The Vision of Revenue Royalties

A White Paper on New Financial Methods
for Public-Private Partnerships in China

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Introduction

Revenue Royalties is a method of finance that shows significant potential as an alternative method of raising capital for many revenue-generating enterprises -- private business, government organizations, public infrastructure utilities, academic research institutions.

In this White Paper, we explore the principles, purposes, policies and practices that make revenue royalties a useful alternative to equity and debt in selected situations. We examine the history of royalties, in ancient Europe and China, across the Silk Road and among the great trading empires of history. Royalties permit organizations with different details of operation, methods of record keeping and approaches to calculating profit to do business with one another based on revenue sharing.

This document also explores one specific anticipated use of revenue royalties -- for public-private partnerships in China. The principles of operation, economic purpose and key policies regarding implementation in China are examined, in search of a unifying vision for core purposes, and action.

Definition of Revenue Royalties

Revenue royalties, as developed, researched and analyzed by well-known Wall Street investment banker and institutional broker Arthur Lipper, are a complete alternative system for the securitization of capital using gross revenues as the means of return to investors.

In its most basic framework, a revenue royalties transaction has the following five basic components:

1. Purchase by investors of an agreed percentage of a defined revenues of an enterprise (known as a revenue royalty);
2. For an agreed period of time;
3. With investor protections and a right of early redemption for the enterprise;

4. With quarterly distribution to investors of the agreed royalty payments, possibly with an agreed minimum;
5. Allowing investors to receive a targeted rate of return on investment.

Knowing just these five variables, we can begin to design a simple revenue royalties transaction.

A company, in this fictional example, may:

1. receive 50 million RMB (approximately $7.5 million) in return for a contractual obligation to pay an agreed share of revenues for an agreed period.
2. The company agrees to pay, for example, 6% of its gross revenues,
3. As conservatively projected year by year over a 10-year time period.
4. The company contracts to automatically pay the designated revenue share to an investor account on receipt of revenue. Royalty payments are then distributed to investors every 90 days,
5. In order to provide a total ten-year internal rate of return of at least 12.5% to investors.

Each point in the above list requires detailed discussion: how the assumptions are generated, the many options in structuring the transaction to meet the needs of both investors and companies, and the analytical tools used.

But that's it: the basic art and science of revenue royalties. We'll go deeper into the detail later in this paper.

Measurement of Revenue Royalties

Revenue royalties are only attractive to investors and issuers if they improve the projected future health of the enterprise. For investors, this outcome is measured in one simple, transparent metric: increasing gross topline revenues, undiluted by expenses, operating costs, taxes, depreciation or any other balance sheet items. So the use of proceeds of a royalties investment is normally fully focused on increasing long-term revenues. This benefits the company, its shareholders, and its royalties investors.

Standard Royalties

There are many types of payments that are called “royalties.” In fact, royalties make up an important, if small, sector of any advanced economy. Let’s have a look at these standard royalties, as distinct from revenue royalties.

Standard royalties are a percentage of revenue derived from selected activities in extractive industries, such as oil and gas, mining, farming, forestry or fishing. Around the world, both governments and private enterprise receive royalties for the use of such assets.

The other common use of standard royalties is to monetize various forms of intellectual property -- theatrical performances, music rights, film distribution, television syndication, books, video games, images and photographs, trademarks and patents. Around the world, millions of artists, inventors, actors, writers and technology companies receive royalties for the licensing of their intellectual property, receiving a payment for each ticket sold, each license placed, each device manufactured. Every mobile phone relies on dozens of licensed patents; every movie likely pays royalties to some of the actors, the director, the producer; every book we read probably pays royalties in some form to the author.

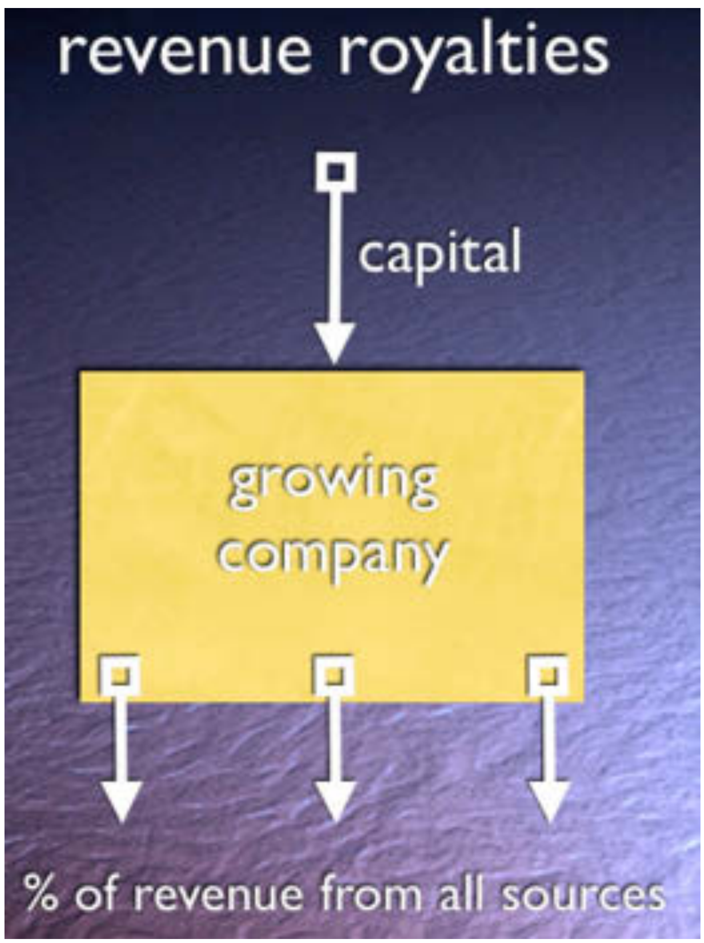
So the framework for standard royalties is well-established, and well understood as a vehicle for compensating those who possess valuable resources or talent.

