



## A PRIMER ON HEALTHCARE ROYALTY & CREDIT INVESTING

Bond markets have historically 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.

The most notable trend is rising interest rates, which have the potential to dampen the total returns of fixed income securities because bond prices tend to be negatively correlated to yields. Further, the diversification benefits

of traditional fixed income securities may be overstated in today's market environment, as a combination of rising interest rates and high equity valuations could cause stocks and bonds to decline in unison in the event of a downturn.

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 correlation 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 R&D to diversify their businesses and may find borrowing against their intellectual property to be an appealing option. Investors can often 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.

While the income generated from these investments resembles an annuity payout, healthcare royalties have traditionally 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, as 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.

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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 around 3%.<sup>1</sup> 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 can often 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. Payments made from these investments are linked to sales of drugs and other healthcare products, which have historically exhibited steady growth, even during economic downturns.<sup>2</sup>

DRUG REVENUES UNCORRELATED TO EQUITY MARKETS

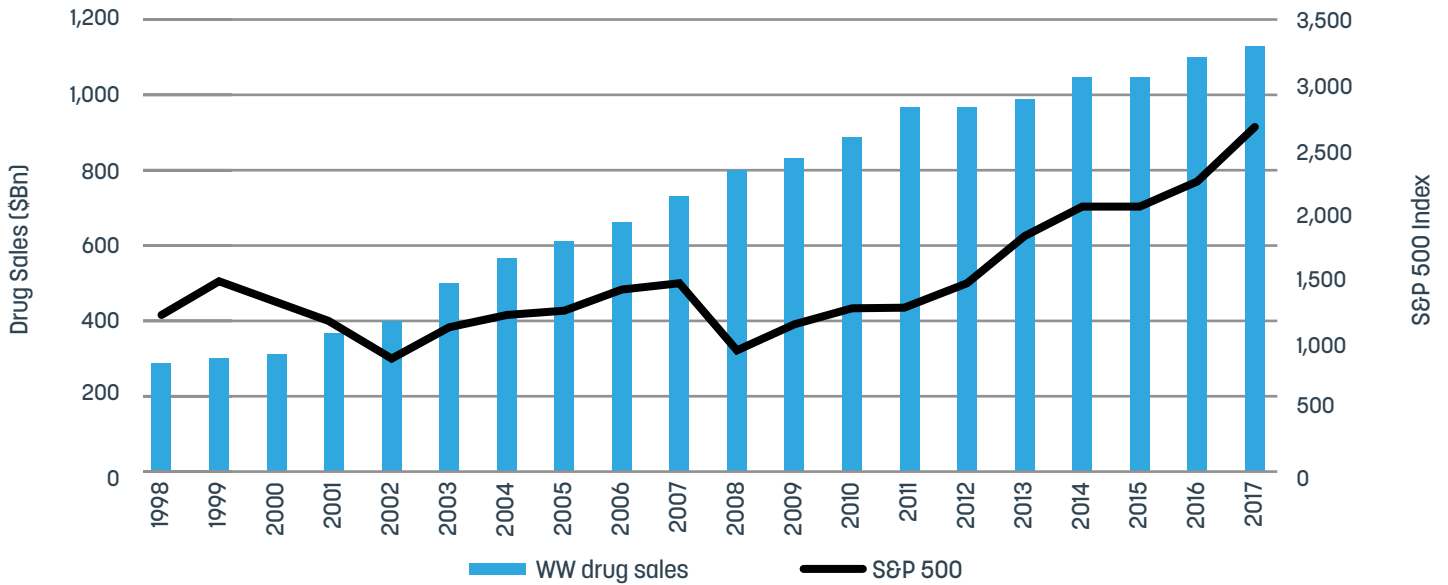
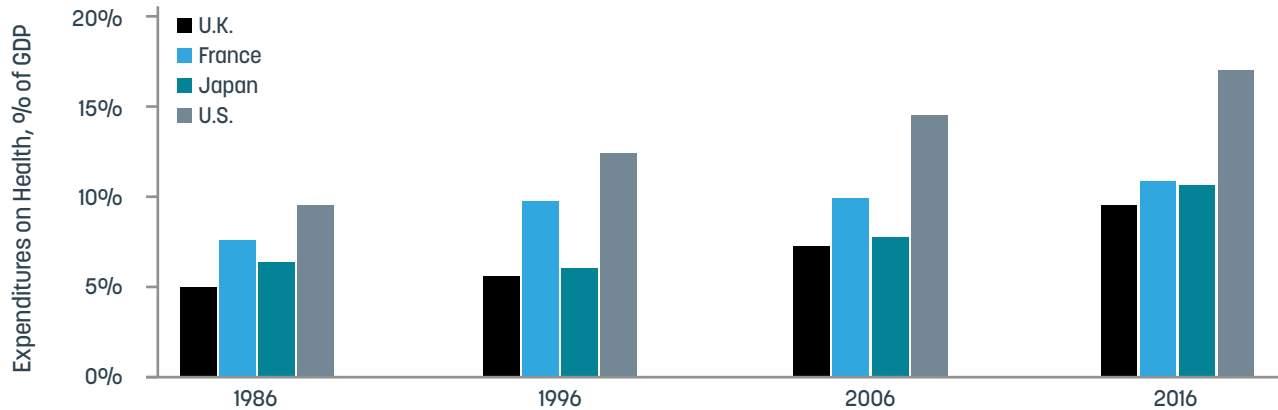


