The Deal

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HEALTHCARE COMPANIES LEVERAGE ROYALTIES, NOT THEIR BALANCE SHEETS

BY SARAH PRINGLE

Choppy equity markets are hurting the valuations of many healthcare stocks, so instead of raising equity or even debt in a traditional way, some of the industry's most voracious users of capital are increasingly funding everything from research to clinical trials to acquisitions through a less conventional, non-dilutive means-royalty or revenue interest financing.

"The power of revenue interest financing is you can raise a large percentage of a company's existing market capitalization," according to Houlihan Lokey Inc. managing director Lionel Leventhal, who heads up the firm's royalty and revenue interest financing team. "This form of financing is like harmless debt. It's almost impossible to get over-levered or be put into a position of financial distress from revenue interest financing as long as it's structured without financial covenants."

A big boast, for sure. Harmless debt? There are risks (long lead times, unpredictable sales, long royalty periods) associated with royalty and revenue interest financing, but Leventhal is right about the structure of such fundings. The borrower doesn't feel undue strain if its business ebbs and flows.

Or, as Todd Davis, co-founder and managing partner of Healthcare Royalty Partners, with about $3 billion under management, puts it, healthcare royalty financing is a "wax and wane" market.

Demand from pharmaceutical, biotech, medical device and diagnostics companies for such financing is growing dramatically, too. According to Duke Royalty Ltd., the U.K.'s first public diversified royalty company, it's a $30 billion sector in North America.

Royalty and revenue interest financing essentially relieves a company or institution from the implied pressure when raising capital with equity, and at the same time is more flexible than traditional debt that requires periodic repayments regardless of performance.

A royalty or revenue interest financing is structured so that payments rise and fall based upon how successful the company is. In other words, the company pays back an agreed-upon percentage of its annual sales or royalty stream each year until the investor achieves a predetermined return on invested capital. Once that negotiated capital of return is reached, the agreement is automatically terminated. Such deals may or may not even have a term.

Conversely, venture debt, offered by the likes of Oxford Finance LLC and Silicon Valley Bank, typically has to be repaid in full within 12 to 24 months after being borrowed, whereas traditional lenders that are generally conservative and tend to lack a true understanding of pharma and medical device companies, protect themselves with restrictive covenants, explained Houlihan's Leventhal.

"It's great if a pharma company is over-performing, but what if it's underperforming just a little?" Leventhal said, referring to traditional debt. "You still have to make these scheduled payments at the end of each anniversary regardless of how the business is doing."

Royalty investors, on the other hand, are knowledgeable and savvy enough that they don't have to embed these arbitrary restrictions to protect themselves, Leventhal asserted

The largest dedicated royalty investment entity is Royalty Pharma, with total assets of more than $15 billion and interests in 40 products, including medications such as Humira (rheumatoid arthritis), Remicade (rheumatoid arthritis), Lyrica (pain relief), Prezista (HIV) and Truvada (HIV), to name just a few. New York-based Royalty Pharma also funds late-stage clinical trials in exchange for royalty interests.

"The volatility and pricing of equity markets have given a lot of CEOs and CFOs pause, and has renewed interest in non-dilutive financing," said Alexander Perfall, vice president and head of investor relations at Royalty Pharma. "A royalty mon-

etization is a good way to fund growth and acquisitions without equity dilution."

While many private companies in the sector viewed an IPO as the best means to raising capital when the equity markets were flying high up through August, "conversely, when the biotech stock market index was down 40%, many stocks felt their company was undervalued," Healthcare Royalty's Davis said. "Some are right. For them, it [royalty financing] is a good option."

Royalty financing originated as a financing tool that was used sporadically in the 1990s, but it wasn't until 2000 that Paul Capital Healthcare's Paul Royalty Fund, a $300 million fund, became the first fund established to exclusively acquire passive royalty interests and provide revenue interest financing. Leventhal was a general partner and co-founder of Paul Capital Healthcare, where he ultimately spent about 14 years. Davis also served as a partner at Paul Capital for a couple years.

As more royalty funds entered the mix-the original three players were Paul Royalty, Drug Royalty Corp. and Royalty Pharma-other investment vehicles followed. From 2005 to 2009, a number of hedge funds took a shot at it, but lock-up provisions proved problematic given the liquid nature of royalties and so they didn't stick in the space for long, Davis noted.

One example is Dinakar Singh's New York hedge fund TPG-Axon Capital, which in April 2008 agreed to pay CV Therapeutics as much as $185 million in exchange for rights to 50% of its royalty on North American sales of its Lexiscan injection. Investment returns are unclear.

Other hedge funds that entered and exited the area include Marathon Asset Management LP and Fortress Investment Group LLC.

Today the royalty and revenue financing market has matured significantly, with about 15 funds that are focused solely on revenue interest and royalty financing, and another 20 to 25 credit strategy funds or special situation groups that operate out of broader debt-focused funds within large private equity firms such as KKR & Co., Apollo Global Management LLC, Blackstone Group LP and TPG Capital, noted Leventhal. A third category of investors are pension funds such as the Canadian Pension Plan Investment Board.

"The demand has skyrocketed, but the supply of capital may have skyrocketed even more," Leventhal said.

That's because North American phenomenon since its inception has finally made its way overseas.

Duke Royalty, for example, in September announced a pharmaceutical and healthcare royalty financing collaboration with Oliver Wyman, an international management consultancy wholly-owned by Marsh & McLennan Cos. (MMC).