The Difference: Standard vs. Revenue Royalties

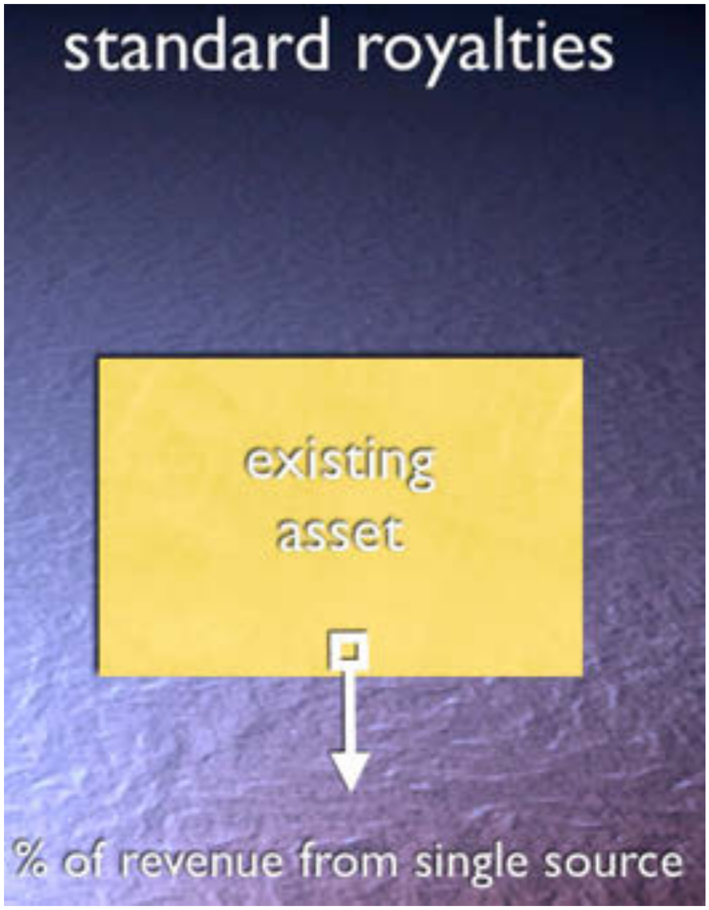
But standard royalties compensate owners for the use of assets which already exist -- and pay for their valuable use, after they are created. A best-selling author may receive an advance for a book, but he or she is responsible for doing all the work needed to write the book, and for its expenses.

Revenue royalties work the other way around, in a sense. The investment is provided in advance to a company in order the produce anticipated result, which is increasing gross revenues over a period of time, for all of its products and services. Revenue royalties reward the growth of new assets, the taking of measured risk, and enterprise; standard royalties reward the exploitation of established resources.

With revenue royalties as described in this White Paper -- explained, analyzed and popularized by Arthur Lipper -- capital is provided to a growing company to facilitate the growth of new revenues over time, and investors receive a percentage of all revenues from all sources generated by that company.



With standard royalties, an existing asset produces revenue, and a percentage of that revenue (which may be one of several projects or products controlled by a company) is paid to the owners or creators of the asset.



Simply stated: revenue royalties are “input” investments; while standard royalties are “output” investments.

Arthur Lipper, Expert Revenue Royalties Advisor

The system known as revenue royalties has been developed over many years by Arthur Lipper. Arthur founded two New York Stock Exchange institutional brokerage firms, and has been a leading figure on Wall Street and world financial markets for more than 60 years. Many call him a financial inventor, and the co-author of this White Paper has worked closely with him for many years, co-founding China Royalties and Pacific

Royalties with him, and engaging him in education and research in the Chinese securities market through Asia-Pacific Group.

Arthur Lipper was instrumental in developing early methods of mutual fund performance analysis and comparison, through the Lipper Index. He was the first to conceive stock index funds and implement stock index futures. Both of these developments transformed global securities markets, and he may be about to do it again, with revenue royalties.

As editor-in-chief and Chairman of Venture, The Magazine for Business Owners and Entrepreneurs, which focused for many years on business founders and owners and their investors, Arthur Lipper witnessed thousands of companies made and broken because of their access to capital on reasonable terms (or lack thereof). He became convinced that the system for allocating capital to fuel growth had a fatal flaw, that results in the waste of tremendous financial and human capital.

That flaw is a mis-alignment of interest, information and power between the investor in growth, and the companies that achieve that growth. More on that topic later.

