Changing the way the world invests
in privately-owned and early-stage companies©

By: Arthur Lipper

The logo above is intended to represent the investment decision-making process of balancing the possible risks and rewards of investing when viewed through a telescope allowing a view of future events. This is what successful investing is all about, balancing risks and rewards in light of what is to come.

After more than a half a century of both advising and observing professional equity investors I offer the following observations:

> **Investment management success is achieved by portfolio diversification and an analysis of data when applied to longer-term objectives.**
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> **The importance of individual investors continues to lessen as increasingly both equity and debt investing is done by professional portfolio managers, especially those associated with organizations having a successful marketing effort.**
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> **The primary concern of investment managers is that of personal career risk by incurring losses in non-conventional investments.. As in many other situations, the risk to the fiduciary of under performing is greater than the reward for over performing. This leads to a concentration of focus on companies and industries found attractive by others.**
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> **The portfolio focus and concentration on issues broadly believed to have a favorable financial future and therefore already selling at**

price/earning levels anticipating continuing success leaves the positions vulnerable to reported disappointing results. So the company's success is in the price of the stock, but not that of a less than generally expected result.

Only a small segment of investment managers have been able to consistently generate a record of significant competitive success.

Equity investment managers and investors have benefited from the inflation experienced in much of the period since WWII.

There are vast amounts of funds not invested in equities and a reduction in the number of areas for investment in which the current price and most recent results favor investment. In other words, the investment manager is being forced to look further into the future to justify the employment of funds.

The most dramatic gains in corporate results and the price of stocks have been in the younger or early-stage companies. Of course, these have also been the most vulnerable to investor disappointment of results based on over expectation.

So what do the above observations indicate? The indication is that only a relatively few professional investment managers have been able to competitively excel for a consistent period, that there will be an increasing amount of money to be invested in early-stage companies and that it is more difficult for investment managers to invest comfortably in publicly traded equities.

In part, as a reflection of the foregoing, the concept of financing the growth of companies through a purchase of a royalty or share of their revenues for an agreed period has been developed.

Believing that it easier to predict a trend of a company's revenues than the level of future per share earnings the company will report, buying a percentage of revenues makes sense.

Also, recognizing that in the case of many privately-owned companies seeking growth capital there is a reluctance to report maximum profits and pay maximum taxes, the solely revenue focused royalty is attractive to both the royalty issuing company and to the investor.

In royalty investing the negotiation between the investment managers of a royalty income fund, which we believe will be the next important development in world finance, and the business owner or manager will focus on the following:

Amount to be paid for the royalty.

Percentage of defined revenues on which the royalty is based.

The number of years in which there is a royalty payment obligation.

The collateralization or means of assuring the royalty issuer's contractual compliance.

The amount paid for the royalty should be sufficient to assure the royalty issuer of achieving a positive cash flow, including recognition of the royalty payments.

The royalty rate or percentage of revenues should be sufficient to attract investors and be something in excess of an Internal Rate of Return (IRR) of 20% per annum over the course of the royalty payment period, based upon a realistic projection of revenues.

The payment period can be adjusted to meet the needs of the parties, but the shorter the period the higher must be the royalty rate for the investor to achieve the investor's objective.

The more comfortable and secure the investor is regarding the assuredness of receiving the contracted for payments the more favorable will be the terms of the royalty. Royalties and debt can be combined.

Royalty rates and royalty payment periods can reflect the cumulative levels of royalty payments received by the investors.

Royalties can also be redeemable, convertible into equity, third party guaranteed as to either or both minimum levels of royalty payments to be received periodically or cumulatively and can be capped as to the maximum amount to be received in any period.

Royalties do not own any part of the company issuing the royalty and do not have any voting rights or other means of influencing the management. Royalty issuers can be encouraged to be highly conservative in their revenue projections by using a "Scaled Royalty" approach in which there

is both a benefit and a penalty for a variance in the revenues achieved versus the projected amounts.

For American taxpayers, royalty payments are tax-free during the period of capital recapture. The income from royalty payments become "ordinary" income once the amount paid for the royalty has been recaptured.

Royalty payments made by companies are tax deductible by the company.

The approach we recommend to both investors and business owners is that which we were able to patent and which is generally described in this writing.

What will be needed to accommodate the many billions of dollars seeking investment in early-stage and privately owned companies will be a corps of trained business analysts capable of both assessing the sustainability of a royalty issuer and an industry experienced assessor of the revenues projected by the royalty issuing company.

There will also have to be experienced commercial bank loan officers recognizing that additional royalty-based capital acquired by privately-owned companies having significant growth potential make them good prospects for term loans on fair terms.

Finally, there will be a need for institutional investors, probably pension and other tax-exempt funds, prepared to buy from original investors royalties issued by companies with growing revenues and having demonstrated the practice of honoring their contractual obligations. The terms of acquiring seasoned royalties, with higher revenues and therefore higher royalty payment obligations will be such that the investment objectives of both the original investor and the new institutional investor will be met.

Eventually royalties will be traded on exchanges much as securities are currently and that is our ultimate wish and expectation. There is no reason why royalties should not become a major force in international financing of companies, creating millions of jobs.

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