Revenue Royalty Notes

What are they?

Why would a company use them for raising capital?

Why might I consider investing in them?

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Summary

While most business financing is either equity or debt, another option is revenue royalty-based financing ("RRF"). Royalty financing has been around for quite a while, even though it is not in the mainstream of most issuers' and investors' sources of capital or places to invest. It has been used in certain instances by issuers to fill some of the gaps between traditional debt and equity securities and investors' risk and return requirements.

Structure and Issuer Company Characteristics

With RRF, a company generally obtains a loan which, by its terms, is paid back to the lender expressed as a fixed percentage of gross revenue, or royalty (e.g., 1-8%), and which may also have a minimum required return, such as an interest rate, along with a cap set as a multiple of the principal amount of the loan, e.g., 1.3x-2x the original amount loaned.

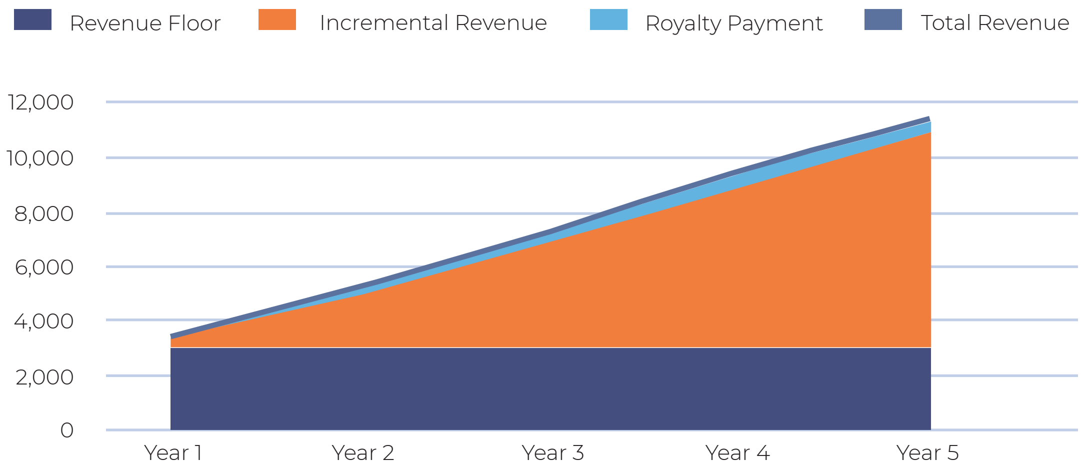
THE RRF INSTRUMENT IS DESIGNED TO OFFER:

- **Investors** - Higher current income with equity-like total return upside, albeit generally capped; and
- **Issuers** - Growth capital without the dilution of selling additional equity in their company.

Such arrangements have been used for some time in various industries such as Software as a Service (SaaS), oil and gas, media/entertainment and biotech.

Increasingly, this financing structure is being used by early stage growth companies in particular in the consumer products sector where companies often have demonstrable high revenue growth and good profit margins. In particular, consumer products companies which are now using highly targeted social media led advertising (e.g., platforms like Facebook, Instagram, Messenger, etc.) and/or leveraging advertising programs on Amazon or through Google Ad Words can be very attractive candidates for issuing RRF securities.

Graphical Representation of RRF



The graph above shows a royalty structure without an embedded interest rate, i.e., royalty only, and calculates payment as a function of incremental revenue earned above a floor. The royalty may, of course, be calculated as a function of all revenues. RRF is highly flexible, and customized structures can accommodate any set of circumstances.

Background

Since the capital market crisis of 2008 and the ensuing economic recession and recovery, small businesses have been challenged disproportionately due either to limited access to capital or to capital provided only with harsh or very expensive terms. Banks have stepped back from that small business market, reducing credit or eliminating it outright for many early stage companies. Because they are looking for so-called “Unicorns,” venture capital firms’ terms also have become much more stringent by insisting on very large investments (which small companies cannot absorb) or at valuations and terms with which companies are unhappy or unwilling to accept, or both.