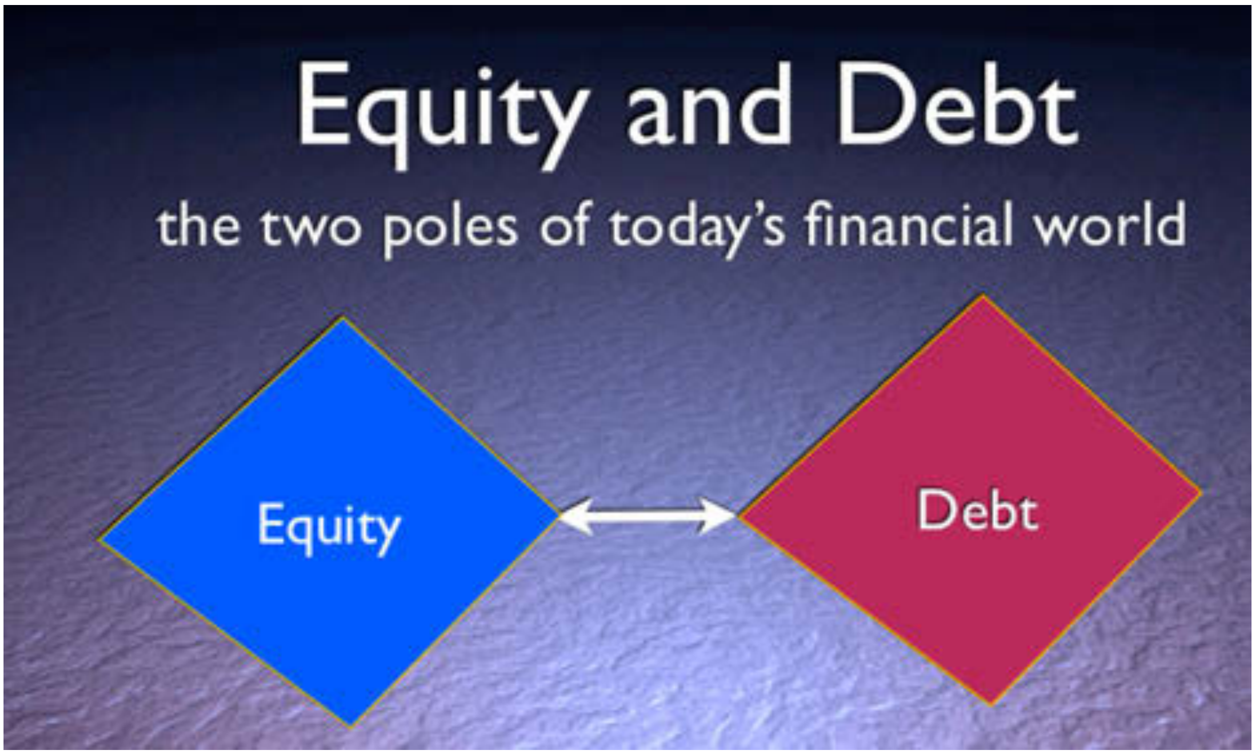
Arthur is an accomplished philanthropist and engaged Board member for many companies, and relishes advising entrepreneurs and their investors on methods that are more fair to both. He is a prolific writer, teacher, private investor, and developer of dynamic computer models that allow people anywhere to analyze, online, an unlimited number of royalties investment scenarios, seeking the best possible deal for all parties.

Recently, Arthur turned his attention to a fascinating challenge faced by the gigantic, fast-growing Chinese economy and its financial systems. The issue: the financing of future large public infrastructure projects, without continuing to tip the debt balance of government organizations.

The Bi-Polar World Financial System

Let's take a step back now, and consider the world financial system from orbit. More specifically, the system that enables the financing of businesses, the rewarding of investors, the management of risk and the accomplishment of sustained economic growth.

From orbit, 150 miles up, an observer would see two poles to this planet's financial system: equity and debt. Virtually every type of security (except the aforementioned small segment occupied by standard royalties) is either equity or debt, or some combination of the two. This applies to stocks, bonds, loans, futures, options, and derivatives of all kinds.



This White Paper proposes adding a third option -- revenue royalties -- to the equity/debit polarity. We believe this may open new sources of capital that can be directed to rewarding growth, and that the hybrid combinations of three elements will produce far more options for investors and the companies who seek their capital.

The Dynamics of Adding a Third Option

Instead of the duopoly of equity and debt, and their combination, investors and their advisors may also structure investments that are pure revenue royalties, or combinations of equity and royalties, debt and royalties, or all three -- equity, debt and royalties. From a total of three options today, we can increase the choices to seven, and perhaps the resulting financial system will have more dynamics, more flexibility, and more stability.

Today, Before Revenue Royalties:

1. Equity
2. Debt
3. Equity - Debt

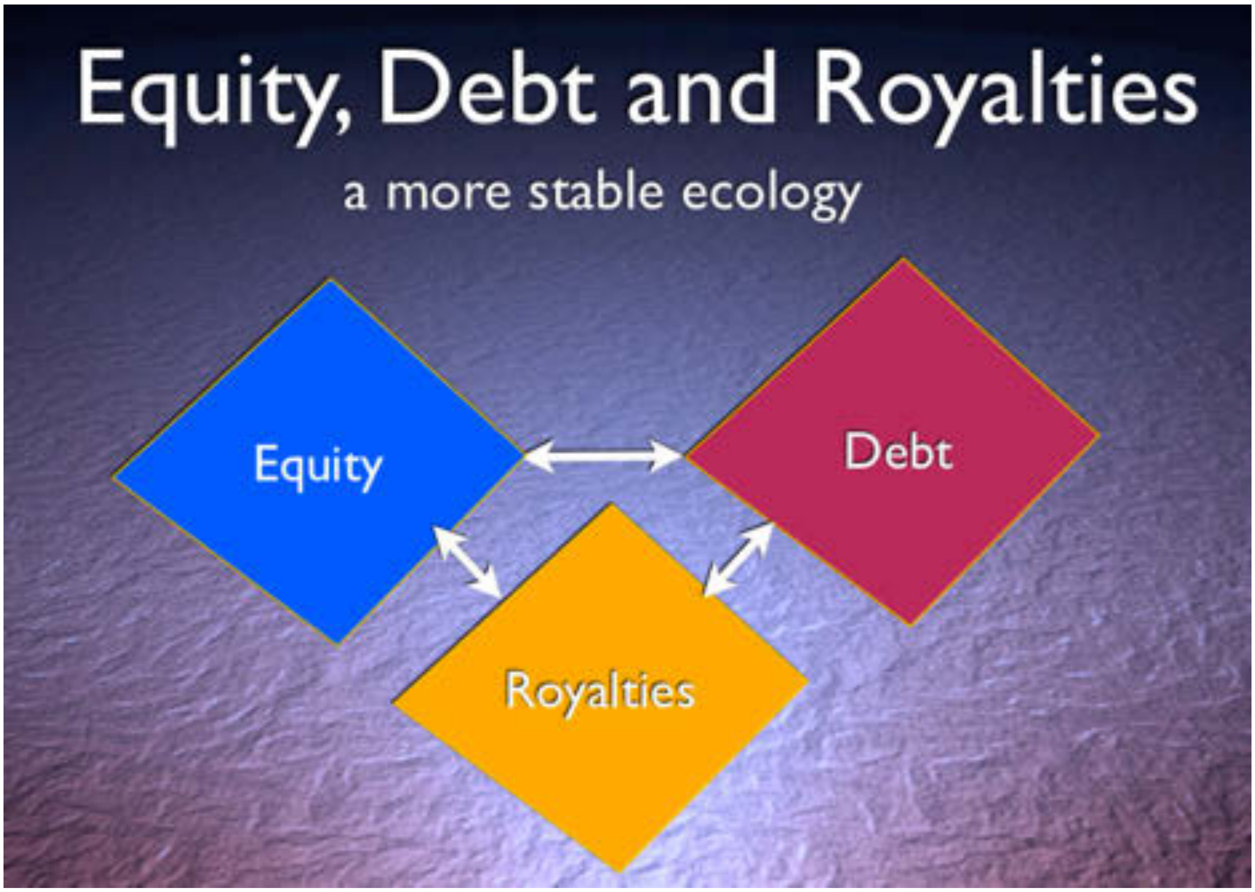
Tomorrow, after Revenue Royalties:

