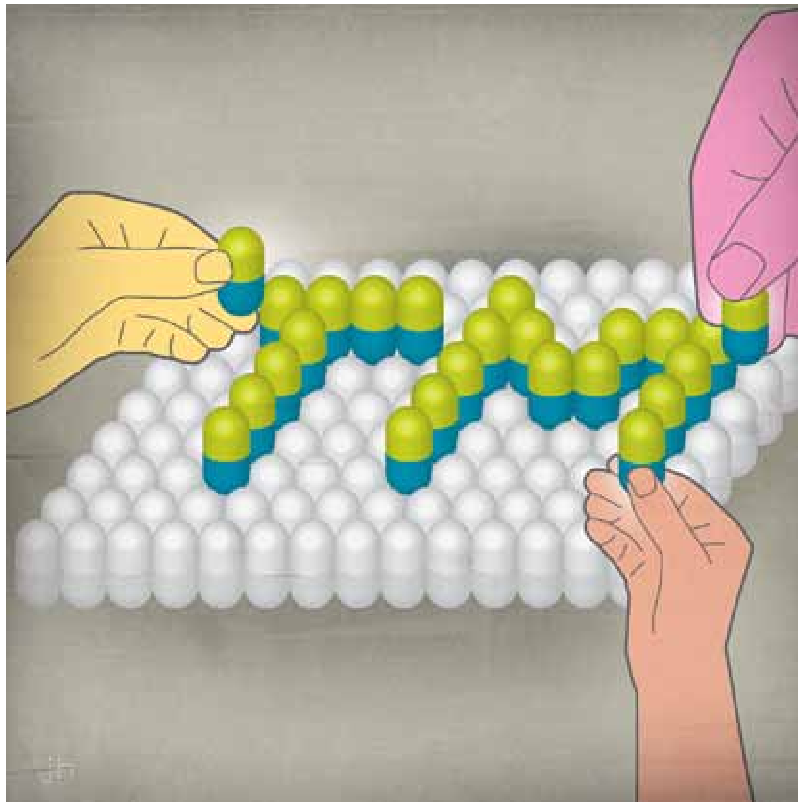
Institutional Investor



Experimental Treatment

Drug royalty securitizations have become a valuable source of financing for Vertex Pharmaceuticals.

●● **BY UDAYAN GUPTA**

THESE HAVE BEEN TRYING times for small, capital-intensive biopharmaceuticals companies, which have been virtually shut out of conventional capital markets. But Vertex Pharmaceuticals in Cambridge, Massachusetts, has discovered a novel solution: intellectual-property securitization.

In July the company announced that it was selling rights to future European revenue from a new hepatitis C drug called Telaprevir, which is in phase-three clinical trials and is expected to hit the market by April 2012. The deal, whose details are still being worked out, would give investors a stake in a series of payments totaling $250 million that Janssen Pharmaceutica, a Johnson & Johnson company, is expected to give Vertex on its successful completion of certain development milestones.

Securitizing drug royalties has quietly become a specialty of bankers at Morgan Stanley, which is advising on the Vertex financing. Since 2004 the firm has put together 17 such deals in the pharmaceuticals sector, raising $60 million to $700 million per transaction. It has found a reliable partner in Stamford, Connecticut–based **Cowen Healthcare Royalty Partners**, an investment fund with $500 million in assets. Cowen, which was co-founded in 2007 by three former partners at Paul Capital Partners, a private equity firm based in New York, has committed more than $300 million in total to ten deals, three of which are structured as drug royalty bonds, the term for this form of debt financing.

The two firms teamed up with Vertex last May on a deal tied to Lexiva, an HIV drug marketed by GlaxoSmithKline. Morgan Stanley crafted a special-purpose $160 million vehicle that Vertex sold in its entirety to Cowen, which, in turn, issued $115 million worth of bonds on behalf of the new vehicle with a guaranteed coupon of more than 15 percent. Cowen bought $15 million of the bonds for its own account and injected $45 million in equity into the deal, a move that could generate hefty returns for the firm if royalties from Lexiva exceed $160 million. The drug generated $52 million in royalties in 2007, the last year they flowed to Vertex.

This structure has advantages for issuers and investors alike. By creating a special-purpose vehicle to issue the royalty bonds, Vertex retains control of its drug pipeline and access to any incremental revenue it generates from additional licensing or drug sales. Bondholders, who have no recourse if the drug fails, are compensated for the risk they take with a fat yield.

"We've created a nondilutive form of financing — not an equity issue or a convertible bond that gives up the upside of the company, but [one] that allows the issuer to keep the upside," explains Thomas Cahill, co-head of structured products at Morgan Stanley. "If the drug doesn't work out and there's a downside, the investors are taking all the risk."

Hedge funds have been big buyers of drug royalty bonds, drawn by the diversification benefits, but other institutional investors have also shown keen interest. Nearly half of Cowen's capital comes from major insurers and pension funds like the Ontario Municipal Employees Retirement System (Omers).

"Investors like the high-yielding coupons, usually in the high teens, and the fact that the payments are not correlated to the markets," notes Clarke Futch, a co-founder and managing director of Cowen.

These transactions require specialized expertise, however. Deal makers and investors must not only assess the promise of a new drug, they must analyze the reliability of the royalties and accurately calculate the payment streams as well. They should also understand the drug approval process in relevant markets.

"You need to think like a doctor first," says Martin Day, managing director of Omers's private equity arm, which manages about 10 percent of the fund's $43 billion portfolio.

Despite their complexity these deals have advantages for a capital-intensive company like Vertex: In tough times they are a low-risk and relatively inexpensive way to get substantial cash in the bank. ••

● *Comment? Click on the **Capital Markets** tab at iimagazine.com.*

JOHN HERSEY