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Royalty Finance: Structures and Trends

GIBSON DUNN

Today's Panelists

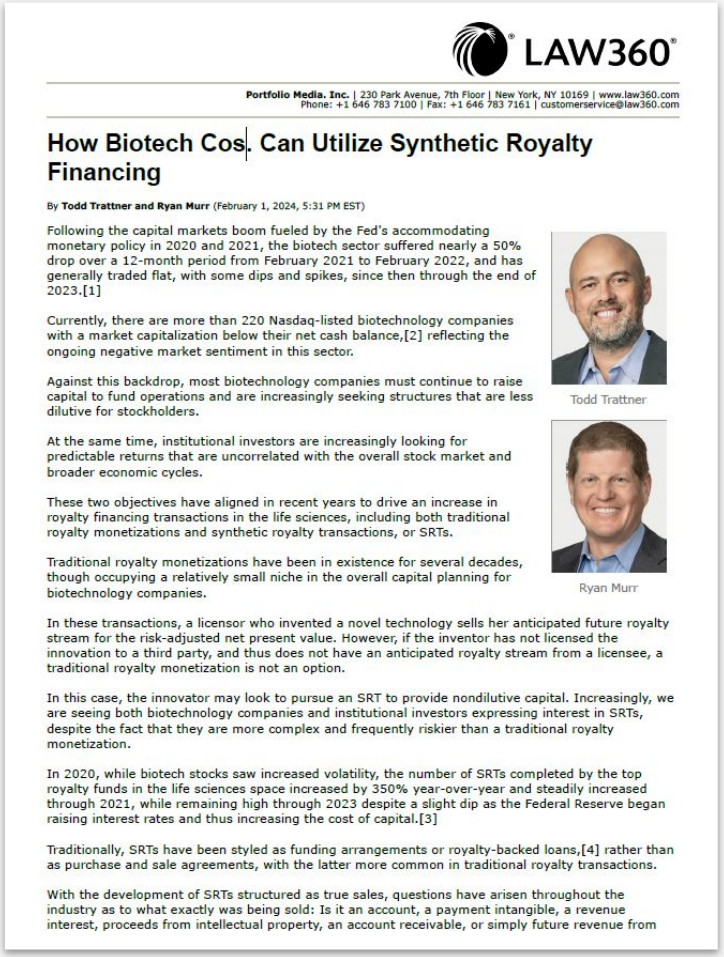
Todd Trattner
Partner – Gibson Dunn

Todd Trattner, Ph.D., is a partner in the San Francisco office of Gibson, Dunn & Crutcher where he is a member of the firm's Corporate Department with a practice focused on intellectual property transactions in the life sciences industry. Dr. Trattner advises public and private companies, investors, and academic institutions in connection with royalty finance, licensing and collaborations, mergers and acquisitions, joint ventures, R&D financing arrangements, venture finance, and manufacturing and supply agreements. He also regularly advises clients on complex intellectual property issues in connection with various corporate transactions. Dr. Trattner advises and represents numerous

Ryan Murr
Partner – Gibson Dunn

Ryan A. Murr is a nationally ranked, leading practitioner in the life sciences industry, advising companies and investors across a range of transactions. Ryan currently serves as co-chair of Gibson Dunn's Life Sciences Practice Group, as well as co-partner-in-charge of the firm's San Francisco office. Previously, he served as a member of the firm's Executive Committee and Management Committee. Ryan has over 25 years of experience representing public and private life sciences companies and investors in connection with securities offerings and business combination transactions. Ryan regularly represents purchasers and sellers of royalty interests, as well as advising management teams and

Royalty Finance
3-Part Series



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How Biotech Cos. Can Utilize Synthetic Royalty Financing

By **Todd Trattner and Ryan Murr** (February 1, 2024, 5:31 PM EST)

Following the capital markets boom fueled by the Fed's accommodating monetary policy in 2020 and 2021, the biotech sector suffered nearly a 50% drop over a 12-month period from February 2021 to February 2022, and has generally traded flat, with some dips and spikes, since then through the end of 2023.[1]

Currently, there are more than 220 Nasdaq-listed biotechnology companies with a market capitalization below their net cash balance,[2] reflecting the ongoing negative market sentiment in this sector.