1. Equity
2. Debt
3. Equity - Debt
4. Royalties
5. Equity - Royalties
6. Debt - Royalties
7. Royalties - Equity - Debt

The needs of growing companies, and the requirements of their investors, are highly diverse. Every investment has qualities that make it unique, and one-of-a-kind. When you combine millions of companies and their securities across hundreds of countries, the economic dynamics are so complex that even the most advanced computer models struggle to apprehend them.

By forcing all investments through a filter of just three options, we have created a financial universe that is narrow, restricted, and fundamentally unstable. Bubbles and bursts follow each other in unpredictable patterns, as the global financial system grows and struggles to fit every opportunity through one model.

It could be that the addition of revenue royalties, with the greater flexibility of a seven-sided model, will help in creating sustained and more stable growth in the future. It will definitely make life for analysts, advisors and economists more interesting. And fill the portfolios of investors, and the capital accounts of companies, with more diverse options.



Analysis: The Inherent Priorities of Equity and Debt

Let's come down from orbit now to 40,000 ft. or so, and break down the poles of equity and debt to understand them in more detail. And to understand the potential complementary profile of revenue royalties.

The objective of an equity investment is monetization of capital gain through fractional ownership of a company. A stock certificate is the security held by an investor that measures the amount or share of ownership. Large, ambitious equity investors may have the additional objective of influence over a company, or even to control its assets.

The only desired "exit" for an equity investor is to sell his position at a price higher than he paid, at a time that represents a fair compensation for the risk he took. The value of his stock is related to the achievement of profitability, margins, growth rates, market perception of the company and its industry, and macro-economic factors that lead to volatility of entire markets -- like wars, revolutions, recessions and depressions, and natural disasters. When all these factors are balanced just right, the equity investor profits.

So Equity concentrates on achieving ownership and sometimes control, in search of a future increase in stock price over the original purchase price. If the company survives to achieve profitability, and/or at least the market perception of future profitability, the results achieved by the equity investor may be spectacular. Or disastrous. Total loss of capital is possible, and common, in privately owned, early stage, companies.

With Debt, the motivations and projected results are quite different. Debt investors are primarily concerned with a conservative assessment of the borrower's ability to repay the loan. The lender may require negative convenants that restrict certain actions by the company. These controls may ultimately lead the debt investor to seek control of a company in order to reduce the risk of default.

But the upside for the debt investor is not spectacular, as it can be for equity. Yet the downside is not totally disastrous either, as companies will almost certainly be able to make timely payments for some time after receiving a loan, and before troubles begin to appear. The debt investor's return is capped at the return of principal and interest, as originally agreed. There is no direct participation in the upside, if a company succeeds well in investing the debit capital it receives.

Debt investors concentrate on risk mitigation, achieved by exercising control.

Let's contrast these two characterizations of Debt and Equity with the business objectives, risk perception, and psychology of the Revenue Royalties investor.

The Inherent Priorities of Revenue Royalties

The objective of the revenue royalties investor is to receive a long-term stream of income, increasing steadily over time. The royalties investor participates directly and immediately in the most simple, straightforward measure of a company's growth: topline revenues. These revenues are not subject to interpretation, massaging or timing, as are profits; they are what they are. The investors' share of gross revenues is defined over selected time periods, with payments made almost immediately. The returns of revenue royalties are only loosely correlated with either equity or debt markets, and are less correlated to macroeconomic risk.

The royalties investor does not wait for years, as in the case of private company investments, for an "exit." He exits a little every day, as royalty payments accrue. This could be called "incremental liquidity."

The return earned by the royalties investor is not capped at a minimum, fixed level; it may rise steadily over time, as the revenues of a successful company rise. In exchange for these benefits, the royalties investor accepts that his returns may decline when revenues decline, and that he may miss that spectacular home-run that some investors experience, once in a lifetime.

