

Larry and Barry on: investing in Fair Revenue Participation Contracts (FRPCs) and why to do so ©

Lawrence (Larry) Lion and Bernard (Barry) Beaver have been used by Arthur Lipper to illustrate the reactions of typical growth oriented entrepreneurs. Larry and Barry first appeared in the monthly column of Arthur Lipper, as Chairman and Editor-in-Chief of Venture, The Magazine for Business Owners. Arthur Lipper's latest book is The Larry and Barry Guide to Entrepreneurial Wisdom has also been published by CITIC in Chinese and has sold well in China.

Larry: I love it. In this new Fair Revenue Participation Contracts deal we only have to worry about their gross sales, not if they declare profits or not.

Barry: Sure, but if they don't give us information about their profits how can we predict if they will stay in business? Of course, there are those critical assets being held for our benefit if they default.

Larry: Ok, so now there is this new exchange in Singapore which trades royalty or revenue participation units of companies. Investment banking firms, which are members of the exchange, underwrite the IPO of the units and thereafter they trade based upon supply and demand.

Barry: I have lots of questions. How do we know the companies are real? Sure everyone knows that Singapore is highly regulated and the citadel of integrity but what about the companies issuing the royalties?

Larry: For starters, the underwriting firms are established members of the international investment community and do their own research as to the viability of the firms they consider underwriting. Some of these companies which are offering to sell long term royalties are quite large and have been in business for many years. It's just that they do not want to sell any stock in their company and, for competitive reasons, do not want to disclose their profitability.

Barry: Yeah. Well if they are so successful why do they want our money and why are they willing to give us such a sure thing as a fixed percentage of their revenues, irrespective of their profits?

Larry: It's all in the information circular, like a prospectus, the company can make more money if they have more money to work with. They want to expand but don't want anyone who isn't a family member to own any shares. Also they do not believe in debt. So selling a piece of revenue makes sense to them. Also 2% of their revenue for 50 years isn't going to hurt a profitable company a lot.

Barry: But what happens if they over expand and get into financial trouble? This happens all the time, as you and I both know.

Larry: Well, that's one of the good parts about this deal. The Managing Underwriter negotiates with the company to transfer their critical assets to a trustee for the benefit of the royalty holders. The trustee then let's the company use the assets without any charge as long as the company isn't in default of its contract with the royalty holders. Once the contract is fulfilled then the trustee transfer the same assets back to the company, all without charge.

Barry: I get it. The company can't operate without the assets and as long as the royalties are paid on schedule nothing really changes for the company in that they have the use of the same assets. What are the critical assets?

Larry: They are assets such as land, buildings, intellectual property, equipment which the Managing Underwriter determines are appropriate and the company agrees to transfer. It's one of the things the Managing Underwriter negotiates with the company.

Barry: What are the other things the Managing Underwriter negotiates with the company?

Larry: First they have to decide they like the company and are willing to risk their own reputation in managing an IPO for the company. Next they have to decide what is a fair amount of money to pay for the level of royalty the company feels it can afford to pay. In other words, they are, in fact, valuing the company or at least its total current revenue of the company.

Barry: So you mean if a company's stock would be worth in the market one times revenue and the revenue was \$100 million then if the company wanted \$10 million the Managing Underwriter might do a deal somewhere between 5% of revenue for 10 years to 1% for 50 years, for the same \$10 million. That's the negotiation.

Larry: Of course, the real analytical decision the Managing Underwriter and any investor has to make is what will future revenues be. Will they be higher or lower? If they use the new money well then revenues should increase. The fixed percentage royalty can be viewed as a bet on future revenue levels. The 1% of \$100 million this year is worth \$1.0 million or a 10% yield on the \$10.0 million provided, but what if the revenue increase significantly over the period of the royalty entitlement?

Barry: So, we as investors, only have to have an opinion as to the trend of revenues, not profits, for the company? Of course, we also have to believe the company will survive and not go broke or if they do that those so called critical assets will have sufficient value to give us at least the return we initially agreed.

Larry: What can go wrong with this deal? Why are we so lucky as being able to invest, which is always a good question to ask?

Barry: Well, for one thing, we may simply be paying too much for the risk being assumed. If the revenue growth is disappointing or the company starts going

downhill then the royalties will trade at lower levels and we could take a loss., all depending on our original cost. Also the liquidity of the exchange they talk about may not always be sufficient for us to sell all of our royalty units at the price we want.

Larry: Seems like the same risks as we normally take in investing in companies. If we pick the right companies and the right time to invest and therefore at the right price we will make a lot of money. If we guess wrong we will lose money. All the same as usual except that these Fair Revenue Participation Contracts seem to offer a better deal than is normally available to investors.

Barry: Seems that way. Let's buy some and try it.

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