While still in its very early stages, Duke Royalty's mandate includes investing in both classic drug royalties and synthetic royalties for healthcare services companies, Duke Royalty CEO and executive director Neil Johnson said. (Synthetic royalties are based on anticipated future revenues from late development stage or pre-commercial launch products, which haven't yet generated meaningful cash flows.)

The collaboration sets itself apart from existing royalty funds in North America largely because of its global footprint, added David Campbell, health and life sciences partner at Oliver Wyman, who said the firm has been fielding calls everywhere from Asia and Europe to North America.

Duke Royalty does all the capital raising and will structure the agreements and acquisition of each royalty interest, while Oliver Wyman, leveraging off the expertise of more than 200 professionals in its life and sciences unit, will use its proprietary data sets and methodologies to analyze and identify financing opportunities among patent-protected products that regulators have approved.

"Johnson and I were introduced at a remarkable time," said Campbell. "We had been formulating a thesis that there was a demand for a different yield product in the U.K. It was an opportune moment, if only we could find someone who saw the same opportunity and someone who could provide something novel."

Johnson, whose investment banking roots lie in Canada, where he led Canaccord Genuity's initiative to attract North American firms to list in London, had been formulating the same, idea.

"The public investors [in the U.K] have not been able to invest in the royalty companies," Johnson said. "The royalty companies raise money and deploy money."

He pointed to the level at which royalty funds outpaced the mining and commodity markets last year in Canada.

"It's a safe haven in a down market," he asserted.

On the flip side, North American royalty companies have already been active doing deals around the world for some time.

Leventhal said he is currently workingwith U.S. and European pharmaceutical and medical device companies in both private and public market deals ranging from $40 million to up to $400 million to $500 million.

Among the best examples in respect to terms and execution, he said, was last year's synthetic-royalty financing by Ariad Pharmaceuticals Inc. (ARIA), which Houlihan Lokey served

as the sole placement agent and financial adviser on.

Ariad in July revealed a synthetic-royalty financing from PDL BioPharma Inc. (PDLI) for up to $200 million at a 10% cost of capital, through which the Cambridge, Mass.-based pharma company agreed to pay PDL a mid single-digit royalty on future sales of its leukemia drug, Iclusig, until the latter garners its fixed internal rate of return.

The deal also included a call protection of two years, well below a typical call period of three to four years. So it the borrower wants to refinance, PDL gets the greater of a negotiated capped IRR and a series of multiples that increase over time (usually the multiple produces a higher rate of return than the capped IRR in the early years.)

Like many pharmaceutical companies, Ariad in its early stages had spent significant capital on R&D to support drug development and was left in a tough position to raise more convertible debt, Leventhal explained. The company needed between $100 million and $200 million to accelerate the timing for its Phase 3 pivotal trial for its second drug, but was sitting with revenue of about $125 million, negative Ebitda of about $155 million and already about $160 million to $165 million outstanding in convertible debt, he explained.

The royalty financing essentially allowed Ariad to accelerate the start of its Phase 3 pivotal trial for its second drug by as much of six months, Leventhal noted.

Besides helping fund clinical trials in exchange for royalties, royalty financing also serves as a financing tool for purposes such as M&A.

"Royalty Pharma has on a number of occasions partnered with pharma and biotech companies on M&A" Royalty Pharma's Perfall said, noting its joint acquisition with Forest Laboratories Inc. of Furiex Pharmaceuticals Inc. in April 2014.

When Forest agreed to purchase Furiex for $1.1 billion plus a CVR worth up to $360 million, it concurrently agreed to sell two royalties for about $415 million in cash to Royalty Pharma. By partnering with Royalty Pharma, Forest said at the time that it expected to cut its price paid by about $315 million after taxes.

But corporations aren't the only beneficiaries of royalty financing, with research institutions and universities contributing to increasing demand.

For instance, a March 4 announcement disclosed that UCLA has sold its royalty rights affiliated with Xtandi, a prostate cancer medication, to Royalty Pharma. The transaction was valued at $1.14 billion in cash, plus potential additional payments contingent on future Xtandi sales, representing one of the largest royalty transactions ever done.

UCLA, in turn, said it plans to use approximately $520 million of the proceeds to fund research and scholarships.

Like many investments, Royalty Pharma had been eyeing Xtandi for some time.

"Royalty financings typically have a really long lead time," said Terrence Coyne, vice president of research and investments at Royalty Pharma, pointing to the recent Xtandi transaction as an example. "Royalty Pharma started following the asset and first approached UCLA in 2010, but it wasn't until about six months ago that UCLA started seriously considering a monetization."

That UCLA waited so long isn't unusual, since its need for financing wasn't immediate. And firms like Royalty Pharma are used to that being the case and are patient because of how long a time they'll collect royalties if a deal occurs.

"We are buying into 15-year assets. Just predicting sales one year from now is challenging; Looking 15 years out, we have to be really cognizant of the many factors that could impact sales," added Coyne.

Healthcare Royalty Partners Davis added that while his firm looks at more than 300 qualified deals a year, about half of those are immediately ruled out from a risk profile perspective, and of the remainder, due diligence results in about six to seven deals a year.

For Davis, there are two types of risks-clinical safety and intellectual property. Healthcare Royalty is typically doing deals involving products that have already received regulatory approval, so that takes care of the clinical safety risk. Then the firm has to assess the intellectual property and commercial risk, measuring such factors as the size market the product is serving.

"There are a lot more deals to do than I suppose we're willing to do," Davis said.

In the end, the deals all come down to the drug compounds and other products involved.

"We see the opportunity to fund more research-put money and capital to work where it is required to accelerate the science," Perfall said. "Before we get to technical issues like patents, it's really the excitement about the science that makes our work so interesting.

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