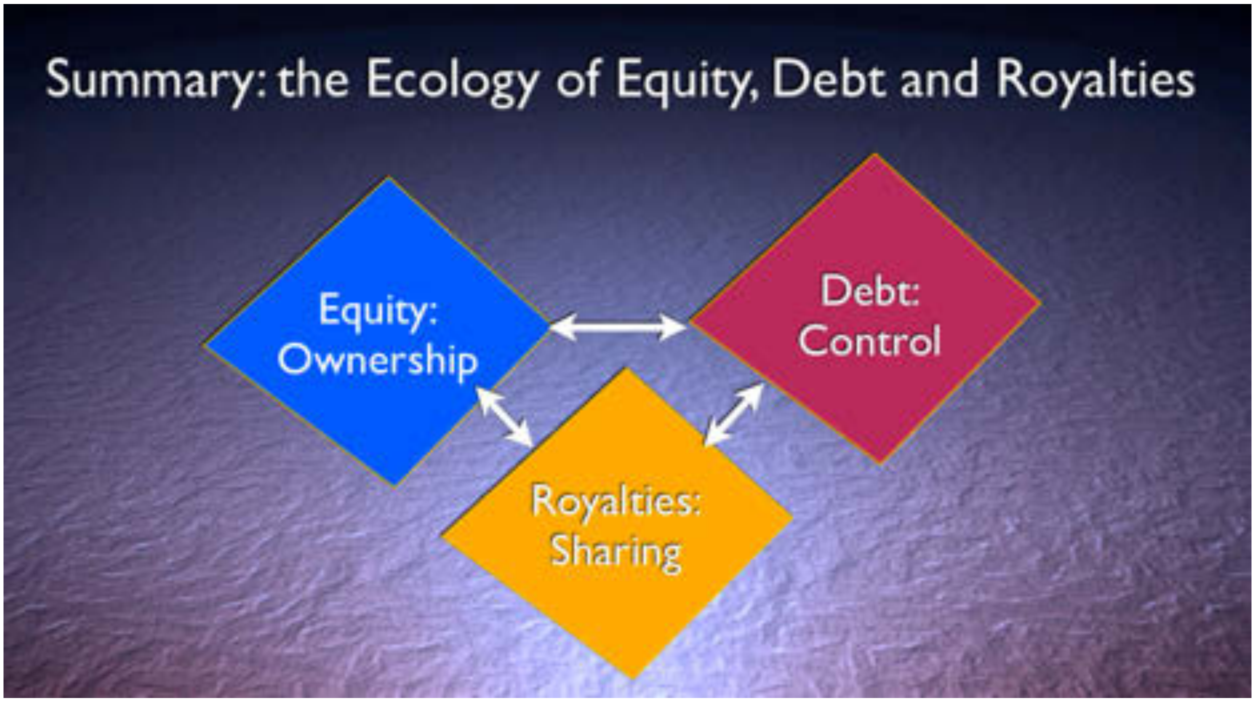
Revenue royalties are concentrated on shared risk and reward.

The New Securities Landscape

Over time, we believe that a portfolio of diversified royalties issues, selected carefully according to Mr. Lipper's criteria, will substantially outperform a portfolio of diversified equities or debt. We do not believe that royalties are for every investor, or for every company. The objectives of some investors will preclude revenue royalties. Both equity and debt, and their admixture, will remain pillars of the financial system, with some deals clearly optimized for one option or the other, or a combination of the two, as we see today.

But we believe that in the future, most investment portfolios that require increasing income will contain some proportion of revenue royalties, to act as ballast for the equity and debt components.

Zooming back up again, the ecology of the new investment landscape could look like this: a balance between equity ownership, debt control, and shared reward.



The revenue royalties system elaborated by Arthur Lipper anticipates many combinations and optional features, to handle varied needs.

A full appraisal of all these permutations is beyond the scope of this White Paper. A substantial library of articles is available on http://www.royalties.website. This site also provides a useful switchboard to six interlocking analytical tools, composed under the "REX" mark by Mr. Lipper with assistance from Michael North.

Variations of Revenue Royalties: On Overview

Let's attempt a preliminary inventory of some of the variations on the simple revenue royalties theme.

Royalty rates may change through time. For example, they may be higher in the initial years, and then decline after five years, and decline again after ten years.

Royalty periods may vary, from a likely minimum of five years, to a likely maximum of 20 years. The longer the period, the lower the schedule of royalty rates, in general.

An initial period of debt may begin a royalties contract, for companies with no revenues or limited revenues. This may convert at a specific time, or according to specific return triggers, into revenue royalties.

Royalties may be pre-set to offer the option of the investor to convert into equity, upon realization of certain benchmarks. Mr. Lipper does not recommend this course.

Royalties may also be redeemable before their term has expired, at the option of either the issuer or the investor, according to a discounted cashflow model applied at the time of early redemption.

Companies may agree to an incentive for exceeding projected royalty payments, if the excess is measured by a given rate over a given time period. The incentive may be a reduction in royalty rate or duration. Similarly, companies may also agree to a penalty if royalty payments consistently fall short of projections.

Single issues of revenue royalties may be combined into managed funds, in order to spread risk and maximize consistent returns. Such funds may concentrate, like mutual funds, for example by industry, geography, or conservative/aggressive strategy

Arthur Lipper, as Chairman of British Far East Holdings Ltd., received a U.S. patent for procedures related to revenue royalties, so a patent license fee may be due when these approaches are used in the design of deal structures. This patent license fee compensates

Mr. Lipper for his many years of design, research and expense in developing the revenue royalties system, and to encourage future development and innovation.
The above list is suggestive, but not exhaustive, of the complexities of the revenue royalties system, which is being taught and studied in major universities, securities firms and government organizations around the world.

The Origins of Royalties

It's now that point in a White Paper when we take a step back in time. Some historical perspective is useful, in understanding where we've been with royalties through history, and where we may be going.

Revenue royalties are not new. The advanced, systematic approach taken by Arthur Lipper contains many innovations, but the basic concept is almost as old as commerce, trade and civilization.

Those engaged in the first ventures in international trade needed a method which facilitated participation in future transactions involving the use or sale of assets of one party by another party. This could, for example, be an agreement allowing someone to cultivate land owned by someone else, in exchange for a share of what was produced. This may not have been called a "royalty", though the asset, such as land, could have been owned by the locally governing "royal" family, who allowed people to work the land in return for a share of proceeds.

Equity and debt have been the traditional instruments of international capitalism for hundreds of years; the mercantile markets of Europe have long allowed for the trading of debit and equity securities. For the colonial empires of Europe, extending their tentacles across the planet on a global integrated scale since at least the early 1600's, the emphasis of financial securities has been to gain and secure control of companies, resources and geographic territories for the benefit of nation-states and their financiers. Extracting the profitability was the primary measure of success, with a dash of balance for long-term sustainability.

Equity, through this recent historical lens, provides the potential for great success, while opening up the possibility of total failure of trade and investment. History is full of colorful examples of both outcomes.

Debt, with its creation of a fixed obligation by debtors to lenders, can create dependency, exert negative control, and limit returns in favor of predictability. The great European empires floated their navies on oceans of debt.

