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With creativity it still makes sense to turn royalties into cash

Jacob Plieth

Turning expected royalty streams into immediate cash became very popular around the 2007/08 financial crisis. Two recent deals, done by Portola and Cytokinetics, show that the royalty financing model is far from dead, even in a biotech market that cannot yet fully be called bearish.

Moreover, the same players are still active: last week's deals involved the seasoned funds Healthcare Royalty Partners and Royalty Pharma. As well as hinting at sellside underestimation of some drugs' future sales, the transactions show that, with creativity, royalty financing can remain an option even in times of plenty (see table below).

That said, royalty monetisation is typically considered a countercyclical trend; after all, if cash is readily available on the equity markets, why mortgage one of your key assets? Paul Capital wound down its healthcare royalty business as the biotech bull market set in in 2013, though there were other issues in play too.

Perhaps it is just a case of managing expectations, and the expected transaction terms surely differ depending on the prevailing climate. One example is Portola's deal with Healthcare Royalty, which looks like a clear case of divergent expectations for the Factor Xa inhibitor antidote Andexxa.

EvaluatePharma compiles sellside consensus forecasts to 2022, and trending these out to Andexxa's patent expiry in 2030 values the NPV of a 5% royalty – a fair estimate of the "mid single-digit" interest actually sold by Portola – at just $94m.

Yet Healthcare Royalty has been happy to give Portola $50m, plus $100m on approval, which assuming 95% success probability amounts to an up-front windfall of $145m. It is obvious why Portola considered such a generous offer from Healthcare Royalty.

Sellside vs Healthcare Royalty: the valuation divergence

	2018	2020	2022	2024	2026	2028	2030
Andexxa global sales ($m)	25	125	279	393	475	525	497
5% royalty ($m)	1	6	14	20	24	26	25
NPV of royalty at 9.5% WACC ($m)				***94***			
Up-front value of deal ($m)				***145****			

*Note: *$50m at 100% probability plus $100m at 95% probability to launch.*

The Cytokinetics transaction, meanwhile, is driven by a creative economic opportunity that arose from the group's 2007 deal with Amgen covering the heart failure project omecamtiv mecarbil.

It turns out that this allowed Cytokinetics to invest $40m in phase III development in return for an additional royalty of up to 4% from Amgen. Now, in Royalty Pharma, Cytokinetics found a buyer for a 4.5% royalty for $90m plus $10m in stock; clearly this gave it the cash to exercise its option, with $60m left over.

The specifics of this deal made it a no-brainer, and show that creativity in royalty monetisation is a way forward. Unfortunately no sellside consensus exists for omecamtiv, so a neat NPV comparison as with Andexxa is impossible, but clearly its development since 2007 gave Royalty Pharma sufficient comfort to pay up.

Risk on

Still, with omecamtiv only in phase II, the deal shows that royalty monetisation specialists, which earlier tended not to strike until R&D was largely over, are now willing to take on considerable development risk.

In 2015 a syndicate of unnamed investors bought a 1.5% royalty in Intarcia's phase III diabetes implant ITCA 650 at a $15bn valuation (*Intarcia, the $5.5bn private company with a $15bn drug, April 29, 2015*). Before that, Royalty Pharma paid $3.3bn for an academic originator's royalty interest in Vertex's cystic fibrosis franchise in a deal that, like Portola's, was a bet on sellside estimates being too bearish.

With academic centres typically being keener on hard cash up-front than on waiting years for a royalty to trickle through, specialists like Royalty Pharma, Healthcare Royalty and DRI Capital should not be written off just yet, and neither should MTS Health Partners, an investment bank that advises royalty sellers.

Then again, it should be noted that Portola's royalty deal was not its first non-equity transaction of late; in December it tapped its partner Bristol-Myers Squibb for a $50m loan. A less comforting conclusion could be that the biotech markets have actually turned far more bearish than has been assumed.

This article has been corrected to reflect the role of MTS Health Partners.

To contact the writer of this story email Jacob Plieth in London at jacobp@epvantage.com or follow @JacobPlieth on Twitter.