Royalties – The Better Way of Financing and Investing in Companies and Projects©

By:

Arthur Lipper, Chairman
British Far East Holdings Ltd.

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1. Definition of royalties

Royalties are contractual arrangements between two or more parties in which the seller (Issuer) of the royalty, in the original transaction of the royalty agrees to pay the other party (ies), most frequently the owner of an asset the Issuer wishes to use (in this case money), an agreed percentage of the Issuer's gross revenues for an agreed period of time. *Royalties are not debt instruments and are an effective and equitable means for the investor purchasing the royalty to participate in the revenue growth of the enterprise selling the royalty.*

The patented Fair Revenue Participation Contracts (FRPC) is a unique and proprietary form of revenue participation, commonly known as a royalty. In the initial instance, the Investor purchases the royalty directly from an Issuer, The acquisition can be made by an individual directly from the Issuer or as a part of a group, through an investment banker, acting as either a principal or agent.

The FRPC approach has been deemed Shariah compliant and a Shariah certification or fatwah, so decreeing, has been received. Therefore, devout Islamic investors and issuers are able to use the FRPC process, unless used in conjunction with a fixed debt.

If the royalty issuing company has annual revenues of $50 million in a future year and has agreed to pay a 5% royalty, the Issuer is then obligated to pay the investor a total of $2.5 million. Royalty payments may be made by the Issuer; daily, quarterly or annually, as the parties agree.

The Issuer, if a privately owned company, is not necessarily obliged to disclose to the investor more than the amount of revenues received in the period. The investor has purchased and owns only the agreed percentage of future revenues for the agreed period of time, not any other aspect or asset of the company. Issuers and investors must agree as to the amount and timing of information to be made available to the royalty owner.

Therefore, the investor has no influence in the managing of the Issuer and holds a diminishing asset, as the royalty is for a specific period of time.

The royalty payments made by the U.S. Issuer are tax deductible to the Issuer and usually constitute ordinary income to the recipient Investor, once there has been a recapture of the invested capital. Therefore, royalties are an ideal form of investment for non-tax consequence investors such as pension funds, charitable institutions and those domiciled in tax advantaged jurisdictions.

2. History of royalties

Royalties have been used as a means of transferring specific benefit for the right to use specific assets for centuries. They are one of the oldest forms of financial instruments and transactions. Royalties avoid the frequently troublesome issues of profitability determination and disclosure.

Royalties convey a percentage of end-product sales or transfers usually, but not always, converted to currency, for all or a portion of the time the royalty Issuer has the benefit of using the asset, usually the funds paid for the royalty. The licensing of patented technology and literary properties usually result in royalty payments, sometimes called licensing fees.

Royalties are used extensively by extractive industries such as mining and oil and gas exploration. Royalties are also used in forestry and a range of agricultural activities. The owners of land, and of the right to use the land, often allow operators to work the property in return for revenue participations or royalty payments.

In financial markets, royalties have also been used as "kickers" or "sweeteners" to induce investors to buy securities and/or to extend credit.

Royalties are not new, but their acquisition has traditionally been a result of a non-cash transfer of assets. In our proprietary approach, the proposition is "use our cash and pay us a percentage of that which is produced – irrespective of whatever profit you may make or report on the production".

3. Advantages of royalties for investors

Investors purchasing and owning equity in a company are usually motivated by a wish to profit. However, they are essentially transients as they only buy the shares with a view to selling them, hopefully at a higher price at some later time. Frequently, in the case of early stage and especially technology oriented companies they are playing the "greater fool theory" game. These investors anticipate both the company doing well as reflected in the reporting of ever increasing earnings and of other investors believing the trend will continue and therefore paying a premium price/earnings ratio. It is the multiplier effect of the high P/E and increasing earnings which create significant gains. If and when royalties are traded publicly, a similar premium pricing will be applied to royalties issued by companies reporting increasing revenues.

A corporate reality is the reporting of profit in successful companies is essentially discretionary, as management decisions can dramatically affect the level of reportable profits. Frequently, it is believed to be in the company's longer term best interest to take actions in one period which reduce reportable profits. Such decisions could be increasing; wages, research, marketing or other expenditures.

In successful privately owned companies the interest of the owners is to report lower earnings than might be reported were the company publicly traded as the lower the reported earnings the less the income tax liability.

In the case of royalties, the percentage of a company's revenue to be paid the royalty holder is fixed and the royalty holder is insulated from management decisions adversely impacting reported earnings as well as from competitor-based profit margin declines.

