Royalty Financing

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Where's the Money?, Fall, 1999

Summary: This primer on royalty financing was written as a chapter in the book called, Where's the Money. I wrote the book under agreement with its' authors Dwayne Moyers and Art Beroff and with Entrepreneur Media, Inc.

RESUME: ROYALTY FINANCING
Definition or Explanation: Royalty financing is an advance against future product or service sales. The advance is paid back by diverting a percentage of the product or service sales back to the investor who issued the advance.

Appropriate For: Established companies that have a product or service or emerging companies about to launch a product with high gross and net margins. Also companies with elastic pricing, i.e. the ability to raise prices without any impact on sales. In addition, royalty financing is most appropriate for companies which experience a quick cause and effect between marketing activity and sales increases.

Supply: Substantial. Royalty financing can appeal to investors who typically do not make investments in private companies. In addition, angel investors, venture capitalists, and even state, city or regional economic development agencies can be sold on the concept of royalty financing.

Best Use: Financing intensive sales and marketing activities.

Cost: Inexpensive for companies whith high margin products or services.

Ease of Acquisition: Relatively easy because the technique appeals to a wide variety of investors. In addition, because royalty financing is essentially a loan, it generally does not provoke state and federal securities laws.

Range of Funds Typically Available: $50,000 to $1 million

ROYALTY FINANCING: THE SECRET WEAPON
Many companies still in their formative stages face a difficult dilemma when looking for equity capital. Equity investors, whether they are angels or venture capitalists, often demand a big piece of the company because of all the risk they are incurring. The dilemma is compounded by the fear that, if the company gives up 30%, 40% or even 50% of the company on the first round of outside financing, there'll be nothing but a grubstake left by the time the company goes public.

INFO BOX:

A Good Deal: Royalty financing is a good deal for investors who typically do not invest in early stage companies because they are able to taste the fruits of their investment almost immediately, and if the company prospers, every month or quarter thereafter.

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Enter royalty financing which eliminates the dilemmas of equity financing by removing them from the picture altogether, according to Peter Moore, founder of Banking Dynamics, a consulting firm in Portland, ME, which helps companies raise capital, and a proponent of the royalty financing technique. "Instead of selling equity," says Moore, "a company simply pledges a piece of its future sales against an advance provide by the investors."

A CASE IN POINT
Here's how Moore structured a financing to help a software company turbocharge its sales.

Rather than angel investors, Moore approached the Greater Portland Building Fund, and Coastal Enterprises, Inc., quasi-public economic development organizations charged with developing business in the state.

But instead of a loan or equity, Moore sought an "advance" of $200,000 for his client against its future sales. If the advance was made, the investors would each get 3% of the software company's sales for 10 years, or until they received payments totaling $600,000. This $600,000 would represent the original $200,000 investment, plus $400,000 more.

At the broadest level, in order for the investors to get the agreed upon $600,000 within the maximum allowable time frame, the software company would have to generate total sales of $20 million over 10 years. Although the software company had less than $1 million in sales at the time, it had over the course of its three year life, double sales each year. "This was a big selling point," says Moore. Moreover, he says that investors were comforted by the fact that the company's software program, which helps companies manage hazardous waste streams, meant there were 300,000 potential customers.

The deal was structured so that the time frame was flexible -- up to 10 years to make repayment -- but the return -- $600,000 -- was not. Because of this, the return which the investors could earn was variable as well, and ranged from pretty good to exceptional. Specifically, if the software company repaid the advance in 10 years the investors would earn a compound annual return of 11.6% on their investment. If however, the company's sales mushroomed, and $600,000 was paid to the investors in five years, their compound annual return mushroomed also to 24.5% -- a rate which even an institutional venture capitalist would have to admire.

INFO BOX

Don't Forget: The initial advance from the investor to the company is a loan [italicize loan], not an equity investment, and as a result, does not in general provoke securities laws.

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THE BUCKS PILE UP HERE
Royalty financing can provide some truly spectacular returns to investors, if sales take off like a jack rabbit. Here are rates of return associated with roylaty financing taking into account the amount of time it takes an investor to get two times their money back.

