

Businesses need capital at all stages of their life cycle until they reach profitability and hence become self-sufficient. Capital for the pre-revenues stages (proof of concept, prototyping and product development) tends to come from the financial resources of the entrepreneur and from those of family and friends. Angel investors, the first "outside" investors, might provide capital for the product development stage. The capital invested in the pre-revenues stages takes the form of equity financing whereby investors receive an ownership stake in the business and usually the right to influence the business' management through key management positions or Board seats.

As the business enters the market with its offering and establishes a dependable and growing revenue stream, additional capital might be provided by venture capitalists to "carry" the business to profitability. Angel investors and venture capitalists tend to invest in businesses they believe have strong growth potential and are likely to be sold either to the public via an initial public offering (IPO) or to a larger company in the following years (usually within 3 to 7 years). Businesses that do not have an "exit strategy" or are not poised for rapid growth are unlikely to attract angel investors' or venture capital.

Financial institutions provide loans and lines of credit only to businesses that have successfully entered the market with their offering and are either profitable or approaching profitability. Credit has been greatly curtailed following the financial crisis of 2008 in the US and the massive consolidation of its banking sector has lead to a dearth of funding for small and medium enterprises. Debt financing is not appropriate for funding pre-revenues stages

Slow Money info and action

Upcoming local meeting:

Saturday, June 7, 11-6
Full Circle Farm, Sunnyvale, CA

Register for Farm Fest

Fundraising with CREDIBLES (prepay your local food)

Organic cream-top French-style artisan yogurt

Neighborhood fresh food store and community space in West Oakland

of the business since they impose fixed periodic repayments irrespective of whether the business has sufficient, or indeed any, revenues to support them.

Royalty financing is a new financing structure that can fund a business in the late product development or early revenues stages of development when debt financing is either inappropriate or not available and when equity capital might be too dilutive given the low valuations of the business.

Let's look at an example. Let's assume we are looking at a hypothetical food hub that is aggregating the produce of a collective of farms and distributing CSA boxes to a nearby urban population. The business has entered the market a few years ago and has an established and growing revenue stream. It needs about $75K to cover its operating costs until it reaches profitability in 2014. While the business has plans to expand, it has determined that its ideal size would be reached when the revenues grow to around $2.3M per year towards the end of the decade. The business is closely held by the farmers it serves and by members of the community. The owners have no desire for the business to either grow beyond its ideal size or be sold to a larger food distributor in the future. The business is currently valued at $300K.

	2012	2013	2014	2015	2016	2017	2018
Sales ($1,000)	152	280	490	870	1500	2000	2300
COGS	98	178	293.6	513.8	869.6	1159.5	1333.4
SGA	89	142.6	195.4	326.5	525.1	700.2	805.2
Net Income	-35	-40.6	1	29.7	105.2	140.3	161.4
cumulative RE	-35	-75.6	-74.6	-44.9	60.3	200.6	362

This type of business would be of little interest to angel investors or venture capitalists since the business does not have an "exit strategy." Nevertheless, let's assume the business manages to raise $75K by selling 25% of its ownership to equity investors. Besides the likely demands of the new investors to be participating in the management and decision making of the business, the new investment would bring with it a dilution of the original owners which now own 75% instead of 100% of the business. The original owners' share of the cumulative retained earnings would therefore be as follows.

($ 1,000)	2012	2013	2014	2015	2016
effective cum RE	-26.3	-56.7	-55.9	-33.7	45.3

($ 1,000)	2017	2018	2019	2020	2021
effective cum RE	150.5	271.5	392.5	513.5	633.4

The business might alternatively opt to raise $100K in royalty financing promising to pay investors 3% of revenues starting in 2013 until a total of $150K is return to them (their initial invested capital plus a $50K premium). Royalty financing would not entail an ownership in the business and would therefore not dilute the original owners.

Pastoral Plate on Credibles

Meat-buying CSA in the Bay Area, sourcing from pastured and grassfed farms and ranches

Bittersweet on Credibles

Chocolate, coffee drinks and housemade treats in Oakland

	2012	2013	2014	2015	2016	2017	2018
Sales ($1,000)	152	280	490	870	1500	2000	2300
COGS	98	178	293.6	513.8	869.6	1159.5	1333.4
SGA	89	142.6	195.4	326.5	525.1	700.2	805.2
Royalty payment		8.4	14.7	26.1	45	55.8	0
Net Income	-35	-49	-13.7	3.6	60.2	84.5	161.4
cumulative RE	-35	-84	-97.7	-94.1	-33.9	50.6	212

Note than since royalty payments occur before the business reaches profitability, the total amount needed is around $100K rather than $75K. Royalty structures can be designed to have the start of repayments be triggered by specific events like reaching a pre-determined revenue target.

While the original owners' share of retained earnings is lower than in the case of equity financing, in the long run royalty financing accrues a larger amount of retained earnings to the original owners.

($ 1,000)	2012	2013	2014	2015	2016
effective cum RE	-26.3	-56.7	-55.9	-33.7	45.3
cum RE with royalty	-35	-84	-97.7	-94.1	-33.9

($ 1,000)	2017	2018	2019	2020	2021
effective cum RE	150.5	271.5	392.5	513.5	633.4
cum RE with royalty	50.6	212	373.3	534.7	694.5

Royalty financing is also a more attractive alternative than debt in case of highly seasonal businesses. Imagine a pastured chicken and egg farmer whose revenues greatly fluctuate with the seasons. During the winter season the egg production of pastured chickens decreases dramatically and so does the farm's revenues. If the farmer where to obtain debt financing, a fixed amount would need to be paid to the creditors on a monthly or quarterly basis regardless of the income generated by the business thereby creating a cash flow squeeze during the winter months. If the same amount where obtained through a royalty structure, the monthly or quarterly payments would be a fixed percentage of the revenues and therefore better in sync with the cash flow of the business. Royalty payments during the winter months would be very small, while being higher during the summer months when the productivity of the farm is greater.

Royalty financing could also be used in the late stages of product development and prior to entering the market with a final product or service. No payments would be due until a revenue stream is established.

In summary, royalty financing provides a flexible way of funding a business from the late pre-revenues stages onward. Royalty financing investors share in the success of the business since their return will be higher if the business is successful and lower if the business trails its revenue projections. Nevertheless, from the investors' point of view, the investment is much less risky than an early equity investment since it is self-liquidating and repayments do not dependent on the timing of break-even or on the level of profitability. Royalty financing does not entail an ownership stake and therefore does not dilute the original owners nor imposes expectations of rapid growth required for an "exit strategy". Since royalty payments are based on a fixed percentage of revenues, it is better suited than debt for businesses with very seasonal revenues or in the early stages of revenues generation.