The Second Mouse Gets The Cheese

Refinancing Companies Using Royalties©

By Arthur Lipper

A great deal of time, effort and money are consumed in the creation of businesses. The blood, sweat and capital of both entrepreneurs and investors are placed in the balance, but sometimes, despite the best efforts of all concerned, the desired result is not achieved in a reasonable time, and the company cannot continue in its current form.

Yet the basic business -- its assets, people, customers and markets -- are still in position, and the potential may be redeemed if all parties are willing.

In order to avert a total loss, some businesses can be refinanced or reorganized.

In many refinancings and in most reorganizations, the original equity holders and founders are penalized by significant dilution, if not total loss of ownership.

In some cases the providers of new capital allow the former equity holders, at least the ones deemed necessary for the continuation of the business, to hold options to buy a negotiated amount of stock, usually at a price relative to that being paid by the new investors.

The goal of all those investing their effort, reputation and capital is ultimate ownership of a successful company. So equity dilution as an outcome of a business restart is the enemy.

One alternative may be the sale of royalties on the gross revenues of the company. This allows business owners to continue their ownership, albeit in a company having the responsibility of making royalty payments.

If the company has, or can be realistically projected to have, a significant profit margin, the sale of a royalty on the company's revenues may work for all concerned, as a means of raising capital. This approach allows for equity retention by a company prepared to narrow its profit margins, and allows the owners to retain more of the company. It also generates an immediate, ongoing stream of income for investors, unencumbered by the traditional mechanisms of equity valuation and liquidity.

Depending on the industry and projected gross profit margin, royalty issuing companies under the tight constraints of recapitalization or reorganization may be able to sell a royalty for approximately 50% of the revenues.

Royalty purchasers will require returns in excess of 20% Internal Rate of Return (IRR) to justify the lack of liquidity, and the risk of projected revenues not being achieved, by a company facing this type of challenge.

The best arrangement for both investors and business owners is a combined debt and royalties structure, which can be fully understood through the detailed model presented on the website, http://www.REXdebt-shareRoyalties.com

In brief, this structure suggests that the company borrow the amount necessary to achieve its objectives for a five-year period at a reasonable rate of interest. Following completion of this five-year loan period, a 1% or 2% royalty would be paid for 15 years. As with any royalty transaction, the terms are fully negotiable.

Original purchasers of royalties may wish to sell them when their original cost has been returned, if they can also receive a satisfactory IRR for the period in which the royalty was owned. The buyer of the royalty from the original purchaser could be either a tax-exempt institution or an aggressive investor interested in leveraging the proven flow of revenue income. The royalty will have been seasoned and demonstrated contractual compliance, as well as a likely and reliable pattern of increasing revenues.

The investor perspective in financing a restart is interesting, since the errors and shortcomings of the failed effort can be analyzed and corrective actions taken. Customer reaction to the product or service can be gauged and more realistically predicted. The restart investor is likely to be able to strike a much better deal (higher returns, moderated risk) than earlier investors. New and stronger executives may replace weaker players, frequently the founders. The founders of a

business can often make a major contribution in a different area of responsibility than they originally held.

Assume that the original concept, product and market on which the company was based are still sound. It may be better to invest in the restart of such an existing company that has made some mistakes and learned from them, rather than in a new company that has yet to be tested.

Refinancing provides an investment opportunity to benefit from the knowledge of prior problems, providing a more attractive basis of participation. This participation may best be structured as revenue sharing, or royalties, rather than profit-sharing, or equity.

Arthur Lipper, Chairman
British Far East Holdings Ltd.
Chairman@REXRoyalties.com

with the assistance of Michael North

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