Royalties have been used for at least 2500 years, though they were not known as royalties until 1670. They were just called the business of trade, in an era when currency, financial markets, and abstract measures of value did not yet exist.

Mediterranean ship captains used the royalties technique, essentially revenue sharing. A captain would set sail from Piraeus, the port of Athens, to Canopus, Heracleion and Menouthis (later consolidated by Alexander the Great and named Alexandria) -- the gateway to Egypt. The captain might carry fine wine, purified olive oil, with vases and dishes for the kitchen. He did not own the cargo; he was entrusted with it by the merchants in Greece.

When he delivered the cargo safely, he was paid a fee for each barrel of wine or oil, and for each fine vase. Payment was often in gold, since currency was in its infancy and coins were often not accepted across oceans and empires. The captain returned the full Egyptian payment to his masters in Athens, who paid the agreed fee to the captain.

This system was easy to understand, implement and track. Everyone knew the risks and rewards, and the more cargo was delivered safely, without damage, the more the captain could earn. He was paid for results; no speculation or excuses. Accounts and record-keeping were simple -- important at a time when literacy was limited.

An Example from China

A similar system of value recognition was used in Han Dynasty China, up to 2000 years ago. It was an orderly method of moving goods and information, both within China and with its global trading partners at the time. Most often seen in rural villages, the system of value recognition was easy for ordinary people to grasp and trust.

For example: I like the shoes your family makes for our village, so I will provide the money you need for your sons and daughters to expand the shoe business to neighboring villages. You can pay me 5% of what you collect for each pair of shoes you sell for the next ten years, and I'll be happy. You'll be happy too, because the last thing you want is some nosy neighbor owning a piece of your precious family business. Or putting you into debt, which sours our relationship because now I'm subordinate to you, I owe you an obligation. This type of village finance valued equality over obligation.

Since variations of this type of trade existed in both Europe and Asia, it was natural for a similar approach to be used sometimes in the era of Marco Polo and the original Silk

Road, one of the longest, most complex and profitable trade routes in all history. A caravan leader would leave Suzhou with his camels laden with fine silk, and upon delivery in Venice he was paid an agreed fee for each bolt of silk that survived the long journey.

So the Roman Empire and Imperial China were both fueled by an economic system that had something in common with the modern system of revenue royalties, in its fundamentals. Using royalties today, in the 21st Century, revisits some of those tried-and-true ways.

The First Royalties Company

One of the oldest companies in the world has roots in royalties -- in fact, it was responsible for the coinage of the word "royalties" itself, meaning "belonging to the King."

We're referring to the Hudson's Bay Company. In 1670, North America was beginning to be explored, and England claimed a huge area for King Charles II -- one piece was the entire drainage basin or rivers leading into Hudson's Bay.

The King granted all rights to explore, market and trade in natural resources in this vast area to a group of London merchant traders. With the merchants' ships, hired adventurers and accountants, people from the early Hudson's Bay Company spread out rapidly across future Canada and the northern U.S., trapping furs, finding minerals, and ultimately starting vast mining, forestry, shipping and agricultural enterprises.

They claimed to "own" 15% of the territory of North America at one point (despite the awkward reality that the First Nations people were already there, and had been for thousands of years).

Setting aside for a moment the breathtaking arrogance of this colonial appropriation of a continent and its people, which would be unacceptable by today's standards -- the "royalty" was an effective, simple and fabulously productive generator of wealth. It worked.

This was the imperative of Empire in that era, and the British Empire was growing fast, across the world. King Charles wanted two simple things from the merchants at Hudson's Bay -- a share of the wealth they generated, and the presence of English subjects in the territory he claimed, to substantiate of his sovereignty. The French, Dutch, and the Spanish had their own competitive ideas about sovereignty over the New World. So long as the King of England was paid this "royalty" income, the merchants had the protection of England's navy, and the blessing of King Charles II.

And the Hudson's Bay Company succeeded, probably beyond anyone's expectation at the time, and survives to this day -- in fact, it thrives. Royalties are still paid, in one form or another, to investors and shareholders, by HBC, a public company respected the world over. HBC (TSX on the Toronto Stock Exchange) will celebrate its 350th anniversary of profitability in 2020. The company owns the global retail giants Saks Fifth Avenue, Lord

& Taylor, huge reserves of commercial land, and many other assets, valued at more than $10 billion, throwing off $5.5 billion in annual revenues.

Very few institutions of any kind have survived the past 350 years, and to be fair, despite the company's colonial beginnings, HBC has become known as a model of stewardship of land and resources; environmentally sound and socially progressive, they have come a long way from the predatory fur trappers, merchants and imperial ambition of their history.

As a business, the Hudson's Bay Company is a historic success for its shareholders and employees, and its roots are literally in royalties. So the technique of paying a percentage of gross revenues to investors has stood the test of time -- a test which few institutions can claim to have passed.

With careful adaptation to a fast-moving modern world, can this royalties idea prove useful to 21st Century commerce? To China, which is today's fastest-growing major economy? These are the provocative questions we pose, and are determined to answer.

We turn to China now, with its remarkable economic transformation, unprecedented in history for the number of people it has lifted from poverty, hunger, disease and dependency. Modern China developed its own unique model of social capitalism, or "capitalism with a Chinese face" -- attempting to harness the productivity of enterprise and capital markets to unifying a nation divided by invasion, colonial dominance and civil war.

It was not easy.

The modern Chinese economic system is effective at delivering economic success to hundreds of millions of people. And one of its founding principles is sharing, social justice and balance, so that most people share in the progress achieved. Though still imperfectly realized, the concept of sharing general economic success through a simple sharing of revenues has logic, and appeal in China.

The first Premier and Foreign Minister of China, Zhou Enlai, was an economic philosopher of considerable resourcefulness and skill. He called for recalibration of China's measurement of risk and reward, for a system of social capital in service to economic fairness. Those original principles are compatible with the principles of revenue royalties.

