



Pacific Royalties

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presentation text

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## "Raising Capital for a New Business in the 21st Century Economy"

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The title of this talk has been suggested by my friend and partner, Michael North. Michael and our wives are promoting in Hawaii and China the concept of both a China Royalties and a Pacific Royalties fund and possibly a royalties exchange.

The reasons those with entrepreneurial tendencies and ambitions are motivated to start a business are multiple and not simply "to make money". Being the author of 5 books on the subject of entrepreneurship and having been the owner and Editor-In-Chief of Venture magazine, "the magazine for business owners and entrepreneurs" with a paid

subscription of 450,000, I claim an understanding of entrepreneurs (as well as an ability to spell and pronounce the word). I have also been involved with the ownership and financing of a great many companies.

In the original French, the word entrepreneur means “one who carries between, connects.” Entrepreneurs are also described in early French dictionaries as “undertakers, meaning those who do new things”. We shall see how apt this root is in the next few minutes.

Entrepreneurs are not motivated to accept risk, as is broadly and mistakenly believed. Entrepreneurs do not see the same risks as others do. They are firmly captives of their vision and believe they can do what is necessary to make it work. Their reasons for starting a business include a mix of a need to gain more control over their own lives than any employee can ever have, the seeking of power to control their lives and destiny and that of others with whom they are affiliated, to earn a desired level of income, to acquire significant wealth, to develop their unique ideas, the significance of which no one else but they can grasp, to have the freedom to make mistakes and to gain the recognition of being a person of merit. Entrepreneurs are not without ego, and ego is constructive.

These desires are all interrelated and achieved with the success of a business. As I tell younger audiences, there are only three kinds of people in the world; they are the unemployed (which includes both the young and frequently the aged), employees, and employers. It is primarily the employers who have the ability to make a significant positive social contribution. Therefore, as a life’s work, I try to help people become successful business-owning employers.

Is raising start up capital really different today than previously? The answer is yes, and all because of the data collection, information transfer capability and instant global information provided by the Internet. Yes, in prior times, when people’s concentration

spans were longer, there was not a Bloomberg TV, which can create a new entrepreneurial role model within each 15-minute segment. We did not have young, individual entrepreneurs becoming among the 100 richest Americans with regularity, and frequently by having created businesses that many of us have difficulty understanding what the company makes or does.

Of course, these well recognized winners are the sirens of our time, and as described in Homer's Odyssey, singing a song which lures many to crash on the rocks of their island.

Entrepreneurs hate to plan, as planning is restricting. They hate doing a business plan as it describes a path they may wish to change and they sincerely believe that they will be able to overcome whatever obstacles are in their path. Indeed, since being a divergent thinker is one of the critical needs of successful entrepreneurs, they frequently can find a way around, over or under problems that would simply block those who depend on past experiences, of their own or taught, as the basis for decision making. Great salespeople have some of the same mindset – believing that a sale begins when the prospect says “no”.

As to mindsets and training, those who have been professionally trained to research prior events to learn that which is good or right or possible ,may not be those best equipped to plan or develop that which is new and different, as they are totally precedent-biased. Attorneys keeps us out of trouble with their advice but have been responsible for the generating the vision of very few successful companies -- and none that I can think of in areas of technology.

The Internet also works against early stage company capital raising as even the greediest of the investing population is also made aware of business failures and failures make good copy for the media.

Today's investors, particularly so-called venture capital investors, are as risk-averse now, or even more so, as ever. They are risk-averse not for the primary reason of avoiding losing money, but because they do not want to be embarrassed by the loss. Many in the position of making investment decisions are well-paid gatekeepers for the wealth of others and are judged more harshly for losses than they are praised for gains. In many cases, professional investors who lose money suffer career risk and as a result find it easier to say "no" to an investment opportunity, rather than to disclose their concern and engage in a discussion of how to address it. For instance, if the investor is worried about the company achieving the earnings projections made in the offering material, the company might obtain a third-party guarantor of a minimum level of earnings in a given period of time, or the company could offer, for whatever it is worth, a "put" or rescission if certain objectives are not achieved as projected. There are frequently imaginative solutions to problems, which can be created if there is flexibility and a desire to get a deal done.