Repayment at the end of:	Compound Annual Return
Year 1	200.0%
Year 2	73.1%
Year 3	44.2%
Year 4	31.6%
Year 5	24.5%
Year 6	20.1%
Year 7	17.0%
Year 8	14.7%
Year 9	13.0%
Year 10	11.6%

It took Moore and his client about four months to hammer out all the details of the deal. One of the key terms that Moore negotiated for was a delay in the commencement of royalty payments. Specifically, royalties did not start to accrue until 90 days after the deal closed. In addition, the actual royalty payments did not have to be paid until 60 days after [italicize after] the revenues were recognized. "All in all, there was five months from the time the company received the financing, and when the first payment was due. This gave them the time they needed to put the capital to work and start producing sales."

INFO BOX

Shop Talk: The concept of 'revenue recognition' takes on greater significance within the context of a royalty financing because it defines the payments to the investor. Should revenue be recognized when the customer agrees to purchase the product or when they pay for it or perhaps after a 30 day return period has elapsed?

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IT'S A GOOD THING
Royalty financing is extremely flexible and can be structured in a myriad of ways. But regardless of the final structure, the technique delivers a host of advantages which entrepreneurs should carefully consider before rushing to sell equity in their companies

- Attractive to Individual Investors. Generally speaking, it's difficult for most individual investors to get involved in financing private companies. Many times, they don't have enough capital to make a difference. Many times individual investor's don't have the minimum net worth requirement established by state securities regulators. But perhaps one of the biggest barriers is that buying straight equity general only provides a return if the company gets acquired or goes public, two very big ifs. Moore speculates that a monthly or quarterly return -- which happens as long as sales occur -- would be more preferable to individual investors than the total absence of a yield and zero liquidity that is typical of early stage venture deals.

- Bypasses Securities Laws. Because the royalty advance is, at the end of the day a loan, it does not, in plain vanilla form, provoke any state or federal securities laws. Most equity financing, where companies sell shares to individual investors require complex filings that mean significant legal and accounting fees.

- Increases Future Financing Options. A company funded by royalty payments increases its financeability down the road. If the funds do in fact ramp up sales, the company becomes a more attractive candidate for additional financing. In addition, sometimes the presence of one kind of equity investor precludes the participation of other kinds. For instance, a company financed with institutional venture capital funds cannot, in most cases, ever go back to raising money from individuals. But by "saving" itself for outside investors to a later round of financing, a company keeps its options wide open.

- Preservation of Equity. The royalty structure preserves the equity positions of the founders. Remember, there are only 100 percentage points to go around, and they begin to disappear with alarming ease once a company begins to raise outside capital. In addition, when founders are able to hold on to a significant portion of the ownership they may be more incentivized to make it successful, than entrepreneurs who have given away most of the store.

NOT FOR EVERYONE
It may sound as if royalty financing is a panacea. Unfortunately, it's not. There are several instances where royalty financing will not work.

- Thin Margins Are A Problem. If a company's gross margin (sales less cost of goods sold) is just 10%, and 6 percent goes to royalty payments, then the remaining 4 percent doesn't leave much room for making any money. In the above example, the software company which Moore financed had a gross margin of 90%. With margins this wide, it could comfortably give up 6 percent of the sale.

- Competitive Pricing. Royalty financing works best for companies whose pricing is fairly elastic. If you can raise your prices to cover the cost of the financing the marketing of the product, and not lose any customers, you are a better candidate than a company where customers are price sensitive.

- Lengthy Sales Cycles. Royalty financing won't work for companies that do not see a rather immediate cause and effect between marketing efforts and sales. "You've got to be able to turn on sales like a spigot," says consultant Moore. Otherwise, one of the primary benefits for which investors are in the deal -- namely a monthly royalty check -- becomes seriously compromised. The one thing a growing company doesn't need are unhappy investors.

This limitation goes even deeper. Royalty financing is not appropriate for financing product development. After all, making something new is tricky. Success may be elusive, or -- and how often does this happen? -- it takes much longer to develop the product or service than originally anticipated.

- Good Marketing Skills. Obviously, just having a product can't win the day. For companies to effectively use this technique, they've got to be able to sell [italicize sell] and market [italicize market] their wares. "Obviously," says Moore, "you have to be able to inspire confidence among investors that you have the skills and experience that will move products or services off the shelf frequently and quickly."

INFO BOX
Taking Action: To get a primer on royalty financing, send a self addressed stamped envelope to Mr. Peter Moore, Banking Dynamics, 97 A Exchange Street, Portland, ME 04101, 207-772-2221.
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