RRF - POTENTIAL BENEFITS FOR THE ISSUER

- No dilution – equity investors keep all their equity and control
- No fiduciary duty to the investor — but a contract, in the form of a loan
- Investor has no voting rights but does have affirmative and negative covenants from the issuer
- Allows the company to grow incremental revenue and brand without having to commit to lofty, fixed cash-flow investment return expectations often needed in debt financing for an early stage growth company
    - Company attributes for which RRF may make sense
        - Healthy gross margins on sales
        - Visible and meaningful sales pipeline with good history of sales growth
        - Strong connection between use of proceeds and sales generation and growth, e.g., advertising-based demand generation program (i.e., social media, other channels)
- Like a loan, disagreements over company equity valuation do not block the investment
    - RRF agreements include many typical loan terms, such as amount of principal, repayment terms (usually with amortization), maturity date, prepayment, events of default, default remedies and reps and warranties
- Unlike a loan, payments are flexible and variable, proportional to revenues
    - Company can prepay the loan, but must pay the capped repayment amount.

RRF - POTENTIAL BENEFITS FOR THE INVESTOR

- Current income payment generally begins quickly, subject to revenue growth and royalty structure
    - Incremental revenue payments paid monthly or quarterly as % of gross revenue (e.g., 1-8%), as defined, along with interest rate, if any
    - Royalty payments provide return regardless of company's profitability
- Capital can be repaid within three to five years or sooner, subject to rate of revenue growth
- The upside may be as attractive as owning equity; target IRRs may approach or exceed those achieved in traditional private equity, although this is not guaranteed
- Since the risk of loss of capital is reduced vs. equity, reinvestment of royalties allows potentially higher IRR in an investor's overall portfolio along with diversification
    - Return of investor capital is not dependent upon issuer being profitable (distributions) or sale of the company (return of principal)

SAMPLE REVENUE ROYALTY STRUCTURE: TERM LOAN PLUS ROYALTY

- A 3- to 5-year term loan repaying principal plus a return on principal, based upon,
- A royalty set at 8% of the issuing company's top line incremental gross revenue. (If there is an interest rate, then the royalty rate likely would be lower, e.g., 2%)
- No fixed schedule for repayment of principal, other than at maturity, but quarterly (or monthly) payment of royalty, as earned. Instead, the return, a payment of the royalty on incremental gross revenue, includes an overall cash-on-cash return which is fixed at, say, 1.5x of the principal amount payable no later than maturity.
- In this structure, even if there is no royalty paid during the life of the loan, the issuer still is obligated to pay back the original principle plus the increment, or for $1 of original loan value, the investor receives at maturity $1.50.

Conclusion

Royalty financing can be an economically attractive alternative for both investors and borrowers. Properly structured and underwritten, the security can meet the needs of companies requiring funding that, heretofore, banks often provided but, given the regulatory pressures to tighten credit standards, can no longer be counted on to offer.

Companies needing growth capital or funding for acquisitions, a buyout of existing shareholders, bringing a company private, or for a recapitalization that distributes funds to shareholders can look to royalty financing as a highly versatile source of funding that need not dilute their ownership and provides a competitive source of capital.

If you want to know about the basics of investing in debt, go here: *https://carofin.com/knowledge-base/security/debt-investment-overview/*

If you would like a bit deeper dive into investing in private debt and what to look out for, go here: *http://carofin.com/wp-content/uploads/2019/01/Investing-in-Private-Debt.pdf*

If your interest is more broadly directed at Alternative Investments in general, go here: *https://carofin.com/knowledge-base/security/why-invest-in-alternative-investments-here-are-3-reasons/*

As always, please reach out to schedule a call if you have questions. (828.393.5401)

And, if you are ready to consider investing in our alternative investments, please click here.