Royalties, equity stakes and shared risk

In this guide we will cover:

- Why consultancies are considering different business models
- Different approaches to client work
- Shared risk as a route to new clients
- Royalties and bonus payments
- Equity stakes and structuring shared risk
- Working with an inventor and self-generated projects

In order to grow the value of their businesses, and to recoup more from the intellectual property generated in the design process, a number of design consultancies are exploring different ways of partnering with their clients.

This can include royalty fees, target-based bonus payments, joint ventures and even equity stakes. Some people believe that such entrepreneurial activity represents the future for successful design companies, particularly those operating in the areas of product design, product development and innovation. For clients too, this approach operates on the basis of an appropriately shared risk and reward in a way that can bring new innovations, products or services to market.

WHY CONSULTANCIES ARE CONSIDERING DIFFERENT BUSINESS MODELS

Doug James, managing director of design group Honey, explains why his consultancy is looking at different remuneration models: 'First and foremost, it's about building long term relationships. Why? It's all about looking to future revenue.'

The standard system of time-based fees, where a design business charges a day rate for the amount of time spent on a project, means that it is very hard for most groups to grow their value and scale over time. Projects come and projects go and the commercial value of the ideas generated by designers is usually entirely transferred to client businesses under the terms of the project contract. Successful design groups might get progressively bigger and better clients and projects, but charging a day rate automatically limits the amount of money that can be made and the duration that a project will deliver revenue.

'The idea of charging for time is quite daft, although the design industry went down that route a long time ago and is now trying to get out of it,' says Ian Webb, a designer entrepreneur and managing partner at design group Webb Scarlett deVlam. 'When you're charging high rates it's not so bad, but as the market becomes commoditised hourly rates are going down and clients are capturing more of the value of IP for much less money. We've even encouraged this commoditisation by obsessing over hourly rates.'

British Design Innovation, the trade organisation for industrial designers and innovation professionals, says that the time is right for consultancies to consider different models, particularly those groups working in product development and innovation. ‘The design and innovation climate is changing rapidly,’ it says. ‘The challenges of convergence, tighter budgets, less risk-taking, free pitching, and the impact of international competition have all played their part in applying financial pressure to designers. As a result, strategic designers might now benefit from being more open to – and sometimes actually instigating – different payment models. By introducing an element of sharing and participation, there is an opportunity for the unique input of strategic designers to be more easily embraced and encouraged, and in a way which works to the benefit of all the parties involved in the innovation chain.’

In fact, Caroline Johnson, a partner at creative industries mergers and acquisitions specialist Results International, claims the hourly rates model is fatally flawed anyway. ‘There is no value in the time-based recoverability model at all. That is a given. Clients and competitors will always undercut you and even if you stick to high rates, you’ll never recover all of your time,’ she says.

DIFFERENT APPROACHES TO CLIENT WORK

While this may be true, realistically all design groups are going to base at least some proportion of their revenue model on time-based fees. But there are alternatives for bolstering that basic income.

Some consultancies are looking to secure more value from the ideas they generate. In a typical client project the design consultancy charges for its time (or with a flat fee), while assigning all rights to the creative ideas – the intellectual property – over to the client. In some cases, these ideas might have substantial commercial value in the marketplace – value that could far outstrip the fee paid by the client to the designers.

So how can designers, especially those working in product development and innovation, start to get a better deal? Some different ways of approaching client projects involve a degree of investment or risk in return for a ‘reward’ later on if a product, service or business proves commercially successful.

To help with this, BDI has launched Propositions into Profit (PIP), in collaboration with law firm Harbottle & Lewis. The PIP programme is designed ‘to support strategic design firms and entrepreneurs, SMEs, universities, technologists, engineers, IP specialists and mid to corporate brand owners to collaborate and more appropriately share the risks and rewards of bringing new propositions, products and services to market.’ A guide to sharing risk and reward is also available from the BDI website.

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> For more information about Propositions into Profit and to download The Shared Risk Guide, visit the BDI website

Harbottle & Lewis asks how this risk and reward could be shared: ‘Typically, the business or individual providing the backing for a new venture will expect to be rewarded well when the venture succeeds, in large part because “the hits fund the misses”. We see a direct analogy with the case of design agencies who are asked, in effect, to “back” a new product or service, by supplying it with valuable expertise and knowledge transfer at no or reduced cost. In cases like this, it is reasonable to expect that the design agencies will seek to agree a structure which enables them to participate fairly, and potentially to reap considerable financial rewards.

There are two challenges to overcome in order to turn this expectation into the reality. First, to achieve acceptance of this as an approach... Second, in suggesting or agreeing a structure which is both fair and workable.’

SHARED RISK AS A ROUTE TO NEW CLIENTS

As BDI is keen to point out, there are many benefits to businesses of sharing risk with designers. In a typical innovation or product development chain strategic designers can provide valuable input at all stages: from early concept and/or technology prototyping, through to an articulation of the potential product, and on to taking that product to market with branding and strategic positioning work.

Business trade shows and fairs play host to many brand owners who might want to work in this way, says Adrian Collins, managing director of packaging design consultancy Ziggurat, which has set up shared risk arrangements with a number of clients, including Jonathan Crisp. 'These people are completely focused on the product, but what they generally don't understand is branding – they can't generate an idea, meaning and awareness around the product. In order to make something a success they need to move from the product-centric stage to focusing on a full commercial brand.

'For us, this way of structuring contracts started with Jonathan Crisp, when we came up with a concept of about eight different "snob" characters and a cost to do it. But the client said he wouldn't pay any more than about a third of that cost. I wouldn't release the ideas for that because I didn't think they would be able to do it properly for that amount of money. So I offered to effectively invest the extra two thirds in the business on the agreement that if targets were hit in 12 months' time he would pay me back twice that amount, which he did.'