Against this backdrop, most biotechnology companies must continue to raise capital to fund operations and are increasingly seeking structures that are less dilutive for stockholders.

Todd Trattner

At the same time, institutional investors are increasingly looking for predictable returns that are uncorrelated with the overall stock market and broader economic cycles.

These two objectives have aligned in recent years to drive an increase in royalty financing transactions in the life sciences, including both traditional royalty monetizations and synthetic royalty transactions, or SRTs.

Traditional royalty monetizations have been in existence for several decades, though occupying a relatively small niche in the overall capital planning for biotechnology companies.

Ryan Murr

In these transactions, a licensor who invented a novel technology sells her anticipated future royalty stream for the risk-adjusted net present value. However, if the inventor has not licensed the innovation to a third party, and thus does not have an anticipated royalty stream from a licensee, a traditional royalty monetization is not an option.

In this case, the innovator may look to pursue an SRT to provide nondilutive capital. Increasingly, we are seeing both biotechnology companies and institutional investors expressing interest in SRTs, despite the fact that they are more complex and frequently riskier than a traditional royalty monetization.

In 2020, while biotech stocks saw increased volatility, the number of SRTs completed by the top royalty funds in the life sciences space increased by 350% year-over-year and steadily increased through 2021, while remaining high through 2023 despite a slight dip as the Federal Reserve began raising interest rates and thus increasing the cost of capital.[3]

Traditionally, SRTs have been styled as funding arrangements or royalty-backed loans,[4] rather than as purchase and sale agreements, with the latter more common in traditional royalty transactions.

With the development of SRTs structured as true sales, questions have arisen throughout the industry as to what exactly was being sold: Is it an account, a payment intangible, a revenue interest, proceeds from intellectual property, an account receivable, or simply future revenue from

1. **Part 1 – Royalty Finance: Structures and Trends (Ryan Murr, Todd Trattner)**
2. Part 2 – Synthetic Royalty Financings and the UCC (Jin Hee Kim)
3. Part 3 – Synthetic Royalty Financings: Risks of Recharacterizing a True Sale (Jeff Krause)

