

Royalty-Based Private Equity Financing

A New Investment Alternative for Private Companies

The Business Development Company (BDC), a \$400 million loan and investment company, has been providing capital to private companies throughout New England for more than 50 years. When planning a fund raise for a new mezzanine investment fund in 1999, the company struggled to find an alternative to the classic subordinated debt with warrant structure that most mezzanine firms use. The BDC recognized that valuations in 1999 were high and warrant positions could very well prove to be worthless in the event of a downturn in valuations. This position proved to be well thought out in retrospect when valuations subsequently declined driving IRRs on vintage year 1999 funds to negative territory five years later. The BDC was also looking for a way to obtain appropriate mezzanine returns without having to rely on a future exit “event” at some point in the future that may or may not happen.

Drawing from their experience on the lending side of their business, the private equity group created a new model for royalty based mezzanine financing that has achieved quite a track record through their first 8 years. Since developing the model and raising its first institutional fund in 1999, the BDC has now raised three funds and both demand for capital and returns have been strong. Their first fund, a 1999 vintage year fund, has returned 17% cash returns to investors placing it near the top of all private equity funds for that vintage year. Their second fund, a 2003 fund, just completed investing and cash returns exceed 20%. Fundraising has just been completed for the third fund. Investors in the Fund include Bank of America, Sovereign Bank, Citizens Bank, TD Banknorth, and many others.

These funds are for growth-oriented private companies, located in New England, needing capital from \$1 million to \$5 million. A royalty-based mezzanine investment is structured as subordinated debt, usually carrying a fixed interest rate, and an additional equity feature in the form of a royalty, based upon a certain percentage of sales. The percentage varies for each company but usually falls in a range of one tenth of 1% to one half of 1% of annual sales. The unique features of this type of financing are:

- No ownership dilution and no loss of control. The BDC does not take any ownership interest and does not take Board seats.
- No back-end payouts. The subordinated debt and the royalty are amortized and repaid over a five-year period. Once repaid, there are no further amounts due.
- Very inexpensive equity capital versus alternatives. Warrant positions for classic mezzanine funds are usually repurchased using a company’s after-tax dollars. With a royalty based, subordinated debt structure, both the royalties and the interest are tax-deductible expenses to the company, thereby allowing the company to repay its capital in pretax dollars. For profitable companies, this form of private equity financing can cost as little as 12-14% when converted to an after tax dollar equivalency.

This form of financing produces win/win results for both the company and for their banks. While the company obtains low cost, subordinated debt, the bank views this financing as part of the equity capital because of the subordinated feature which allows the bank to trigger a standstill on payments to the BDC in the event an expansion plan goes awry.

This type of financing is not for everyone however. Companies need to possess strong management teams and a well thought out business proposition. The BDC seeks out companies with unique and defensible product or market niches where those qualities reflect in strong gross profit margins. The BDC also looks at the ability of a management to scale the business and to generate strong future cash flows.

For more information on this unique financing contact:

Mr. Kenneth J. Smith, President
The Business Development Company
500 Edgewater Drive, Suite 555
Wakefield, Massachusetts 01880
781-928-1100
www.bdcnewengland.com