

## **Royalty-Based Financing**

### ***Description***

With this tool a CEDO receives investor financing for a venture from which the return is paid back through royalties (a percentage of each sale or of overall sales receipts) over whatever period of years is needed to provide the agreed-upon pay-back to the investor. This contractual relationship can finance either starting a company or expanding one. Royalty-based financing is appropriate for a venture that has considerable promise for long-term success and a high margin per sale, but does not entail an expectation of fast growth or large scale expansion - features usually required for conventional venture capital.

This venture capital technique actually has only rather infrequently been used, although it would seem to have interesting advantages, both for investors and for the business owners. Historically, it has been a technique for economic development programs of a few states in the U.S. Because governments are ordinarily less interested in major financial returns and do not seek large, quick returns, royalty-based financing is more easily accepted in the public sector than in the private sector. To the contrary, however, if the government or economic climate changes, such patience may no longer exist; and the most active programs in fact lapsed with the troubled economy of the late 1980s-early 1990s.

Private venture capital firms investors have virtually ignored this technique. The (U.S.) private investment firm (capitalized at about \$3,000,000) that is known for its inventive specialization in this technique has been successful in obtaining its target return of five times its original investments within five years. This is attractive, but not as great as what conventional venture capital equity investors expect.

For the investor, the deal would conventionally be structured as a note secured only by a claim against sales receipts until the agreed-upon multiple was reached. The risk for the investor (aside from failure of the company) is an unexpectedly long payback period. There are many advantages for the owners, including the fact that they do not have to give up any ownership stake and that the payments are not fixed but fluctuate with the annual sales level of the company. That is, payments are geared to the firm's success. Also, accounting conventions permit the company to charge as an expense some portion of the annual payments and, ultimately, all payments over the original investment principal—i.e., as an analog to interest on a loan.

While a CEDO might seek this sort of financing on behalf of a local company, the concept is especially appropriate for financing the CEDO's own venture, if in fact the business is likely to have the kind of sales that make the deal attractive to an investor.

***Benefits***

The main advantage of this technique is that it provides "patient money" - that is, the venture does not have to begin to pay back until it is selling successfully. That is a major aid in start-ups or expansions which need to restrict the drain of early costs. Also, the fact that no loss of ownership rights is involved can be a big selling point for community-owned ventures.

***Major challenges***

Because royalty-based financing is not a frequently used tool for investors, finding a friendly capital source that is familiar with this technique may be the most difficult task. However, if the CEDO has general access to potential patient money, it can suggest the royalty format as an alternative for the investor. Again, this technique is appropriate only for products/services with a high profit margin - typical of successful new software, for example.

***Some practical steps***

There are no particular specialized steps for this sort of financing agreement, as opposed to any other. It will entail the same sort of negotiations as any investment agreement. Naturally, the foundation of the agreement will be the strength and prospects of the target venture, most particularly a reasonably firm projection of scale and timing of sales.

***Resource organizations & contacts***

The private firm that has used this technique, Royalty Capital Fund, is located in Lexington, MA – tel. 781-861-8490. Consultation for a fee is available from the president, Arthur Fox.

***Publications***

- Julia Ann Parzen and Michael Hall Kieschnick's book, *Credit Where It's Due* (Temple University Press, Philadelphia, PA, 1992), discusses royalty-based financing in the format of an economic development finance fund. But the same principles prevail for an individual investment.
- "Hidden Treasures," an article by Eleena de Lisser in the *Wall Street Journal*, March 30, 1998, describes innovative investment strategies, including the Royalty Capital Fund.