4. Advantages for entrepreneurs and company owners

Business owners, particularly founders of businesses, believing in the increasing earning potential of their companies are, and should be, reluctant to sell equity in their enterprises. Indeed, investors might pause to consider the sincerity of the entrepreneur's earnings projections if the entrepreneur was anxious to sell shares at a level which would be a bargain if the projections were achieved – if there was an alternative means of raising the necessary funds.

The sale by a company of a royalty is an alternative to the sale of equity and of incurring debt. The payment of the royalty obligation during the royalty payment period will cause a lessened level of cash flow and profit for the royalty Issuer. Therefore, only companies having or predicting healthy profit margins should consider selling royalties. Similarly, investors should only consider buying royalties if there is likely to be an Issuer profit margin sufficient to accommodate the royalty payments.

Frequently those investing in the stock of companies and therefore anxious for the company to report ever increasing levels of earnings, believe they should, by right of significant ownership, have an ability to advise company managers on various aspects of the company's activities. In many cases, investors require a board of director position in companies in which they are invested. The presence of outside directors tends to increase if companies fail to achieve predicted objectives. Royalty owners do not have ownership in the royalty Issuing company and have no right to "assist" managers with their advice.

Royalty owners are not concerned with levels of executive compensation or other factors equity investors might question.

Royalty owners do not benefit from the reporting of increased earnings or the payment of higher income taxes.

5. Disadvantages of royalties for investors

Royalty owners do not have a contractual ability to influence managers of the royalty Issuers.

Royalty owners do not, unless they cover the matter in the terms of purchase, have a voice in the sale or merger of a royalty issuing company.

Royalty contracts do not survive bankruptcies. Therefore, in our proprietary approach the matter is addressed by a transfer of "critical assets" at the time of royalty purchase.

Royalty payments received are reportable as ordinary income for tax purposes after the original investment has been recaptured by cumulative royalty payments.

Royalty owners do not benefit from investor enthusiasm regarding an Issuer's future prospects for higher earnings or greater market share.

Unless adequately provided for in the terms of the royalty purchase agreement there is naturally an investor concern as to receiving a full, timely and accurate accounting of revenues.

6. Disadvantages for entrepreneurs and company owners

The existence of a significant royalty will reduce the value a prospective buyer of the company will be willing to pay.

The existence of a royalty will be, in the future, a matter an underwriter or placement agent of an Issuer's equity will have to consider and subsequent financings may be more difficult or costly.

Royalty payments have to be made regardless of an Issuer's actual or reported profitability. Royalty payments are a fixed cost of doing business and create an operating leverage which the sale of equity does not.

Royalties can and, in many cases, should be redeemable.

Royalties can have terms deferring and accruing royalty payments under certain conditions.

7. Mechanics of operations in the use of royalties

There are only 4 points which have to be agreed between Issuers and Investors. These are:

1. **The amount to be paid for the royalty. Is the amount sufficient and reasonable in light of the size and scope of the Issuer?**
2. **The percentage of revenues to be paid to the royalty owner. Royalty payments can be changed based upon circumstances during the period of royalty payment obligation.**
3. **The royalty payment period. The royalty payment period should be of sufficient duration to permit the royalty owner to earn a sufficiently attractive return to justify the purchase of the royalty.**
4. **The means of securing the royalty payment obligation of the Issuer. In our proprietary approach the Issuer's intellectual property and other assets necessary for carrying on the business are transferred to a mutually agreed party. That party then provides an exclusive, international, royalty-free license to the Issuer to use the transferred assets, for so long as the royalty payment obligations are met.**

Amount – Is the amount sufficient for the Issuer to achieve stated objectives? Is the amount reasonable in light of market conditions and projections?

Percentage – Does the percentage of future revenues provide a satisfactory return to the royalty purchaser if the revenues projected are produced? Is there a minimum level of revenues guaranteed or a mechanism for increasing the return in the event revenues are at a lesser than expected level? There can be minimum levels of payments stipulated.

Duration – Does the royalty payment period cover a sufficient number of years to produce the anticipated return to the royalty owner? When does the royalty payment period begin and when does it terminate? Are there implied or expressed minimums?

Security – How is the royalty purchaser protected from either possible Issuer fraud or failure? What are the mechanics of the protection? Does the use of an independent trustee satisfy the natural concerns of the Issuer while still providing the protection needed by the royalty purchaser?

Each of these issues is subject to negotiation and may differ by virtue of circumstance and the needs of the parties on a transaction by transaction basis.