Chart Source: Express Scripts Drug Trend Report, 2016.

## DEFENSIVE NATURE OF THE HEALTHCARE INDUSTRY

There are several trends in the healthcare industry that are expected to drive future spending growth and further mitigate downside risk for royalty investors. Most notably, the U.S. currently spends approximately 18% of GDP on healthcare. This figure has been growing rapidly for several decades and is expected to reach 20% by 2025.<sup>3</sup>

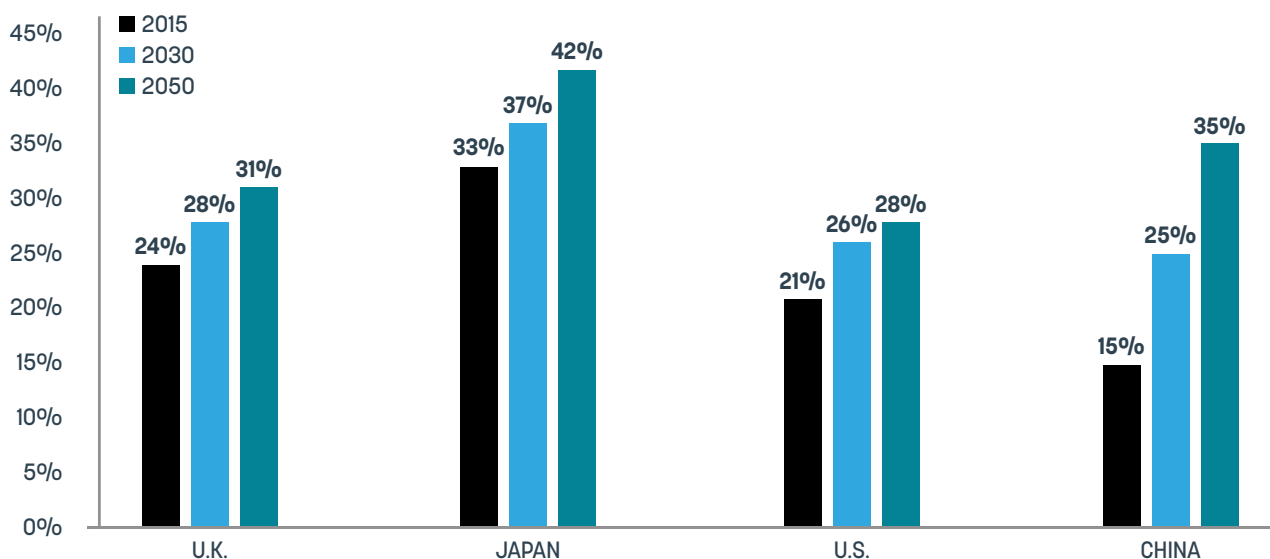
GLOBAL HEALTHCARE EXPENDITURE AS A PERCENTAGE OF GDP:  
A SECULAR GROWTH INVESTMENT OPPORTUNITY



