Larry and Barry Decide to Raise Capital without Debt or Equity by Using Revenue Royalties©

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 Entrepreneurs. Arthur Lipper's latest book is *The Larry and Barry Guide to Entrepreneurial Wisdom*, originally published by Select Books in 2002, has recently been published by CITIC in Chinese and has sold well in China.

Larry: Sure, we can well use additional money to make this business grow faster and bigger, but I've never before heard of a company selling a small percentage, or as they call it, a sliver, of future revenue.

Barry: No, neither had I, as it's a brand new idea, one they have patented in the United States. The fact that it is both new and very different means they have a lot of education marketing to do.

Larry: I really like the idea of neither having to borrow more money or sell any equity as I am not anxious to have other than you and your family members as my partners in this business.

Barry: That's good, as I doubt we could borrow much more money on reasonable terms and one of the things I've been considering is using the money they are suggesting to pay off all of our debt.

Larry: Being debt free would help us in a lot of ways, but at what cost? The quarterly royalty payments, though mechanically easy to arrange, will take money away from us, which we may need at times in the operation of the business.

Barry: That's why they said that unless we now have or will have a high profit margin that revenue participation may not be in our best interest. However, it's really a great deal for companies earning good profit where the owners do not want to have more shareholders or debt.

Larry: I like the part of not having to ever repay the funds they will provide.

Barry: There may be some tax issues, in some jurisdictions, about our selling future revenues but I'm pretty sure we can find a way to deal with the matter.

Larry: The part I like best is not having to report higher profits every quarter as some of our friends feel they have to do once they became publicly traded. That means they have to pay higher taxes all the time and also it's not really good business to force profit reporting as sometimes it’s better to spend more on research and longer term projects, which reduce shorter term profits.

Barry: I didn’t realize you had become so conservative. Bravo. Yes, you are right the need to report profits to keep transient shareholders happy can be disruptive to the building of a solid business.

Larry: Ok, let’s talk about the $20.0 million we need to open the next city, which looks like it should be so very profitable.

Barry: We could easily afford to pay a small percentage of the revenues from that operation for 20 years and transfer all of the directly-related assets to the trustee they require as long as we had the use of those assets until we met our obligations to the royalty entitlement holders.

Larry: But would they give us the full $20.0 million we need without more of an inducement?

Barry: I don’t know, perhaps they’d want to only deal with the whole company. That’s what we’d have to negotiate with the parties interested in owning a share of our revenues. If, in effect, they’d let us do project financing, we could give them additional security by transferring additional assets to the trustee or even guarantee that at the end of the contract period an agreed minimum amount of royalties would have been paid.

Larry: We could even afford to give them a higher royalty after the first few years after opening or an agreed minimum royalty payment every quarter. There are lots of ways this deal could be made to work.

Barry: It’s all a matter of how much we are prepared to pay to keep the control and ownership of our company exclusively in our hands. To me that’s worth a lot.

Larry: Yeah, I agree. I also understand we can buy in and cancel the revenue participation contract units either on an exchange, trading the royalties or through a tender offer, perhaps even using securities should we ever decide to go public.

Barry: But what happens if we go through a losing period where our costs exceed our revenues, do we still have to pay the royalties?

Larry: We sure do unless we negotiate to pay a premium for an accrual and delayed payment. It’s all up to the results of a negotiation as to what they are willing to accept.

Barry: So, we get $20.0 million, less some level of placement fee of say 5% to 10% and have to pay a negotiated percentage of the unit’s revenues for 20 years. Now what happens when some large company wants to buy us at a time when we want to sell? Wouldn’t they pay less if they have a continuing royalty payment obligation?

Larry: Sure, but we would still own the stock we would have had to give up for the $20.0 million and we’d be in a better position to arrange for the funds to buy back the royalty entitlement contract units so we could cancel them or we could just accept a lesser price for the company. We’d still have been the only decision makers in managing the company.

Barry: The royalty holders have no seats on our board or ability to give us "advice" or in any way help us run our company. As long as we pay the royalties we need have no contact with the investors who provided the $20.0 million.

Larry: So what's wrong with the deal?

Barry: Nothing as long as we continue to enjoy good profit margins so we can afford to pay the royalty and still have sufficient money to run and expand the company. The trustee holds the assets we or anyone else need to keep the company in business so we have no alternative but to comply with the contract.

Larry: One more thing. How do they collect the royalties and know they are getting a good count?

Barry: The terms of the deal are tough. You, I and all the other directors have to personally attest as to the accuracy of the revenues we report. Then annually there is a revenue audit by an accounting firm on which we agree.

Larry: And the royalty collection process?

Barry: That's even simpler. We designate a limited number of banks into which we agree, for the entire period of the contract, to deposit all payments received for the sale of goods or services. We have to give those banks irrevocable instructions to deduct the agreed royalty from every deposit and quarterly to transmit the funds to the trustee company, which then makes distributions to the royalty entitlement contract unit holders. If the bank won't agree to make the deductions then an agreed party having access to our account will do so.

Larry: As the trustee company already owns, until the end of the royalty payment period, all of the critical assets of the company, though we can use them without any payment, we have no option but to comply with the terms of the contract.

Barry: We would anyway as we are honest people, as the due diligence the investor or their agent did before agreeing to buy the royalty would have learned.

Larry: Yes and they agree to help us write the offering document describing the company and the industry in which we compete. They also will provide us with the list of facts we are obliged to advise the investor(s).

Barry: Do you really believe in the expansion project enough for us to take their money and enter into such a long-term relationship?

Larry: Well, we could give them a higher royalty for a lesser period or take a lesser amount of money so it would be easier to buy back the contract units.

Barry: Yes. And if the royalty units were to be listed on an exchange that would allow us to know the price we would have to pay to get some or all of them back.

Larry: Right. I like the idea of there being a royalty exchange, as that will probably reduce the percentage of revenues we have to pay for the money.

Barry: One more thing. As we are in a business Muslim investors do not find offensive and if we no longer had to pay interest on loans we would be Sharia compliant and therefore be eligible for Muslims to invest in the royalties. Indeed, they have already received a fatwa decreeing royalties to be Sharia compliant.

Larry: That would be great as I've read there are rapidly growing billions of dollars of assets held by accounts which require Sharia compliance and our being ok for them to invest in would create more potential investors for our contract units in the IPO, resulting in our being able to negotiate a better deal with the managing underwriter.

Barry: Great. Let's meet with them and get started.

Arthur Lipper, Chairman

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