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A Primer on Healthcare Royalty and Credit Investing

By Nick Veronis and Dan Fletcher, CFA®



INVESTMENTS & WEALTH INSTITUTE®

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Bond markets historically have played an important role for investors seeking to build well-diversified investment portfolios. Fixed income assets can offer a stable source of current income and lower volatility than equities while providing meaningful diversification benefits due to their negative correlation with stock markets' returns. However, several market trends that are unfolding have led investors to rethink the composition of their fixed income portfolios.

One of the most notable trends has been persistently low interest rates over the past decade, which has dampened yields. Further, the diversification benefits of traditional fixed income securities may be overstated in today's market environment, because a downturn in the economy could cause stock and bond prices to fall in unison.

In response to this shifting investment environment, investors and their advisors continue to look to alternative asset classes to enhance their return profiles. One potential solution has been healthcare royalties and structured credit investments, which have demonstrated the ability to generate significant yield premiums over traditional fixed income assets while exhibiting low correlations to equity markets.

HEALTHCARE ROYALTIES OVERVIEW

Royalties have become an increasingly prominent tool throughout the

healthcare industry. Inventors of new drugs and medical devices typically lack the resources to produce and distribute their products at scale, leading them to enter into licensing agreements.

Under these agreements, intellectual property holders sell the rights to their product to receive contractual payments based on future revenue streams, allowing them to retain an economic interest in the product and participate in revenue upside as production scales.

However, these entities may be motivated to monetize their future cash flows by selling their royalty interests to third-party investors. For example, a university that has created a successful drug may be more inclined to receive a lump-sum payment that can be re-invested into a diversified portfolio or used to invest in new buildings than to receive ongoing payments from a single product.

As an alternative to selling royalty interests, many small biotech companies that own this intellectual property seek to take out structured loans as a means of fundraising. These companies often need capital to invest in research and development to diversify their businesses, and they may find borrowing against their intellectual property to be an appealing option. Investors often can capitalize on these opportunities and receive sizable yield premiums relative to public debt markets while adding additional diversification to their portfolios.

INVESTMENT CHARACTERISTICS

The market for healthcare royalties and structured credit investments offers a compelling opportunity for experienced managers. Royalties provide investors with annuity-like income streams, allowing them to realize returns on their investment almost immediately due to the contractual payments associated with these agreements.

Although the income generated from these investments resembles an annuity payout, healthcare royalties traditionally have offered a meaningful yield premium over traditional fixed income investments, in part because competition for deals is somewhat limited. iCapital has observed that the current competitive landscape for healthcare royalties and structured credit is relatively small, with only a handful of experienced institutional managers of scale competing in this space. Barriers to entry are also high, because executing deals in this market typically requires a strong, established network to source opportunities, as well as the ability to understand the complexities of a deal from both a scientific and financial standpoint. Traditional Wall Street lenders are not equipped to be active participants in this market due to the complex nature of the diligence process, the expertise required, and the risks associated with investing in small businesses or institutions.

As a result of these dynamics, we've seen that managers typically seek to price their transactions to generate

low- to mid-teens returns. By comparison, the yield on 10-year U.S. Treasury bonds is currently below 2 percent.¹ Further, royalty investments contain the potential for upside if revenues of the underlying product exhibit meaningful growth, while structured credit investments typically include warrants that allow investors to capture equity appreciation.

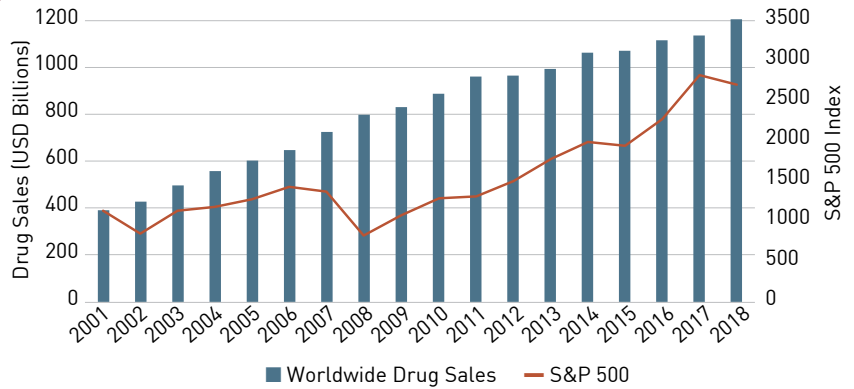
In addition to the attractive return profile of royalties and structured credit investments, these deals often can provide investors with significant diversification benefits and downside protection. Most commercial drugs and medical devices are protected under patent laws (normally the life of a patent is 20 years from the date of original filing), mitigating the potential for competing products to emerge and capture market share. Returns for healthcare royalties also tend to have a low correlation to equity returns (see figure 1). Payments made from these investments are linked to sales of drugs and other healthcare products, which historically have exhibited steady growth, even during economic downturns.²