Financing a company is first of all a matter of who and when. Who is going to provide the capital and when will they do so? There is also the critical issue of what form will the capital provider demand or require, as in the Golden Rule -- "those with the gold make the rules" -- is very alive and ever-present. Of course, the first round of financing is usually with family and friends of the entrepreneur and theirs is a mixed motivation -- both wanting to help and support the entrepreneur, and wishing to benefit if the entrepreneur succeeds. However, these "angel investors" typically have neither the experience nor mindset of a profit-only investor and they have defined profit differently. The result is they usually buy stock in the company and either lose their money if the company fails, or fails to get adequately financed. Or they are diluted greatly, along with the entrepreneur, if the company is successful. Successful companies usually require increasing amounts of capital, and later stage investors have the leverage at the time of the transaction.

From the investor's perspective convertible debt, or debt with detachable warrants, are the ideal way of investing in early stage companies. From the entrepreneur's perspective, non-voting common stock is the best means of raising capital. The middle ground used by professional venture capital investors is convertible preferred stock, which has liquidation preferences. The preferences provide that they receive back an agreed or imposed multiple of their investment in the event of liquidation, before the common shareholders get anything.

Early stage companies are not able to simply borrow money unless they have marketable assets to use as collateral or have loan guarantors satisfactory to the bank. In some cases a company could be well advised to pay a guarantee fee permitting a bank loan, as such a transaction, though expensive, does not have to require a lessening of ownership. VCs will also insist on representation on the Board of Directors, frequently with control of the company shifting to the investors in early rounds of investment. I remember well lunching with the manager of one of San Diego's largest VCs and being told that he "had to remove the CEO of 72% of the companies his firm had financed". As it happened, he also was effectively removed, since the fund did not perform well.

Financing companies requires an understanding of each company, its range of products, costs, margins, customer payment cycles, terms of sale, competitive environment, legislative risk issues, labor relations and degree of dependence of its key executives. Most importantly, the investment banker assisting the company must understand the company's projections as to revenues and profits, in order to know the amount of money needed for the company to achieve the point of being cash flow positive. All too frequently, companies raise too little money initially, and are forced to seek additional capital before they have developed to the point of profitability or sufficient cash flow generation. This subsequent round of financing is likely to be highly expensive for the company in terms of equity dilution. It is not unusual for the founders, having once

owned 100% of the company, to find themselves owning less than 25% once several rounds of financing have occurred.

As entrepreneurs go through the process, so important and so frequently ignored, of profit margin projection, they should understand the relationship between production of goods and services and the cost of doing so, with the knowledge that the funding to achieve their objectives will be expensive if available. The entrepreneur and the investment banker must also understand the competitive market environment to have a sound view of the ability to price the company's offerings at a level needed to achieve acceptable profits. Does it pay to go into a low profit margin business? This is a fair and necessary question. Incidentally, the reason why technology companies are attractive is that initially the margins are high due to barriers to competitive entry. Also, they do not have to be as well-managed as companies operating in lower profit margin environments. However, with the passing of time, technology companies tend to encounter competitive pressures, and pricing becomes an issue.

Recognizing the above problems -- and we can discuss them after my droning ends-- what would be the ideal form of financing from both the investors and the entrepreneurs perspective? The theoretical answer is straight debt if the entrepreneur is able to accurately predict the profitability of the company and is somehow protected from the real world problems of managing a business. Of course, this is an improbable situation, as no professional lender is going to provide a loan without the full guarantee of an entity of known financial strength; the fee for such a guarantee, if available, would be very high.

The best and most realistic answer is a revenue-sharing royalty, which leaves the founders and their associates with the ownership of the business and gives the investors, who provide capital, an agreed share of the company's gross revenues.

What's wrong with this concept from the entrepreneur's perspective? What's wrong is the royalty payments must be made irrespective of whether the company is profitable, unless there is an agreement to defer them under specific conditions. Will the royalty payments therefore add to the company's losses, perhaps triggering unpleasant events? Yes, this is possible and the terms of the royalty should be negotiated realistically.

