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Royalty Financing: Another Creative Way For Start Up Financing

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Still frozen credit market, rather onerous or non-existent funding channels and business uncertainty have made it rather impossible to launch a new business. Nonetheless, a rather novel funding option may relatively facilitate start-up financing. Royalty financing has long been used in entertainment deals. Now, royalty financing is making inroads into financing of other kinds of business ventures such as technology and business. Let us further explore the details and potential pitfalls.

SOME BACKGROUND ON ROYALTY FINANCING

Entrepreneurs aspiring to launch their businesses have mainly had two sources of financing, aside from their family and friends: venture capitalists or angel investors. Nonetheless, such funding sources mostly require substantial equity in the start-ups or demand extremely ambitious returns.

Alternatively, royalty financing has surfaced as a potential funding alternative previously available to mostly entertainment and mining-related ventures.

CHARACTERISTICS OF ROYALTY FINANCING

A. Royalty Financing Definition

Royalty financing simply means a company paying back the loan using some percentage of its revenue.

B. Royalty Financing Terms Differ

The terms and condition of royalty financing arrangements in technology and other potential-growth companies, aside from entertainment and mining, usually differ. Often such arrangements have some variation of the following:

- Raising funds from institutional investors with some specified amortized loan payment schedule for 5-10 years.
- Raising funds from institutional investors with some amortized loan payment schedule PLUS stock warrant as a safeguard, if the company's stock appreciably appreciates in value such as Google or Twitter.
- Companies usually agree to pay some kind of incremental revenue ranging from 2%-6% over a specified time period OR until a negotiated multiple of the investment is paid back. The latter strategy is extremely prudent especially when the company does not intend to pay more than a specified sum.

CAVEATS OF ROYALTY FINANCING

A. Royalty Financing Cannot Be Secured for Many Companies

This is extremely important to ascertain many companies are not potential candidates for royalty financing because of their growth potential. The underlying principle for royalty financing is the company will be making money in a relatively short period of time after launch. Nonetheless, the reality is many start-up companies because of their business model or no fault of their own, especially in this economy, bleed money at the inception of their business venture.

B. Royalty Financing Could Be VERY EXPENSIVE and ONEROUS, TOO

Given such royalty payments, in a long term, could add up to a lot more than what a bank debt would have cost a business, it is incumbent on business entrepreneurs to negotiate some cap on such royalties.

In addition, if possible, business entrepreneurs to mitigate onerous terms, should negotiate a structure in which no or relatively lesser royalties are paid if a major customer leaves or the company experiences a financially bad year.

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