Isaacs Advisory
Financing Advisory Services

Royalty Funding:
What is it and how does it work? Part 2

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.

In my previous article on royalty funding, I provided you with a general overview of royalty funding as well as a summary of its salient features.

To recap, given its cost, structure and features, royalty funding more closely resembles equity than debt and as such it should be compared and contrasted to raising equity as opposed to debt.

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Royalty funding can however be a very effective solution for businesses where:

- The business owner does not want to raise traditional equity as it would dilute his or her ownership.
- It can facilitate an M&A transition where a purchaser has limited equity to invest.
- Either a traditional and/or non-traditional financing solution does not meet the total financing needs of the business.
- It can quickly facilitate a management, shareholder or partner buyout.
- A business does not have an asset-rich balance sheet making it difficult to qualify for a traditional and/or a non-traditional financing solution.
- A business needs funding quickly.

Unlike more traditional and non-traditional financing solutions, asset appraisals are not typically required and there is no need for setting up special banking facilities as is sometimes required for non-traditional solutions.

Royalty Rate

While the royalty rate is expressed as a percentage of sales, the effective annual cost needs to be computed based on the amount of the initial funding received and typically ranges between 15-25% per annum. It is important to also understand that, as the revenues of the business increase, so does the quantum of the royalty paid because it is paid as a percentage of sales. As the initial loan does not increase, the effective cost increases over time.

Exiting Royalty Financing

As noted in Part 1 of this article, to exit the royalty, the business can either do a partial repayment or buy-down of a portion of the initial advance or payout the royalty in full. Some royalty lenders require 1.5 to 2x the principal repaid while others simply require the repayment of the principal.

Comparing Royalty to Equity Solutions

Given the quasi-equity nature of royalty funding it is appropriate to do an apples-to-apples comparison to understand the differences between equity and a royalty solution. More specifically, you should compare:

1. **Costs** – one should consider equity-related costs when considering this option, not the costs of borrowing from a bank. Equity related costs can include legal fees for the preparation and negotiation of a shareholders agreement, business valuation costs, and professional fees for tax planning advice on share structure.
2. **Non-financial considerations** – another important factor to consider when thinking about equity is that bringing on a partner is somewhat like a marriage. You need to have goal alignment, be in sync on management style, business culture, growth plans, exit strategy, buy out values, etc.
3. **Enterprise value** – to the extent the business is growing rapidly, giving up equity could be much more expensive if the business performs well over time and increases rapidly in its enterprise value.
4. **Availability/access** – royalty funding is readily available when you need it whereas finding a suitable equity investor can take up a significant amount of a business owner's time and take months, if not years, to source and secure.

In conclusion, while many business owners experience an element of sticker shock when they understand the costs of this type of a solution, when one steps back and considers the many costs and non-financial considerations of an equity raise, a royalty solution can play a valuable role in helping a business owner take their business to the next level at a time when they need the capital and can do so while retaining full control of their business.

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.