Revenue Royalty Notes (or “Royalty Notes”)

A form of debt investment with equity return potential ... an alternative for investors pursuing exceptional current cash returns.
Royalty Note investment has been around for many years, although it isn't one of the more broadly understood or available alternative investment choices. Carofin believes Royalty Notes can be a valuable addition to investors who are looking for higher levels of current income within their alternative investment allocation.

**THE BOTTOM LINE IS THAT ROYALTY NOTES CAN PROVIDE INVESTORS:**

- Higher current income than other private lending opportunities;
- Equity-like IRR return upside, albeit capped;
- A less risky investment than an equity investment in the same Issuer;
- A final full repayment date.
Note Structure and Types of Borrowers

By borrowing through Royalty Notes, a company (the “borrower” or “issuer”) obtains a loan which is paid back to lenders through a contract. This contract obligates the borrower to pay lenders a fixed percentage (or “royalty”) of the borrower’s ongoing revenues. Unlike a traditional loan, however, the royalty payment is not an interest rate. There is no interest accrual or compounding during the life of the loan.

- The royalty rate is typically set as a flat rate at 1-8% of monthly or quarterly gross revenues.
- The note provides lenders regular cash payments up to an aggregate capped amount of 1.3 times to 2.0 times the principal amount of the loan.
- The rate of return (“yield”) achieved by the investor is a function of the future revenue growth rate of the Issuer, the typical IRR* resulting from a Royalty Note investment is 15 – 30%.
- Faster revenue growth retires the Note earlier and delivers a higher IRR.
- Slower revenue growth results in a longer repayment timeframe and a lower IRR for the investment.
- Any amounts necessary to reach the entire capped amount become due and payable on the maturity date of the Note.

*IRR (Internal Rate of Return) - An “IRR” provides a measure of the “time value of money,” and thus is also a measure of an investment’s return. It is the interest rate at which all the cash flows (both positive and negative) for an investment equal zero. Equivalently, it is the discount rate at which the net present value of the future cash flows is equal to the initial investment.
Pure royalty structures, as well as Royalty Notes, have been used for some time in businesses using Software as a Service (SaaS) business models and in industries such as oil and gas, media/entertainment and biotech.

With the advent of e-commerce, relatively predictable “Demand-Generation” digital-marketing campaigns are now commonplace for many consumer product companies. Royalty Notes are a good fit for those high-growth companies deploying social media-led advertising on Facebook, Instagram, Messenger, etc. and/or leveraging advertising programs on Amazon or through Google Ad Words.
## Royalty Note Comparison to Other Direct Investments

From an investment perspective, Royalty Notes fit between traditional private debt and equity securities in terms of expected return, risk profile and other characteristics.

<table>
<thead>
<tr>
<th></th>
<th>Traditional Senior Secured Debt</th>
<th>Royalty Notes</th>
<th>Preferred or Common Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Targeted Investment Returns</strong></td>
<td>8% to 15%</td>
<td>15% to 30%+</td>
<td>25%+</td>
</tr>
<tr>
<td><strong>Capped Return</strong></td>
<td>Yes, the interest rate on outstanding principal</td>
<td>Yes, typically 1.3 to 2.0 times the invested capital</td>
<td>No</td>
</tr>
<tr>
<td><strong>Source of Investment Return</strong></td>
<td>Operating Cashflow</td>
<td>Gross Revenues</td>
<td>Profits and/or net asset value</td>
</tr>
<tr>
<td><strong>Difficulty projecting Source of Investment Return</strong></td>
<td>Higher</td>
<td>Lowest</td>
<td>Highest</td>
</tr>
<tr>
<td><strong>Overall Risk profile</strong></td>
<td>Lowest</td>
<td>Lower than equity</td>
<td>Highest</td>
</tr>
<tr>
<td><strong>Current Income</strong></td>
<td>Yes, typically monthly or quarterly</td>
<td>Yes, typically monthly or quarterly</td>
<td>Not Normally</td>
</tr>
<tr>
<td><strong>Final Maturity</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
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Royalty Notes - Investor Benefits

- 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 borrower’s 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, for example, 5% of the issuing company’s top-line incremental gross revenue. (If there is an interest rate associated with the Royalty Note, 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 revenues are generated by the borrower up to a capped cash-on-cash return which could be fixed at, for example, 1.5 times the original principal amount of the loan.
- At maturity the borrower is obligated to pay back the original loan principle plus additional returns up to the capped amount, inclusive of payments made previously over the term of the loan. In other words, the full capped amount set for the Royalty Note when it is issued must be satisfied at maturity.
The graph above shows a royalty note 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. Royalty Notes are a highly flexible, and customized structures can accommodate varied issuer circumstances.
Conclusion

Royalty financing can be a win-win for certain investors and borrowers.

For Investors/lenders - they offer the promise of very attractive current returns within a set time horizon (i.e., the maturity date) and an investment that has less risk than equity.

For Issuers/borrowers - Because Royalty Notes are not equity, they are not dilutive to existing equity holders of a borrower. Therefore, they provide high growth borrowers with a lower cost of funds than equity issuance albeit a higher cost of capital than traditional debt, if that form of indebtedness is available to the borrower.

Given the above, Carofin anticipates offering a growing number of private placements involving Royalty Note investment. We are pleased to address questions investors may have about this investment structure and suitability within individual investment portfolios.

If you want to stay abreast of our articles, please “Follow us” on LinkedIn.

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.