Source: OECD Health Data, Center for Medicaid Services National Healthcare Expenditure Projections

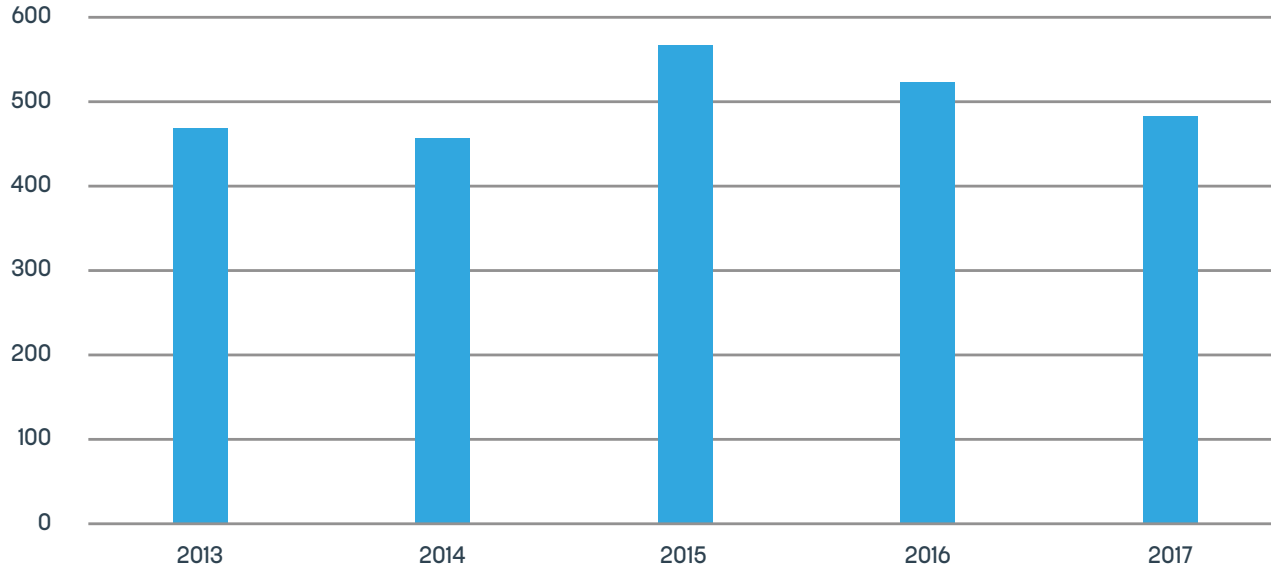
Growth in spending has been driven largely by shifting demographics throughout the world. Seniors, who represent an increasing percentage of the overall population, tend to spend significantly more on healthcare than younger generations. In the U.S., per capita healthcare spending totals nearly \$17,000 annually for individuals aged 65–84 and over \$32,000 per year for adults over the age of 84, compared to \$4,500 per year for adults aged 19–44.<sup>4</sup> Given that this tends to be non-discretionary spending, revenues generated from healthcare products are expected to remain robust even if the U.S. experiences an economic downturn.

PERCENTAGE OF POPULATION OVER AGE 60, SELECTED COUNTRIES



Source: United Nations Department of Economic and Social Affairs Population Division; World Population Prospects 2017

## LICENSING DEAL IN THE BIOPHARMACEUTICAL INDUSTRY IN NORTH AMERICA



Source: OECD Health Data, Center for Medicaid Services National Healthcare Expenditure Projections

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 last five years, the North American biopharmaceutical industry has produced between 400 and 600 licensing deals<sup>5</sup>, creating an expanding opportunity set for investors to purchase royalty interests.

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. As part of a broader portfolio, 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.

## END NOTES

<sup>1</sup> Source: The Wall Street Journal. As of December 2018.

<sup>2</sup> Source: Express Scripts Drug Trend Report, 2016.

<sup>3</sup> Source: OECD Health Data, Center for Medicaid Services National Healthcare Expenditure Projections.

<sup>4</sup> Source: Centers for Medicare and Medicaid Services, most recent available.

<sup>5</sup> Source: BioPharm Insight, Infinita



**Nick Veronis**

Co-Founder & Managing Partner



**Dan Fletcher**

Director, Research and Diligence



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