Establishing Royalty Rates in Licensing Agreements

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Manufacturers possessing proprietary technology, know-how or 'brand value' in their products and who are looking to expand their operations sometimes consider licensing. Pursuant to a licensing arrangement, the Licensor typically offers a Licensee the right to produce and distribute the Licensors' products for a defined period in exchange for a royalty. Licensing arrangements frequently are associated with international expansion efforts, where the Licensor does not have the resources to penetrate a new market on its own, and therefore finds a 'partner' that is familiar with, and has an established infrastructure in the territory. From the standpoint of the Licensee, a licensing arrangement can provide it with access to proprietary technology and other intangible benefits that would otherwise be difficult, costly, or in the case of patented products, impossible or impractical to develop on its own.

The first issues that normally arise in discussions between the Licensor and Licensee when negotiating a new licensing arrangement or modifying an existing arrangement are the terms of the license agreement and the amount and structure of the royalty payment. These issues are directly interrelated. This article examines various factors that normally should be taken into account when establishing an appropriate royalty rate, including the related provisions frequently found in license agreements.

Royalty Structure

Conceptually, the bases for structuring royalty payments generally are either a fixed sum per unit sold, or a percentage of revenues or operating profit derived from the sale of licensed products.

Fixed dollar royalty payments often are adopted where licensed products are sold as components of larger 'system' type sales, and the price received for the licensed products may not be determinable in isolation. Where a fixed dollar amount per unit sold is adopted, the dollar amount generally is adjusted for inflation, although this is not always the case, particularly where a minimum royalty amount is specified. The drawback of the fixed dollar basis is that there typically is no recognition of changing market conditions. Therefore, at any given point in time, or over time, fixed sum royalty arrangements may prove to be economically unfair to either the Licensor or the Licensee.

Royalties that are based on a percentage of the Licensee's revenues or operating profit relating to the licensed products require that the measurement base be clearly defined. For example, where net revenues is the term adopted, the license agreement should be clear as to whether the price received for Licensee-customized extensions or modifications to the basic licensed products are subject to royalty, and what deductions are allowable in determining net revenues (discounts, product returns, external sales commissions, and so on). The percentage of revenue basis of royalty determination inherently gives effect to inflation.

Where operating profit is the measurement base, it often is determined by applying a pre-established profit percentage to revenues generated from licensed products. The profit percentage is negotiated between Licensor and Licensee, and should reflect direct manufacturing and selling costs related to the licensed products, as well as a 'reasonable' allocation of fixed overheads. Use of a predetermined percentage operating profit avoids any issues associated with accounting discrepancies. Where properly and equitably determined, profit-based royalty payments generally make the most economic sense to both Licensee and Licensor. However, a percentage of revenue generally is adopted due to the difficulties of the parties agreeing on an operating profit percentage, and for ease of administration.

Royalty Rates

Concurrent with the issue of royalty structure is the determination of royalty rates, i.e. the dollar or percentage amount that is to be applied to the agreed measurement base. The guiding principles of royalty rate determination are that the rate should be based on 'economic fairness' to both Licensor and Licensee, and that it should be reflective of the 'value' received by the Licensee from the Licensor over the term of the license agreement. The value that is conveyed from Licensor to Licensee is a function of specific factors relating to the licensed product(s), the terms of the license agreement, and the particular characteristics of the Licensor.

Among the product-specific factors that should be considered in establishing royalty rates are:

- the uniqueness and competitive advantage of the licensed products, including the scope and remaining life of any patents relating thereto. The importance of ongoing technology and product improvements to remain competitive, and the Licensee's rights to those improvements, also should be considered;

- the markets in which the Licensee will sell the licensed products, including market size, growth rates, extent of competition, and recent developments in that regard. While the size of the territory should be specified in the license agreement, the market dynamics within a licensed territory influences perceived profit potential and hence the level of interest among prospective licensees, which in turn is reflected in the royalty rate demanded by the Licensor; and

- the degree of complexity in the sale of licensed products, and the extent of customization in customer-specific applications. A greater level of sale complexity and Licensee customization generally results in a reduction in the royalty rate from what it otherwise would be.

The license agreement sets out the rights, privileges, and obligations of both Licensor and Licensee. The provisions within a license agreement that generally have the greatest influence on royalty rates are those relating to:

- the size of the licensed territory, including any restrictions, and whether the Licensee is afforded exclusivity within that territory. As a practical matter, where exclusivity is not granted, royalty rates tend to be significantly reduced;

- the length of the initial license term and provisions for renewal. Where the provisions for renewal are favourable to the Licensee, that would cause royalty rates to increase. Where a Licensor does not intend to renew an existing license agreement, it must develop a transition strategy to a new Licensee or in-house resources. Depending on the nature of the product and the territory, the Licensor may find that it has substantive barriers to terminating an existing license agreement;

- the provisions for termination. The conditions for unilateral license termination (principally intended to protect the Licensor) generally involve the Licensee committing a material breach of the agreement terms, and not rectifying that breach within a specified time period. In addition to license termination, a party that commits a breach of contract may also be subject to damages for loss of existing or potential business, loss of reputation, and so on;

- whether or not a minimum royalty exists; and

- the Licensee's ability to assign the license to a third party, either directly or indirectly (i.e. through the purchase of a Licensee's shares by a third party acquirer). To prevent the latter from occurring, license agreements sometimes specify that the license can be terminated upon a change in control of the Licensee.