8. Methods of creating liquidity for royalties

Were there to be a liquid market where the original purchaser of a royalty could sell the royalty the original purchaser would likely be willing to accept a lesser percentage of revenues than if the purchaser had to face the prospect of holding the royalty to its maturity.

A reduction in the royalty percentage desired or required by Investors would encourage a larger number of company owners to use the royalty approach in the financing of their businesses. The greater the supply of royalties the greater will be the interest of investors and all parties would benefit.

Royalties as negotiable contracts permitting sale and transfer can be traded; directly between interested parties, with a dealer or broker or on a Royalty Exchange, through which members or those having trading privileges could exchange information and transact business. It is the Royalty Exchange which would provide the greatest liquidity and therefore be in the best interest of all concerned. This is the reason for our continuing interest and effort to establish such an exchange.

Royalties, regardless of the trading forum, will trade on the basis of a predicted future value of the anticipated royalty payments. Absent any Investor benefit derived from the Issuer's critical assets used to secure payment obligations, there would be no value to a royalty if there were no prospects for revenues. However, if there were clear prospects for increasing revenues then the anticipated yield from the royalty payments would trade at significant premiums to the interest yield on fixed-interest obligations, as it would naturally be assumed the revenues of the Issuer would increase, as opposed to any fixed-interest payment.

9. Conclusion and prediction

I believe that ultimately investors, business owners, investment bankers, fund managers, attorneys, accountants and professional corporate advisors will conclude that royalties are "the better way" of financing and investing in many companies and projects.

They will so conclude as the advantages of isolating the terms and source of financing from the operations of a business are logical, appropriate and fair. The providers of capital do not have to be the captives and frequently the victims of the value change predictions of the ever optimistic capital seekers.

Also, through the use of royalties the owners and managers of businesses do not have to make operational decisions based upon a fear of losing their jobs or control of the business in the event they "do not make their numbers".

First royalties will be used in the financing of privately owned companies by aware investors and entrepreneurs, and then royalty investment funds will be formed to create increasing flows of income for passive investors. Then secondary trading of existing royalties will begin at the dealer/broker level. Finally, the trading of royalties on electronic exchanges on a 24/7 basis will commence as a natural consequence. It is also possible that options and futures relating to exchange traded royalties will eventuate.

It will all happen as the device of royalties, intelligently used, meets the natural needs of the parties.

10. New Ideas:

There are refinements and improvements to the royalty approach which naturally evolve through the course of negotiation. These include:

a. **Royalty Investment Funds – The receipt of quarterly distributions resulting from an interest in a fixed percentage of a portfolio of revenue increasing companies will produce extraordinary returns. The portfolios can be tailored to the needs and preferences of the investors and can be; geographic, activity focused and of different stages of size and development. These funds can be leveraged and can either distribute or reinvest the collected royalty payments.**

b. **Investor Issued Royalty Futures (IIRF) – As royalties are simply financial instruments, contracts, between two or more parties, they can be issued by parties having no connection to the company whose revenues are the subject of the contract. Royalties can be viewed as futures, as a percentage of the cumulative revenue flow is the subject of the contract. In other words, the parties could identify a publicly traded company and express, through a negotiable contract, divergent views as to levels of that company's future revenues.**

c. Royalty Exchange – As has been described, the natural result of increasing numbers of Issuers and Investors creating and trading royalties is the creation and operation of an international electronic contract market. This could be a section of an existing exchange or as a new and independent Royalty Exchange.

d. Redeemable and convertible royalties – Due to both the needs of Investors and Issuers in many cases there is a desire to have in place a mechanism for the termination of a royalty agreement and obligation. Such a termination can be achieved through the use of a redemption clause. The primary consideration in the issuer initiated redemption is "what's fair" as a consideration for the denial of additional years of royalty receipt by the Investors. As royalties can be made to be convertible into equity and/or debt of the Issuer, there are a broad range of possibilities for satisfying the needs of the parties.

e. Issuer third party guaranteed royalties – As with all investments, the perception and reality of investor risk is a major factor in the determination of pricing or anticipated yield fairness. Were some level of royalty receipt guaranteed by an entity acceptable to the investor the increased Investor benefit would be reflected in a lessened demand for royalty payments and a portion of the differential could be used to induce the issuance of the third party guarantee.

There will be lots more improvements and refinements in the use of royalties and both Investors and Issuers will benefit.

Arthur Lipper, Chairman
British Far East Holdings Ltd.
Chairman@REXRoyalties.com
858 793 7100 – Skype: artlipper