

INTELLIGENT RISK-TAKING

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In the past several years, royalty financing techniques with respect to pharmaceutical and biotech assets have been increasingly utilized as a source of capital. These techniques have grown in complexity, evolving from fairly straightforward passive investments in monetary flows from pre-existing contracts (“royalty interest” transactions) to more complex investments in the anticipated future revenues from late development stage or precommercial launch products (“revenue interest” or “synthetic royalty” transactions).

A review of publicly announced transactions demonstrates the growing application of these techniques. In 2000, there were two publicly announced deals, one royalty interest transaction and one revenue interest transaction, with aggregate investments of \$145 million. In 2007 and 2008, there were 27 publicly announced transactions (19 royalty interest transactions, five revenue interest transactions and three “hybrid” transactions using multiple financing techniques, including royalty financing components) involving aggregate announced investments of \$3.3 billion. Although the number of investors in these transactions has grown, it still involves a relatively limited number of specialty investment funds. **Capital Royalty LP, Cowen Healthcare Royalty Partners, DRI Capital Inc., Paul Capital Healthcare and Royalty Pharma** are among the leading market participants. Of the 27 announced deals in 2007 and 2008, 22 were led by nine unique market participants (including these firms) and five transactions involved multiple investors.

The increasing range of complexity with these investments is further highlighted by the use of hybrid structures and the willingness of market participants to adapt their investment objectives creatively to those of the seller. For example, in August **Dyax Corp.** completed a \$50 million financing with Cowen Healthcare Royalty Partners, carrying a 16% coupon plus warrants, using a traditional secured lending model with the principal security comprised of Dyax’s phage display Licensing and Funded Research Program (LFRP). Dyax used the proceeds from this financing to repurchase a previously sold revenue interest in the LFRP and retained net proceeds of nearly \$15 million. This demonstrates investors’ creativity in applying their

expertise in this space to provide mutually attractive financing in what was, and remains, a challenging financing environment.

As the community of investors and sellers of these financial products grows, the trend toward broader, more complex service offerings should be expected to continue, with the associated effect that more sellers will find the range of offerings attractive alternatives to traditional financing models.

Both royalty interest and revenue interest transactions fundamentally involve the monetization by a seller of the future cash flows from an identified asset or pool of assets. The seller wishes to monetize certain assets that are anticipated to generate future cash flows, typically by receiving a lump sum payment. Occasionally, the seller wants to receive (or is compelled by the investor to accept) a discrete series of future payments tied to the achievement of identified benchmarks (ordinarily consisting of the achievement of regulatory or commercial hurdles). The monetization of the future cash flows from these assets has historically been achieved by a sale to one of a handful of specialty investment funds of a specified percentage of those future cash flows. The seller is able to take potentially unpredictable, and therefore risky, future cash flows in exchange for an upfront lump sum payment.

The investor’s motivation for making a royalty financing investment is the expectation of receiving a private equity level return (e.g., modeled internal rates of return often exceed 20%) in an asset class (directly or indirectly consisting of intellectual property interests in pharma and biotech assets) that is relatively non-correlated with broader market indices. The investor’s return expectations are predicated on its assumption of the risks of the sustainability of future cash flows (for royalty interest transactions) and of the commercialization of assets that have not yet generated meaningful cash flows or made substantial commercial penetration (most frequently in synthetic royalty transactions.) The investor’s ability to take on these risks intelligently is predicated on the synthesis of highly specialized capabilities in analyzing the commercial and regulatory landscape for the relevant assets, including assessments on the

strength of the underlying intellectual property in the relevant markets, the likelihood of competing or cannibalizing products and the likelihood of market acceptance for the underlying products.

Earlier uses of royalty financing transactions involved a seller (usually a university health system or small pharmaceutical or biotech innovator) that had an existing out-license of intellectual property, often with a large pharmaceutical or biotechnology counterparty, for which it received specified regular royalty payments. In exchange for a lump sum payment, the investor in the royalty interest transaction became entitled to receive a specified percentage of those royalty payments.

In recent years, royalty financing transactions have, with greater frequency, involved purchases of revenues from assets where future cash flows are not derived from an existing license or royalty agreement but are instead dependent on either future product sales by the seller, future out-licenses of the product or underlying IP by the seller, or a combination of future sales and licensing efforts. These transactions ordinarily involve nonuniversity sellers and the assets are typically at a not-yet-final approval or precommercial launch phase. Since there is no existing meaningful out-license to model, the investor's expectations with respect to future revenues are dependent on its analyses of the projected path to approval or commercial launch for the product and the likely market acceptance of the product once it is approved and launched. As a result of the earlier stage at which the investment is made, the investor will frequently insist on staging its investment, with funds being made available after critical regulatory and commercial hurdles are achieved. The added risks attendant to an investment at a pre-approval or prelaunch phase, without the support of a strong counterparty committed to the commercial success of an existing product, has tended to result in investor demands for yield enhancements, whether in the form of higher IRR targets or the inclusion of warrants or other equity kickers.

Synthetic transactions have also resulted in greater emphasis being placed on maintaining an alignment of interests between investor and seller vis-a-vis the subject asset's future success. Since the revenue stream in a synthetic interest transaction is typically dependent on an actual product that requires future seller commitment for successful approval or commercialization, it becomes imperative that the risk of a lapse in seller's attention to the product's success be addressed. Again, this might be done by requiring the seller to retain a meaningful residual interest in the product or by giving the investor both early termination rights (if the seller fails to abide by its obligations to support the product properly) and equity participation rights so the value that develops in the seller, but outside the product, can serve as a mitigant

for the seller's failure to support the product properly. These considerations have largely been absent from royalty financing transactions because the cash flows from those transactions are derived from an already well-defined asset (i.e., the out-license or royalty agreement under which the seller receives the cash flows being monetized.) In a royalty interest transaction there is typically little for the seller to do in order to continue to be entitled to receive the cash flows under the out-license or royalty agreement and the risk that the seller's other business initiatives could undermine the investor's cash flow assumptions are substantially diminished.

In addition to the increasing levels of complexity that have developed with the arrival of synthetic interest transactions, there has been a fairly steady increase in the numbers and types of end-users of royalty financing products. The traditional seller in a royalty interest transaction has often been a university medical center or research arm that had developed early stage intellectual property that it had out-licensed to a counterparty intent on making commercial use of the IP. Given the typical de-emphasis on commercialization in the university setting, university medical centers have not been good candidates for synthetic transactions. Small pharma and biotech innovators, on the other hand, are candidates to utilize both the royalty interest structure and the synthetic interest structure. If these innovators have already obtained an out-license of their IP, they can utilize the out-license in a royalty interest transaction. If they are committed to commercialization they can go the synthetic interest route.

Finally, with the increasing level of activity within the royalty financing space there has been a trend toward increasing deal sizes (e.g., 11 of the 28 publicly announced transactions in 2007 and 2008 involved investments in excess of \$100 million). This has already led to partnering arrangements among the specialty investment funds (many of whom have historically dealt with investments below \$100 million) and nontraditional sources (e.g., hedge funds) seeking to capitalize on the unique capabilities of the specialty investment funds in assessing the underlying IP and the regulatory and commercial landscape.

As more market participants use royalty financing techniques as an alternative financing tool, and as the transactions continue to increase in size, there is likely to be a corresponding continued increase in transactional complexity, with additional product offerings tailored to the needs and expectations of the respective participants.

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