The Role of Public-Private Partnerships

Public-private partnerships (PPP), now being widely adopted in China, harness the resources of government in land and natural resources to the capital investment and efficient management of the private sector. But PPP is still running on an engine of debt, and China is over-leveraged.

How to raise capital without continuing to increase debt? Royalties may offer an answer in China. If used with PPP's, royalties may reduce dependence by the public sector on continuing to raise debt for much-needed infrastructure projects. They could make more and larger projects feasible. They could make financing for huge new energy generation and conservation projects feasible, with a positive contribution to the national priority to improve the quality of the environment and public health, secure greater energy independence, and contribute to the lofty goal of building an "ecological civilization."

Royalties may open up options for re-structuring existing debt, replacing it with long-term revenue sharing obligations. They might play a role in fueling other types of alternative securities that are new to China, including Real Estate Investment Trusts, or REITs. They could provide higher returns for conservative investors, possibly without increasing real risk.

The Simplicity of the Revenue Royalties Model

Use of royalties in China could improve trust and understanding of financial markets, and reduce the popular "casino mentality" perception of financial markets in China, because royalties are so inherently transparent and easy to understand:

"How much topline revenue did our toll bridges collect today? 1 million RMB (about $151,000 USD at current exchange rates). What is the current royalty rate? 4.5%. How much is owed to royalty investors for their original capital contribution? 45,000 RMB ($6,795 USD) for today."

"Right, so let's put 45,000 RMB into a special investor account this evening, and every 90 days we'll issue checks to investors for everything collected in the past 90 days, along with a statement of the gross revenues collected."

Anyone can understand that conversation. The royalty obligation appears as a foot-noted contractual expense on the balance sheet of the enterprise, not as debt and not as capital stock. The expense is variable, but fairly easy to project for enterprises, like the electric bill or the mobile wireless bill. When they generate more revenue, they pay proportionately a little more in royalties that quarter.

If income is seasonal, and revenue fluctuates -- like many PPP projects, a toll bridge for example has higher traffic in the summer than in winter -- then royalty payments are lower for that period. Investors know this, and expect it. Enterprises can plan for it, and don’t have the fixed obligation of a debt payment, that remains due regardless of what happens with their revenues.

Freeing up Frozen Capital

For the millions of careful savers in China who keep their money in cash, in old phone books, in a box on the top shelf, or under the mattress -- they could now have a place to invest that they can understand and trust. They can see that toll bridge for themselves, they can see the cars crossing it, they can see the tolls being collected, mostly electronically these days. They can know that 4.5% of the collections are coming to them.

They can invest in a portion of the bridge’s revenues and receive the income, or reinvest it for the future, giving financial institutions a windfall of cash to manage for retirement, health, savings, college, new businesses. Fresh sources of revenue for the financial services industry appear, putting all that new cash to carefully-managed, productive use.

So PPP royalties could also have the benefit of flushing some of that hidden cash out of savers’ mattresses, and putting it to productive use in the real economy. The call for a strong focus on the “real economy” is very clear to China’s financial management community.

Shadow Banking

A recurring issue for the financial services system of China today is shadow banking -- unauthorized, unregulated lenders who provide loans to small businesses at very high interest rates.

The shadow banking system exists to fill a need -- for capital to grow small businesses. Capital is not sufficiently available, on reasonable terms that are easy to understand. So some lending activity is driven underground.

This exacts a big cost to the economy, with payment of interest rates that sometimes exceed 30% annually, with defaults that can lead to crisis and bankruptcy when excessive payments are not made. The undocumented liabilities of shadow banking, of a size and extent that is unknowable to financial regulatory authorities, cast a shadow over the soundness of the economy.

Banking authorities in China understand this issue very well, and have prioritized policies designed to restrict unauthorized, unregulated banking.

Revenue royalties could be a way to help limit shadow banking, through incentives rather than penalties.

If those businesses working with shadow bankers today were to receive capital from royalties-powered sources -- on terms which are easy and concrete for them to understand and trust -- they could access the funds they need to grow their businesses on reasonable terms, without incurring crippling debt.

It is also possible that some shadow lenders, who have legal, private capital to invest, may be drawn into the sunlight by investing in regulated royalties income funds. They would receive a fair return on their capital without the risk of operating illegally, and without being subject to the many potential penalties inherent in being a shadow banker.

A balanced combination of consistent, fair enforcement and strong penalties, plus reasonable incentives, is the best way to effect lasting, fundamental change.

Credit and Volatility

Adoption of revenue royalties could also have positive effects on the balance sheet of participating public-private enterprises -- improving their rating with the major credit ratings agencies. This could lower their cost of future borrowing, should they need to call on it.

The amount of royalties payments depends entirely on the gross revenues of a single enterprise -- therefore royalties have a low correlation to other securities, like stocks, bonds or currencies, which are influenced immediately by large market forces and investor perceptions. The forces that create volatility in those markets are quite different from the forces that drive revenues for a single company. Regardless of what happens on the Shanghai Stock Exchange today, people are still going to cross that toll bridge tomorrow, and royalties can be generated for investors even in challenging economic times.

Of course, over time, macroeconomic forces will also affect the growth rate of every business in the economy. But royalties will likely be a lagging indicator, fluctuating less than securities markets. Investment in royalties may diversify and improve the risk profile of a managed portfolio of securities, which is another growth opportunity for investment management firms.

Releasing Opportunities for Growth

Finally, a range of growth opportunities may be revealed by revenue royalties, when they become widely available to private companies. Some small and medium-size companies may qualify for financing with royalties that would not otherwise qualify for bank or other forms of debt. Those same companies may also have difficulty in securing venture capital, mezzanine or private equity financing on favorable terms, without experiencing a significant dilution of equity ownership. They may qualify for royalties financing, where they do not qualify for venture capital.