ROYALTIES AND BONUS PAYMENTS

Royalty or bonus payments can be traded for discounted design fees. In this way, the reduced design fee is offered in return for a percentage payment back to the design group based on unit sales, sales thresholds or the achievement of performance targets at the client's business.

Royalties can be linked to things such as:

- Profits
- Gross sales
- Sales over certain thresholds
- Net receipts

And they might be organised on this basis of a:

- Fixed or sliding scale
- Guaranteed minimum
- Cap

Because the upfront design fee is lower in this set-up, royalty agreements can be an option for smaller, entrepreneurial clients that might not have the budgets for all the design work required to make the company a success. Of course, it is up to the design group to decide which clients are worth backing in this way.

At Therefore, discounting fees in exchange for royalties or bonus payments is the preferred model, says Hunt. 'Our preference would be to discount design fees for royalties because [the money generated from royalties] gives stability in what would otherwise be a lumpy business, in terms of revenues. Five years ago we worked on 100 per cent design fees; now it's around 50 per cent.'

Royalties can be organised in a number of different ways, so it is worth consulting an IP law specialist to understand the differences between these set-ups and how they might apply to your situation.

ROYALTY PERCENTAGES

Royalty percentages are likely to range from one per cent up to 12 to 15 per cent, depending on the nature of the business, the product and the scales and risk involved. Of course, an agreement can set any rate at all, so calculating and negotiating the percentages you're after is very important. BDI recommends a few things to consider, including:

- Estimates of the 'time cost'
- Estimates of the likely timeframe for funds to emerge
- Realistic sales projections
- The risk (bearing in mind what the cost to the client would be if it borrowed elsewhere)

'We generally agree the royalty amount in advance,' says Patrick Hunt at Therefore. 'A key issue is the projected sales volume as this will influence the unit royalty. We tend to know in advance how long our development will take and therefore what the fee would be if we were using the standard consultancy model [of time-based fees]. If we agree to discount our fees we then multiply the remainder by a factor which depends on risk, client track record, the speed of sales and so on. This amount governs the unit royalty and we may choose to lessen the royalty amount after a certain number of sales.'

Another option that could be added to the equation is bonus payments. 'You might agree a bonus based on some threshold of an uplift in sales, plus royalties,' explains Webb. 'You need to fix this in time so that present sales are "ground zero" and any bonus is purely performance-based because it is specific to a sales uplift. There are lots of ways of baking the royalties and bonuses cake, all based around shared risk.'

EQUITY STAKES

Yet another route is to negotiate an equity stake in the client's business, again probably by discounting design fees during the project. Doug James is managing director of design consultancy Honey, which has taken a stake in its salad bar client Tossed. James says that taking equity in a client's business demonstrates that you are interested in being a long term, strategic partner, but warns that it is not something to be entered into lightly.

'Only take the equity route once you've tested each other out properly. Be very cautious, because you don't know if you're going to get on and equity is more of a long term investment because you're not going to get anything back for at least three to five years – two at the earliest. So you need to validate the product, check out whether there's a gap in the market and show the client that you intend to be a long term partner, not just there to do projects.'

If a business takes off, being the owner of a stake is clearly a bonus, especially if it is successfully floated on the stock exchange. But equity has its downsides: if something goes wrong in the business, you are part of it, whereas royalties based on margins are essentially all upside.

If you are thinking of approaching a client to take a stake in their business, here are a few things to remember:

- Test out the relationship for at least six months
- Only invest in something when you believe all parties can deliver what is required
- Always take some fees; don't work for equity alone
- Don't base your remuneration criteria on the client business' profit, because the company controls what is determined as 'profit'
- Ensure your contract states that IP will return to you if it is not used by the client within a certain timeframe
- Talk to an accountant about the tax implications of holding a stake in another business.

HOW TO STRUCTURE SHARED RISK

In any project some work will be undertaken on a fee basis and some may use discounted fees in return for later rewards, under one of the shared risk models described above. But which elements should be handled in which ways?

Assuming that designers have been involved throughout a new product development or innovation cycle, BDI recommends that 'early assessment knowledge' - which creates ideas and sets up proof of concept – should be paid on a fee-basis, while the following stages, where a route is chosen and developed for market, are where shared risk is best negotiated.

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To download BDI's The Shared Risk Guide, visit the BDI website

WORKING WITH AN INVENTOR

A collaboration or partnership could also arise when someone approaches the design group with an invention, asking for help to refine the idea and turn it into a marketable product. As with all the above scenarios the challenge for the design group is to determine, Dragon's Den-style, which ideas have commercial potential. It's then a case of being clear from the outset how the collaboration or partnership will be structured, who will own IP (who will register it and pay for the registrations) and how and when revenues and payments will be allocated.

SELF-GENERATED PROJECTS

Another way of building revenue streams beyond time-based fees is through self-generated, self-funded projects. Needless to say, this requires time, money and a willingness to shoulder some risk. But any successes will provide a steady income to the consultancy, some of which can be invested in additional self-generated projects.

Therefore began this process a few years ago and now has under its belt the Presso coffee machine (spun off as a separate business), a hi-fi stand design ultimately sold to Naim Audio and an innovative school desk originally sold by educational IT group RM.

'It's really hard to get up that first step. The first two years were very hard for us in terms of time and money, but once you're there and you've got some assets it gives you a revenue stream on which you can build future projects,' says Therefore creative director Patrick Hunt.

This design group as entrepreneurial business: conceiving an idea and selling it to a company that can market it and distribute it effectively. There is a risk involved, but the ongoing benefits of any successes can be shared between client and designer alike.