Royalty Financing White Paper

What is Royalty Financing?

Royalty financing is a way for life science companies to raise non-dilutive capital as an alternative to raising equity or venture debt. Typically the companies that have access to this type of financing have products that are commercial or near commercial stage and are generating product revenue. Typical uses of royalty financing include operating expenses like launch financing or strategic investments like M&A or licensing activities.

Why would a life science company pursue this type of financing?

Royalty financing may be a useful financing tool for a company when equity is a non-preferred source of capital. If a company's share price has been adversely effected by macro environment volatility or by a heavy short interest position, a follow-on or equity-linked (convertible debt) financing may not be attractive to management teams and to current shareholders. All the while, biopharmaceutical companies continue to require significant amounts of capital to operate the business and seek to achieve growth. It is expensive to launch products, hire a sales team and execute on a commercial strategy! This is precisely where royalty financing can be an attractive alternative form of financing for companies – when growth capital is needed and equity is not an attractive option.

How large is the market?

The royalty financing market has grown significantly over the past 15 years as companies have become aware of this alternative financing strategy and as more investors have raised capital to complete these financing transactions. In 2016, there were over $4.8 billion in royalty financing transactions completed[1]. Since 2000, this dollar figure has grown at a compounded annual growth rate of 23%, further illustrating the robust growth in the market.

Importantly, well known, successful companies are utilizing royalty financing as an attractive way to fund growth through non-dilutive capital. Over the past decade, companies that have completed royalty financings include Vertex Pharmaceuticals, Halozyme Therapeutics, Relypsa Inc., Intarcia Therapeutics and Portola Pharmaceuticals.

What does a typical deal look like?

Fundamentally, a royalty financing can be categorized into one of two buckets. In the first instance, a company has out-licensed technology to another company who is marketing the product, and in exchange for licensing the product there are typically quarterly royalty payments made in exchange for use of technology. These quarterly payments can be monetized, or brought forward, in a single financing transaction. This transaction can be structured as an asset sale (sell 100% of the future economic rights) or as a financing (a loan secured by and recourse only to the future economic rights). This may be an effective way to monetize a non-core asset and unlock value for shareholders as the company can deploy this capital in higher returning projects.

In the second instance, if a company is seeking to commercialize a product themselves but is looking for non-dilutive launch financing, a royalty financing firm can provide upfront capital in exchange for future

[1] Based on publically available information and HealthCare Royalty Partners estimates.

fixed or variable (sales-linked) payments. These transactions can look very much like senior secured loan transactions (fixed interest and amortization schedule) or can take the form of synthetic royalty transactions (selling or creating a future royalty stream). This may be an effective way to finance commercial activities without raising equity, while providing the company with operating flexibility and a long-term or back-end loaded repayment.

What is a typical cost of capital?

These types of financings are typically individually negotiated, and so the details on each transaction will vary. One of the hallmarks of this type of financing is the bespoke nature (no one deal is alike) of the individual structures and key terms. Royalty financing typically provides capital that is less expensive than equity (if the company performs well) but also offers a longer and more flexible repayment schedule in additional to a larger investment size when compared with venture debt. Correspondingly, the cost of capital may be higher than venture debt but less expensive than issuing equity. Importantly, these types of investments do not dilute the existing shareholders, enabling them to benefit from share price appreciation.