Investors may be more willing to provide capital through the royalties method than through equity or debt, because of the immediate income benefit, and because of greater transparency. If this proves to be the case, royalties could unleash a new generation of capital for promising young firms, spurring innovation, high-income employment, demand for advanced education, and opportunities for young entrepreneurs.

Revenue Royalties and the Economic Priorities of China

The overall competitive profile of a large, dynamic nation like China, in which young companies provide the competitive edge in new technologies, could be further enhanced by the careful introduction of revenue royalties as a financing option. And the long-term economic goal of the central government and provincial governments, which is to accelerate China's transition from its industrial-agricultural roots to a future commanded knowledge industries, service providing, intellectual property and technical advances, could be aided by the wide adoption of revenue royalties.

For the financial sector, revenue royalties would establish China as an innovator in fintech, or financial technologies -- a key to China's presence on the world stage of trade and markets. It could accelerate the wide adoption of the RMB as a global reserve currency, and provide new methods of financing for China's ambitious international development policy, the One Belt, One Road.

It is possible that royalties may play a role in the implementation of China's national resources policy, called "ecological civilization." The massive new infrastructure of renewable energy, conservation, pollution control, environmental cleanup, and waste management needed may be financed by the fresh capital introduced through revenue royalties. Not all projects will be suited to the approach of using a direct share of revenues, because some will not have immediately, directly measurable economic benefits that can easily be shared with investors.

But some projects, especially solar, wind, tidal, geothermal and other green energy generating projects, can directly replaced hydrocarbon kilowatts generated today with oil, coal and gas. Those green revenues can be directly measurable, and compatible with a revenue royalties approach. When implemented as part of the national policy to clean up the air, water and earth, revenue royalties could contribute directly to China's long-term energy independence, and to the health of its people, while producing millions of new, high-skill jobs.

With the benefit of experience and advice from seasoned American firms, China can identify best practices and adapt them to its own unique setting, priorities and history. With the benefit of a new type of financial security specifically optimized to the needs of the international investor, an influx of international capital could be attracted to China, for the first time directly supporting the development of its domestic public infrastructure through PPP's.

All of these factors could advance the highest long-term goals of economic policy and financial services: the advancement of balanced prosperity, international co-operation, the further integration of China into the global economy, and the creation of a network of financial interdependencies that are the surest long-term guarantor of peace.

Challenges to Implementation

This grand potential, however, does not come immediately, easily or without cost. New opportunity requires investment, education, adaptation of regulation and professional practice, and time.

First among the actions needed to implement revenue royalties for PPP and the private sector in China is education of the financial community about how this new asset class actually works. Academic institutions need to know how to teach and advise about it. Investment bankers need to know how to explain it and market it to their institutional clients.

Sound methods need to be developed to provide for secure, auditable recognition and accounting of gross revenues of an enterprise. Lawyers and legislators, government regulatory experts and think-tanks, need to be well informed so that revenue royalties fit within existing securities laws and practices. Tax policies need to be examined, with input from accounting firms and government tax experts, to be assured that the tax treatment of new capital coming into enterprises through royalties is correctly classified, that VAT is correctly applied, that the taxation of royalties payments, for both individuals and institutions, domestic and foreign, is levied appropriately. Different tax practices may apply to public enterprise than to private enterprise, to preferred new industries as distinct from legacy industries, and to income received before the original capital is recovered as distinct from long-term gains.

The major securities exchanges, from Shanghai and Shenzhen, to specialized exchanges in Tianjin, Guangzhou and smaller regional exchanges, need to be educated early about revenue royalties, preparing for the possible listing of new royalties income funds and individual companies on public exchanges.

It will be necessary to determine terms of authorized compensation that may be earned by the financial institutions and their advisors who arrange for revenue royalties investments, and the managed Funds that follow. Consideration should be given to a royalties-based incentive fee structure which, after covering administrative costs, would compensate participating institutions using a percentage of the royalties generated. This may be a creative alternative to the standard formula, that uses a percentage of assets under management (AUM), with a base hurdle rate founded on an international standard like LIBOR, and a share of the value appreciation generated.

Royalties, as a new asset class, may perhaps be implemented with a new compensation structure for the institutions that introduce and manage it.

Implementation: First Steps

All of these questions need to be carefully evaluated by a wide range of financial and government professionals, managed to a common set of objectives and standards, and directed to commonly accepted deadlines. Participation led by the Ministry of Finance, including the major commercial banks, especially CITIC Bank, the innovator in this field, by the National Development and Reform Commission (NDRC), by the China Securities Regulatory Commission (CSRC) and by the nation's central bank, the People's Bank of China (PBOC) would be appropriate starting points.

A well-structured PPP institution already exists in China: the China Public-Private Partnership Center, which involves major institutional shareholders including China Great Wall Asset Management, China Orient Asset Management, and CITIC Trust. Its efforts to investigate the usefulness of revenue royalties are being led by one of its members, the Tianjin Financial Assets Exchange, with participation from Asia-Pacific Group and the authors of this White Paper.

The United Nations already has a significant PPP development effort, and China has a presence in that forum. Further involvement with key global financial institutions, including the major investment banks, with multilateral institutions like APEC, WTO and Davos, should be developed, to cultivate shared experience, standards and partners.

This is a solid beginning.

A national committee, empowered to authorize market experiments and pilot programs with revenue royalties in focused industries or geographies, could be one method of managing and expediting progress in the practical adoption and financing of revenue royalties in China. A proposal for such a committee is under discussion.

The Vision, Revisited

At the beginning of this White Paper, we sought a vision of how revenue royalties could be implemented.

An equally important question, next to “how,” is “why.” An understanding of fundamental purposes is needed, to guide the implementation of a new financial method. This mission should be revisited continuously as the project develops, to measure accumulated actions against original vision.

Revenue royalties represent a refreshed economic revolution for modern China.

Their underlying philosophy is true to the original spirit of China, the aspiration that drove the formation of a new nation in 1949.

It is based on community, shared commitment, equality for all, openness to ideas from around the world, lifting up all people, and dedicated to peace.

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