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'Blame' It on the Weak Equity Markets

Record Year for Royalty Deals Builds Optimism for 2012

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Not everyone is upset about the turmoil in the equity markets. Last year was a record year for the sale of royalty streams and other structured product deals, in large part because of the lack of other options for biotechs.

The number of publicly announced royalty deals tracked by Cowen Healthcare Royalty Management LLC increased 85 percent last year, with the cumulative value of the royalty deals quintupling compared to 2010.

This year is shaping up to be more of the same. "The deal flow has never been this robust," Todd Davis, founding managing director at Cowen, told *BioWorld Insight* from the J.P. Morgan Healthcare Conference. "We have well over a dozen actionable opportunities just from this week."

Cowen will have plenty of capital to invest, having just closed an approximately $1 billion fund. The firm was only planning on raising $550 million, but received interest from a few large limited partners (LP) as it was concluding fundraising and decided to increase the size of the fund.

Davis said LPs are attracted to funds investing in royalties because the funds' returns are correlated with the performance of products rather than the equity markets. "In '08 and '09, in the first fund, as we anticipated, all of our investors continued to get their cash flow" through twice-quarterly distributions, he said.

The weak equity markets also drive the availability of royalties that the funds can purchase. When it's unattractive to raise capital through selling equity in the company and debt is hard to obtain, selling assets becomes one of the only options. Royalty streams are often the most valuable asset a biotech owns.

Royalty funds also buy royalty streams from universities and other nonprofits, which may be more inclined to accelerate their payments during tough economic times. "There are a lot of state budget issues, where funds are short, and if a university has a royalty, this is a very nice way to supplement their budget," Davis said.

Davis said the number of passive royalty deals will go up some this year, but the growth of product-focused structured finance deals will grow faster.

Biotechs in need of cash that own drugs in their entirety can monetize their asset by establishing synthetic royalties. The biotech receives up-front cash in exchange for giving up a percentage of its revenue from the drug. Alternatively the deal can establish a structured debt where the loan is collateralized by the revenues from the drug.

Drugs missing analysts' expectations recently would seem to make it harder to value royalties, but Davis said his firm is typically more accurate than Wall Street because it has access to confidential information, which often times results in a more conservative estimation.

Royalty funds also have the advantage of being long-term investors. They're valuing the assets over the life of the deal, measured in years, so slow launches aren't a major problem like they are for equity investors. "This is a long-term business where people are executing on long-term strategies, but they're judged on a quarter to quarter basis," Davis said of equity investors.

The sell-the-launch mantra that has caused many biotechs' valuations to slip recently could actually benefit royalty buyers, as it makes capital raises through equity sales less attractive. ■

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