The particular characteristics of the Licensor that normally have a bearing on royalty rates include:

- the Licensor's presence within its own markets, its financial viability, and whether it has critical mass in terms of size, senior management depth, and depth of technical knowledge. License arrangements often are pursued by Licensors that are themselves small or medium sized businesses, and which may not be well financed, or which may be reliant on the strategic, selling, or technical abilities of one or only a few individuals. The greater the risk that the Licensor may not be able to support its licensed products, both financially and through ongoing technological improvements, the greater the risk to the Licensee, and hence the greater the pressure to decrease royalty rates;

- the Licensor's plans, strategies, and level of commitment relating to the licensed products. This should include committed R&D funding for improving licensed products and for developing new products that would form part of the existing license agreement. A Licensor with a well-formulated strategy based on market analysis and research will be in a better negotiating position with respect to royalty rates. Ideally, the plans and strategies would be shared with the Licensee to ensure consistency in objectives and to help promote a 'partnership' atmosphere; and

- the extent and timeliness of support offered to the Licensee, both in terms of technical product advice, and assisting the Licensee with sales and marketing efforts in its territory. This is especially important for technologically sophisticated products and applications, and for those products involving a complex selling process, particularly during the initial years of a license arrangement where the Licensee must go through a learning curve. Typically, the better the support offered the Licensee the greater should be the royalty rate, and vice-versa.

While the Licensee normally pays for the value received from the Licensor in the form of cash royalties, the Licensee may offer the Licensor other things of value as well. The royalty rate will be influenced by the respective estimates of both Licensor and Licensee as to aggregate sales potential within the licensed territory given the characteristics of the Licensee. A Licensee with sound financial viability and an established market presence may offer strong support and instant credibility for the licensed products. The Licensee may also contribute value to the Licensor in the form of product enhancements and new product developments. In some cases, the Licensee may assist the Licensor in the areas of strategic analysis, sales and marketing relating to the licensed products. Where the Licensee provides the Licensor with non-cash forms of value, this normally would reduce the cash royalty rate otherwise determined.

Depending on the circumstances, as a general benchmark subject to fact-specific adjustment, an amount equal to approximately 25% of the Licensee's operating profit derived from the sale of licensed products often is viewed as an appropriate royalty payment where the Licensor provides the Licensee with significant value. Significant value generally implies all of the following: (1) products with a long term competitive advantage; (2) license terms that are favourable to the Licensee; (3) the Licensor has critical mass, and strongly supports its products and the Licensee; and (4) the Licensee does not provide any non-cash value to the Licensor. Where some or all of these criteria are not met, an appropriate royalty rate based on operating profit would be reduced.

Other Considerations

The determination of an appropriate royalty rate becomes more complex where the Licensee is required to purchase certain components used in manufacturing the licensed products from the Licensor (so called 'mandatory supply arrangements'). The Licensor may argue that the arrangement is necessary to ensure the quality of manufactured products or to protect its proprietary know-how. In most cases, the mandatory supply arrangement results in an additional source of profit for the Licensor (the quantum of which seldom is disclosed), and which therefore tends to decrease the royalty rate otherwise determined. Where the Licensor and Licensee are located in different countries, this arrangement may also subject the Licensee to shipping delays and foreign exchange risk. Where a mandatory supply arrangement forms part of the license agreement, the Licensee should ensure that the prices of the components in question are clearly established, and that there is an acceptable means of controlling price increases.

Finally, where royalties are paid in a currency other than the Licensor's home currency, it generally is the Licensor that bears the exchange risk. While it often is possible to hedge exchange risk over a relatively short period (one to two years), due to practical limitations, it may not be possible to effectively hedge over a longer term. Since the duration of licensing agreements typically extends beyond a short time frame, the Licensor may be exposed to devaluation in its royalty earnings based on long term structural economic factors in the licensed territory. The Licensor should account for this risk when determining an acceptable royalty rate.

Conclusion

Licensing can be an ideal means for both Licensors and Licensees to attain their strategic goals. For this to occur, it is important that both parties perceive the basis for determining royalty payments to be fair over time, which normally means expressing the royalty rate as a percentage of revenues generated from the sale of licensed products. The royalty rate agreed to should be based on an objective assessment of the value received by the Licensee from the Licensor, which is a function of the characteristics of the licensed products, the terms of the license agreement, and Licensor-specific factors. Where the Licensee provides the Licensor with value other than cash, this also should be considered in determining the royalty rate.

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