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Royalty Funding:
What is it and how does it work?

A favourite funding solution of Mr. Wonderful

Kevin O'Leary (or as he is infamously known, "Mr. Wonderful") from Dragons' Den or its US cousin, Shark Tank, often offers budding entrepreneurs the option of royalty funding instead of an equity investment in their business.

So what exactly is royalty funding?

This is the first of two articles on this topic. This first one provides a general overview of this form of financing and the second addresses its costs and which types of businesses are best suited to this solution.

> The number of royalty funders coming into the market are increasing and their offerings vary widely in contrast to current players in terms of size of transaction, business life-cycle stage, etc.

Because royalty lenders typically do not require any form of collateral or personal guarantees, one cannot really compare this solution to obtaining bank or other forms of non-traditional financing where those requirements are mandatory.

While royalty funding is not legally or technically an equity investment it closely resembles this type of capital raise. Its cost is comprised of royalty payments that can be compared to a dividend payment, and a buy-out or buy-down component (see below) that can be viewed as a capital gain.

Here is a brief summary of the important features of royalty funding:

1. **Lump sum received** – the royalty provider gives a company a lump sum of cash. It appears that as the royalty proceeds are neither debt nor equity, they can generally be accounted for at the discretion of the recipient business.
2. **Monthly royalty payment** – the recipient pays a monthly payment computed as a percentage of sales which is called the royalty payment. This generally ranges from 1 to 3 percent of sales. It is important to be aware that as sales increase, so will the monthly royalty payments (because they are a percentage of sales) and therefore the cost of capital effectively increases over time.
3. **No collateral or security required** – most royalty funders do not require a charge or lien over the business assets, but those that do it will not require a first charge, and will generally rank after or subordinate to any of the current or future lenders of the borrower.
4. **No equity required** – the royalty funder does not require equity and therefore there is not dilution to shareholders' equity or ownership, albeit the royalty provider often requests a board seat – depending on the size of the company.

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5. **No personal guarantees** – the royalty funder generally does not require the business owner to provide a personal guarantee.
6. **Term** – some royalty financings operate in perpetuity but include an option to repay the initial funds received based on an agreed formula (see below "Buy-down or Buy-out provisions"), while others have a fixed term.
7. **Default provisions** – while this type of financing does not provide the royalty funder with the default rights or remedies of either lenders or shareholders, there are often provisions in the royalty agreement which convert the royalty into a perpetual obligation if a monthly payment is missed and not corrected in the prescribed period as noted in the royalty agreement.
8. **Buy-down or Buy-out provisions** – many of these royalty solutions provide the recipient with the ability after a certain period of time to either make a partial pay-down or buy-down of the amount initially received or to repay it in full.

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There is definitely a role for royalty funding in the market place. In my next article I will discuss some of those scenarios and review the costs of this type of solution along with more on buy-down and buy-out provisions.

Isaacs Advisory are experts at sourcing financing solutions for small to medium-sized businesses with financing needs of $100K to $1Million. We work with a wide array of traditional and non-traditional lenders across Canada to source and structure financing solutions to meet our clients unique financing. For more information, please contact Adrian Isaacs at (416) 835-4511 or aisaacs@isaacsadvisory.ca.