“ROYALTY FINANCING”: THE NEW, NEW THING IN VENTURE CAPITAL

By Cliff Ennico

“I have a successful retail business that I want to take online with a killer website and a social media marketing campaign on Facebook and Twitter.

The problem, of course, is money. I need to raise $100,000 to build the website and launch the campaign, but am having trouble finding the money. My business has strong cash flows, but has never officially shown a profit. There aren’t a whole lot of tangible assets in this business, and I don’t have tons of equity in my home, so most local banks won’t even talk to me. And I’m not really willing to give up 50% of my company to a venture capitalist.

Are there any other options out there I may have overlooked?”

You sound like a near-perfect candidate for the hottest new development in venture capital: so-called “royalty financing”.

The concept of “royalty financing” has been around for a long time. Basically, the idea is this: someone lends you money (in this case, $100,000), but instead of a fixed interest rate, you agree to pay the lender a percentage of your gross sales (not net profits) each month – 2% to 6% is customary. The royalty payments may continue for a specified time period (generally three to five years), or until the lender has received all of their money back plus a 20% return on their investment (in this case, $120,000 in total payout). Once the time period expires or the desired return has been achieved, the loan is considered fully paid and you stop making the royalty payments each month.

Most, but not all, royalty financings also involve an “equity kicker” – the lender takes a piece of equity in your company (or, more commonly, a warrant to acquire

shares) on top of the royalty payments each month. So if your company grows and becomes profitable, the lender will be entitled to a piece of your "upside" growth.

Why is royalty financing gaining traction right now? Basically, in a difficult economy where most entrepreneurial companies are struggling to break even and taking longer to become profitable, lenders to growing businesses have become tired of waiting for their money. Your business is not currently showing a profit, and it will have to do so before legally you can pay any sort of dividend or distribution to your investors. That may take years. Because most "royalty financings" are structured as loans, they do not run afoul of state laws requiring that dividends be paid only out of "earnings and profits". And your investors see a steady return on their investment each month.

There are several advantages to both parties in royalty financing. Because the lender is getting money back every month, it is taking less of a risk than it would making a traditional equity investment in your company. If your business grows rapidly, so will the lender's monthly royalty payments, meaning they will get their return on investment a Heck of a lot faster than they would buying stock in your company. Accordingly, a royalty investor may be willing to accept a smaller amount of equity as its "kicker" than it would in a traditional equity investment -- this leaves you the entrepreneur with more equity in your business, and less dilution for you and your business partners.

Also, the default provisions in royalty loans are usually much less onerous than in traditional bank financings. While most royalty loans require a minimum royalty payment each month, many investors will allow you to pay less than the minimum royalty for two, sometimes even three, consecutive months without putting you into default. Many royalty investors will also insist on converting their loan into straight

equity in your company, rather than foreclosing on their loan, if you default in your royalty payments.

There are, however, some disadvantages to royalty financing. If your company is not demonstrating strong, steady and predictable cash flows each month, you are not likely to interest an investor in royalty financing. Also, royalty financing deprives you of some much-needed cash each month that you otherwise would pay for rent, payroll, business expenses, not to mention your compensation as owner of the business. Most investors insist that their royalty payment be made "on top" – i.e. before you pay other expenses – which may leave you cash-strapped at the end of the month if business unexpectedly turns down.

Having said that, though, for businesses with few tangible assets and zero profits, it may be the only type of financing you can get in a difficult market.

So where do you find royalty investors? A number of firms are setting up venture funds built entirely around the royalty financing concept. Among those are Arctaris Capital Partners L.P. in Waltham, Massachusetts (www.arctaris.com); Cypress Growth Capital LLC in Dallas, Texas (www.cypressgrowthcapital.com); Revenue Loan LLC in Seattle, Washington (www.revenueloan.com); and Noventi Ventures in Menlo Park, California (www.noventivc.com).

But as royalty financing becomes more popular, even local venture firms will be testing the waters. There's no harm in asking . . .

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