REUTERS

By Toni Clarke | Reuters.com

DRUG ROYALTY FINANCING THRIVES IN DIFFICULT MARKET

Aug 20, 2008

BOSTON (Reuters)

BOSTON (Reuters) - Private equity funds that specialize in healthcare royalty financing are gaining momentum as investors seek new ways to hedge risk, and companies seek new ways to raise capital.

For nearly a decade, the acquisition of drug royalties has been the province of a handful of specialty funds, which have won loyal, but not widespread, attention from investors.

Now, two trends are converging to generate greater interest: there are more royalties for sale from cash-strapped biotechnology companies, and there is more interest from investors seeking stable returns in a volatile market.

"Large pools of capital have become interested in these investments because they do not correlate to the traditional debt and equity markets," said Timothy Bryant, a partner at the law firm McDermott Will & Emery LLP. "This is a huge market and we are only at the early stages of its development."

A royalty asset gives the holder the right to receive future revenue on a pharmaceuticals product. It is a form of investing that has historically been dominated by four firms: Royalty Pharma, DRI Capital, Paul Capital and Capital Royalty.

Recently a new fund, **Cowen Healthcare Royalty Partners**, was formed whose principals broke away from Paul Capital earlier this year.

Cowen says it is already attracting interest.

"With the equity markets closed and credit markets without much liquidity, it's not surprising that many of these biotech companies are coming to us and we're seeing a lot of high-quality opportunities," said Gregory Brown, who helps manage the firm's $500 million in funds.

Despite the growing interest, don't expect many new funds any time soon, said Joshua Salisbury, managing director of DRI Capital, which has $1.1 billion in healthcare funds and is raising another $1 billion.

"Investors have a great interest in this," he said. "Hedge funds would love to do what we do but it is a very complex model that requires a lot of commercial and scientific expertise."

That is not stopping a growing number of hedge funds from trying.

"When something works, other people come in and try to do it," said Daniel Spiegelman, chief financial officer of biotechnology company CV Therapeutics Inc.

In April, TPG-Axon Capital, a hedge fund with more than $15 billion under management, agreed to pay CV Therapeutics up to $185 million in exchange for rights to 50 percent of its royalty on North American sales of Lexiscan, a stress agent used in the detection of coronary artery disease.

Some analysts were surprised.

"The magnitude of this deal is much bigger than we would expect, since physicians we have queried seem relatively uninterested in a novel cardiac stress agent," said Joseph Schwartz, an analyst at Leerink Swann, in a note following the announcement.

Time will tell if TPG's bet pays off.

One way or another, it is clear that investors, which include big institutions and endowment funds, are attracted to an investment whose rate of return is not tied to the stock market or a company's share price. The fund does not gain if shares soar; neither do they suffer if they fall.

Instead, returns are tied to the growth of the world-wide pharmaceuticals market, and tend to fluctuate within a fairly narrow band — which Cowen is targeting in the mid-teen to low 20 percent range.

With a high barrier of entry into the market, these firms stand to grow exponentially.

"The notion of financing pharmaceuticals on a product-by-product basis will be ubiquitous in 10 years," said McDermott Will's Bryant. "The tailwind is behind this story entirely. This is the age of biology and healthcare.

FACTBOX:
What are royalty and revenue interest investments?

Aug 20, 2008

Investors seeking to capture the promise of new drugs while decreasing risk are turning to royalty investment funds. Some facts about how royalty interest investments work:

- The royalty market is made up of two main types of investment: royalty interest and revenue interest.

- A royalty interest is an asset acquired when a fund pays an up-front lump sum for future royalties on a pharmaceuticals product. For example, a fund might acquire a royalty that is paid by a pharmaceuticals company to a university that discovered the drug. The university might use the funds to build a new wing or fund scholarships.

- A revenue interest, also known as a synthetic royalty, is a royalty created by a fund where none had previously existed. In such cases, the fund provides non-dilutive financing for companies looking to finance their business, such as to develop new products or fund acquisitions. The companies receive an upfront payment in return for a percentage of future sales.

- Cowen Healthcare Royalty Partners estimates the market for traditional royalties at $12 billion to $20 billion a year and estimates the market for synthetic royalties at $120 billion a year.

- The investments give companies an alternative fund-raising mechanism to PIPEs, mezzanine financing, traditional bank and venture debt and dilutive stock sales.

- Investors in such funds include big institutions and endowment funds such as OMERS Capital Partners, New York Life Insurance Company and The Travelers Companies.

- By putting money in a fund that acquires royalty streams, investors are not exposed to fluctuations in a company's stock price. They make money if sales of a drug exceed the expectations of the fund and the amount paid for the royalty stream over a certain period. They lose money if the drug underperforms.

- Returns on investments in royalty funds tend to remain in a fairly narrow band. They do not increase if a company's stock takes off, neither do they plunge if a company suffers a setback. Returns are tied to broader political and demographic trends within healthcare.

- The following are the most prominent private equity funds that specialize in healthcare royalty financing:
  — Paul Capital Partners
  — Cowen Healthcare Royalty Partners
  — Royalty Pharma
  — Capital Royalty Partners
  — DRI Capital
  — Non-specialist hedge-funds such as TPG-Axon Capital and Deerfield are also stepping into the arena.

(Reporting by Toni Clarke; Editing by Daniel Trotta)

CHRONOLOGY:

Chronology of recent royalty financing deals

Aug 20, 2008

Drug royalty financing is increasing as biotechnology companies find themselves locked out of the capital markets and investors seek to reduce risk.

Some recent royalty interest deals:

- December 2007 — Royalty Pharma acquired a portion of Northwestern University's royalty interest in Lyrica, a drug to treat nerve pain and pain caused by fibromyalgia, for $700 million. Lyrica is marketed by Pfizer Inc. Northwestern retained a portion of the rights and said it would use the money from the sale to support financial aid for students and to fund construction of new buildings.

- January 2008 — DRI Capital launches a $300 million structured finance fund, a hybrid debt and equity fund to provide capital to life sciences companies in exchange for an interest in future revenue streams.

- January 2008 — Artes Medical Inc enters revenue financing agreement with Cowen Healthcare Royalty Partners for $21.5 million in return for an interest in ArteFill, the company's injectable dermal filler to correct "smile line" wrinkles.

- March 2008 — DRI Capital Inc agreed to pay $10 million to Nanogen Inc in return for all future royalties from Applied Biosystems ABI which licenses technology from Nanogen used in molecular detection and diagnostics.

- April 2008 — TPG-Axon agrees to pay biotechnology company CV Therapeutics up to $185 million for rights to 50 percent of the company's royalty on North American sales of Lexiscan, an agent used to help in the detection of coronary artery disease. CV Therapeutics receives a royalty on the product from Astellas Pharma.

- April 2008 — Vivus Inc announced it entered a $30 million agreement with Deerfield Management in which Deerfield agreed to provide funds for a late-stage clinical trial program for avanafil, a treatment for erectile dysfunction. Vivus granted Deerfield a royalty interest on sales of its existing Muse product for ED. Deerfield will also receive a royalty on sales of avanafil, if approved.

- July 2008 — Cowen Healthcare Royalty Partners announces closing of its fund at $500 million, substantially exceeding its initial target size of $350 million.

- August 2008 — Dyax Corp enters $50 million loan agreement with Cowen Healthcare Royalty Partners, secured by the company's drug development technology.

(Reporting by Toni Clarke; Editing by Daniel Trotta)