What else is wrong with the sale of a percentage of revenues? The royalty purchaser will likely want to have some means of being comfortable the company will continue to meet the obligations of the royalty agreement. The royalty agreement, in the simplest of terms, is that X percent of sales will be paid to the royalty owner for an agreed period and if this is not done there will be consequences. Royalties can be paid daily, monthly, quarterly or whenever is agreed. The consequences of non-performance could be that the company might not be able to continue operating, since an agreed agent of the royalty owners could have acquired the intellectual property needed by the company for nominal consideration. It is also possible the agent of the royalty owners could have acquired other critical assets of the company, again for nominal consideration, which the company has the continuing right to use without charge for so long as the company was in contractual compliance with the royalty owners. If this were to be no longer the case, the right to use said assets would be cancelled. In the event the company were reorganized, as many companies are once they get into trouble, the agent of the royalty holders could be required to agree to a continuation of the royalty agreement, if agreed by the reorganized company.

In a well structured royalty financing there is much less risk for the royalty holder than the equity holder, but there is also theoretically much less margin of possible profit, especially if the company ultimately becomes the subject of an acquisition or public offering. As the critical assets of the company are owned by the agent for the royalty holders, the creditors of the company are not able to gain control of these assets.

What is good about a royalty transaction from the perspective of the business owner is the fact that there has been no equity dilution, even though there has been a diminution of profitability by the payment of the royalties. Royalties should only be sold by business owners who are comfortable with the prospects for their companies and who understand the achieving of gain frequently requires accepting the burden of risk.

Some other aspects of royalties should be understood. The royalty owner is only interested in the growth of revenues, not profits reported by the company. Therefore, royalty owners are not concerned with such matters as executive compensation issues or company policies regarding a range of matters, including the amount invested in research and development, marketing plans or the cost of employee and/or executive retirement plans. Also, the royalty holder does not care if the executives fly coach or in the front of the plane. It is only the growth or revenues and the assurance of the adherence to the royalty payment agreement that concerns royalty owners.

Royalty owners are entitled to be advised of the revenues of the company quarterly and have the benefit of an audit of revenues annually. They are not entitled to serve on the company's Board of Directors, or to have the same level of financial and operational information about the company, as would be the case if the investment were made as equity or even as debt.

It is important to note that royalty investors in early stage companies will want to hold an investment having an Internal Rate of Return in the mid 20% range as the company succeeds. Therefore, a successful company will naturally want to reduce the amount of royalties which are outstanding, as every dollar paid in royalties would be a dollar of profit if not paid. The royalty issuing company can acquire the ownership of some or all of the royalties issued either by purchase or redemption. Royalties can also be convertible into the shares of the royalty issuing company under specific terms and

conditions and may be called by the company, forcing a conversion, albeit on terms providing great benefit to the royalty holder.

An important element in the investor's decision as to the percentage of revenues necessary to be attractive on a risk/reward basis is the fact that royalties are inherently illiquid. Royalties are negotiable instruments, but without there being an exchange the spread between bid and offer is likely to be very wide, if it exists at all. Were royalties to be traded on an exchange, therefore granting them liquidity, the terms of royalties would be more favorable to the companies selling royalties and even more business owners would seek to sell royalties, which would increase the supply and benefit investors seeking increasing income opportunities. Remember, royalty payments increase as revenues increase, and therefore royalties may be a good inflation hedge as well as an attractive source of income.

This is why we are currently in discussion with various stock exchanges and government regulating bodies. We are convinced that royalty exchanges would be both highly profitable and would benefit those directly involved as well as the communities of the areas of the companies which were being royalty financed.

Royalties are not a new idea. Land grants hundreds of years ago, arrangements with ship captains, authors, farmers in sharecropping, inventors, playwrights, entertainers and mining, oil drilling and timber companies are all kinds of royalties. Royalties are used to separate participation in a company's or project's stated profits from the more easily-ascertained revenues.

Of course, the royalties we hope to facilitate will result in expansion of royalty issuer revenues and increased employment.

What's easier to determine -- the number of boxes coming off a production line or the profits made from making and selling what is in the box? The number of trees cut down or the profits made from the sale of the trees? Why get involved in questions about whether the profit calculations are fair and reasonable, when it is possible to simply own a piece of the revenues?

Incidentally, in the U.S. patent I was able to obtain the process of daily collection of the royalties due, and the use of company assets to secure contractual compliance are detailed.

This talk was not intended to pitch royalties to you, but the logic of the thought overtook me as I thought of the title Michael gave me to use. Therefore, it is Michael's fault.

Thank you.

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