DEFENSIVE NATURE OF THE HEALTHCARE INDUSTRY

Several trends in the healthcare industry are expected to drive future spending growth and further mitigate downside risk for royalty investors. Most notably, the United States currently spends approximately 18 percent of gross domestic product (GDP) on health care (see figure 2). This figure has been growing rapidly for several decades and is expected to reach 20 percent by 2027.³

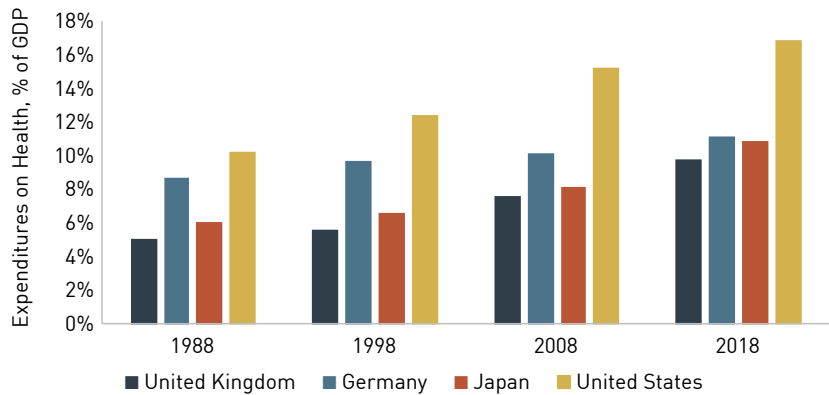
Growth in spending has been driven largely by shifting demographics throughout the world (see figure 3). Seniors, who represent an increasing percentage of the overall population, tend to spend significantly more on health care than younger generations. In the United States, per capita healthcare spending totals nearly \$17,000 annually for individuals ages 65–84 and more

Figure 1 DRUG REVENUES UNCORRELATED TO EQUITY MARKETS



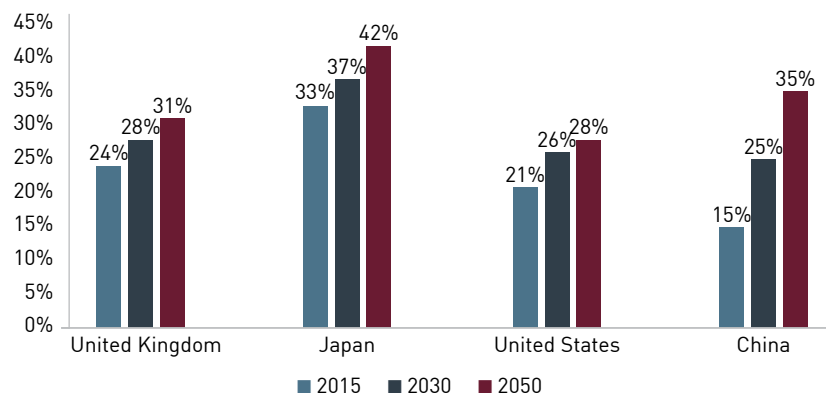
Source: Statista.com and Yahoo Finance. For illustrative purposes only.

Figure 2 GLOBAL HEALTHCARE EXPENDITURE AS A PERCENTAGE OF GDP: A SECULAR GROWTH OPPORTUNITY



Source: OECD Health Data. For illustrative purposes only.

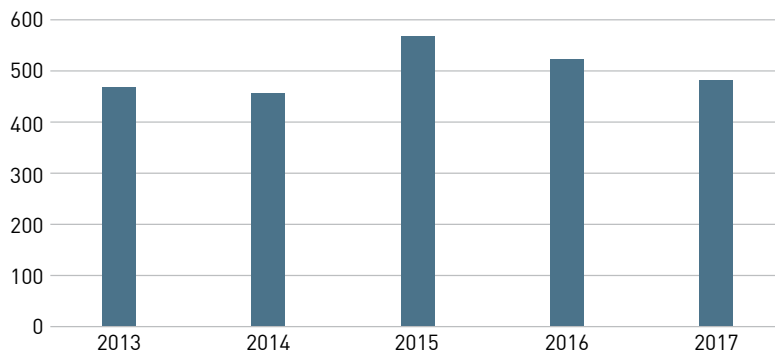
Figure 3 PERCENTAGE OF POPULATION OLDER THAN AGE 60, SELECTED COUNTRIES



Source: United Nations Department of Economic and Social Affairs Population Division; World Population Prospects 2017. For illustrative purposes only.

Figure
4

LICENSING DEALS IN THE BIOPHARMACEUTICAL INDUSTRY IN NORTH AMERICA



Source: OECD Health Data, Center for Medicaid Services National Healthcare Expenditure Projections. For illustrative purposes only.

than \$32,000 per year for adults older than age 84, compared to \$4,500 per year for adults ages 19–44.⁴ Given that this tends to be non-discretionary spending, revenues generated from healthcare products are expected to remain robust even if the United States experiences an economic downturn.

Further, as healthcare spending continues to rise and new products enter the market, the number of licensing deals completed each year has held strong. Over each of the past five years, the North American biopharmaceutical industry has produced between 400 and 600 licensing deals,⁵ creating an expanding opportunity set for investors to purchase royalty interests (see figure 4).

These two trends—rapid growth in healthcare spending and a steady stream of new licensing deals—have combined to create a compelling market opportunity for investors in healthcare royalties. As a higher volume of revenue flows to intellectual property holders via licensing agreements, healthcare royalty investors appear well-positioned to find attractive investment opportunities and produce strong risk-adjusted returns.

INTEGRATION INTO A DIVERSIFIED PORTFOLIO

Given the existing investment opportunity in healthcare royalties and

structured credit investments, a growing number of investors have turned to this asset class as a solution to increase diversification and enhance the risk-return profile of their portfolios. The current income and downside protection associated with healthcare royalty investments make them a natural fit to replace a portion of an investor's fixed income allocation.

The competitive landscape for healthcare royalty investing is relatively small compared to more traditional investment strategies, because there are only a few established institutional managers in the space. Managers dedicated to the space include Athyrium, CRG, DRI Capital, Healthcare Royalty Partners, Oberland, OrbiMed, and Royalty Pharma. As part of a broader portfolio, however, healthcare royalties and structured credit investments can produce meaningful diversification benefits due to their low correlation to equity markets, while generating considerable yield premiums over more traditional fixed income securities. ●

Nick Veronis is a co-founder and managing partner at iCapital Network. He earned a BA in economics from Trinity College. Contact him at nick@icapitalnetwork.com.

Dan Fletcher, CFA®, is a director on the Research and Due Diligence team at iCapital Network. He earned a BA in economics and psychology from Bucknell University. Contact him at dfletcher@icapitalnetwork.com.

ENDNOTES

1. *Wall Street Journal*, as of September 2019, <https://www.wsj.com/market-data/quotes/bond/BX/TMUBMUSD10Y>.
2. "Express Scripts Drug Trend Report, 2016," <http://vbidcenter.org/wp-content/uploads/2017/02/Express-Scripts-2016-Commercial-Drug-Trend-Report-3.pdf>.
3. OECD Health Data, Center for Medicaid Services National Healthcare Expenditure Projections, <https://stats.oecd.org/Index.aspx?DataSetCode=SHA#>.
4. Centers for Medicare and Medicaid Services, most recent available. <https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Age-and-Gender>.
5. BioPharm Insight, Infinata.

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INVESTMENTS & WEALTH INSTITUTE®

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org

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