Presentation Overview

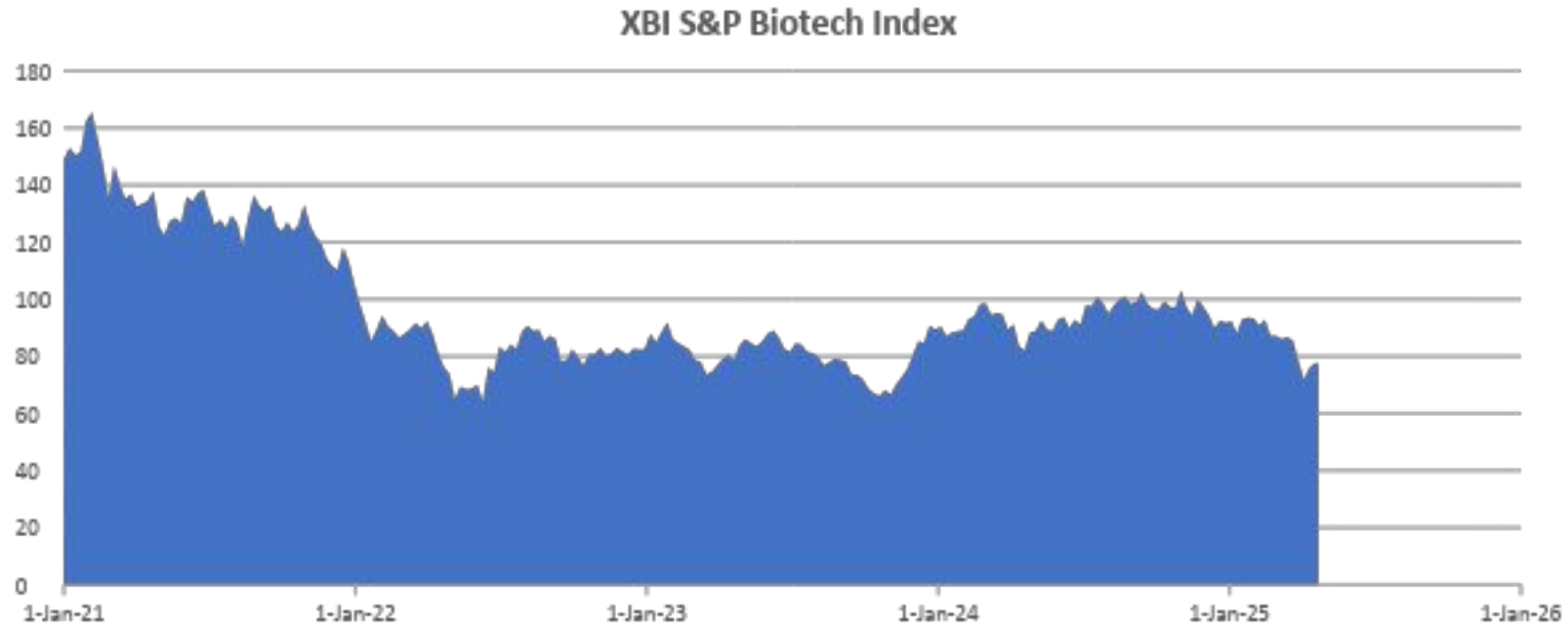
ROYALTY FINANCE
INTRODUCTION

01

In Search of Non-Dilutive Capital

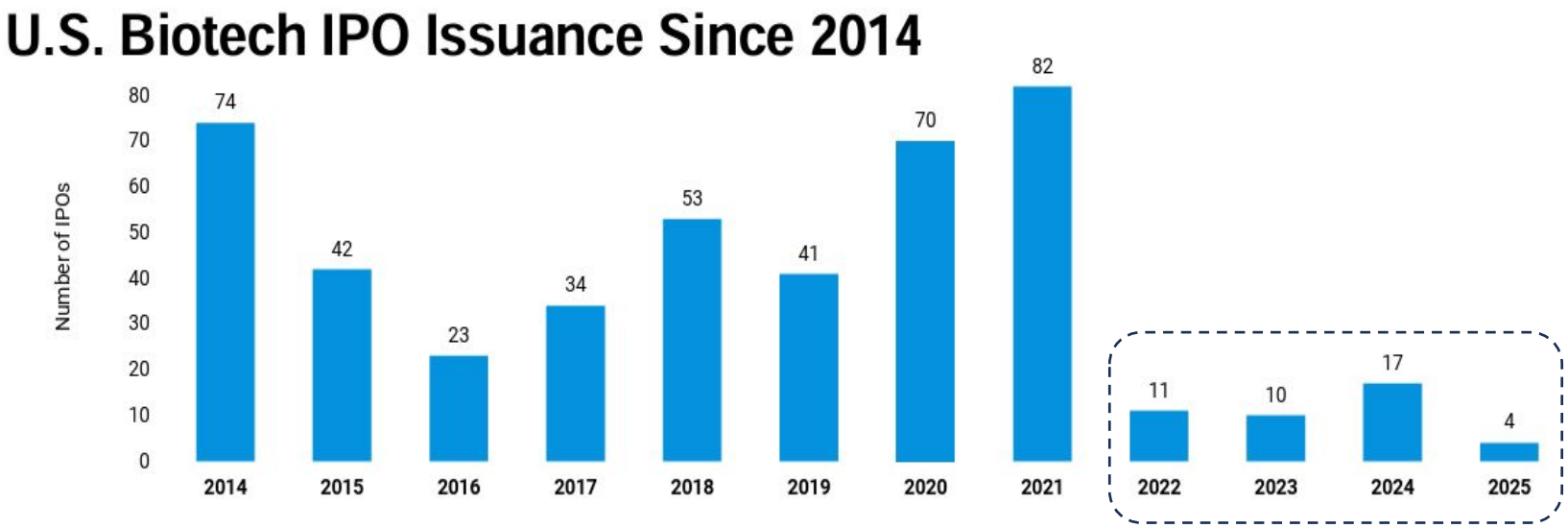
-48%

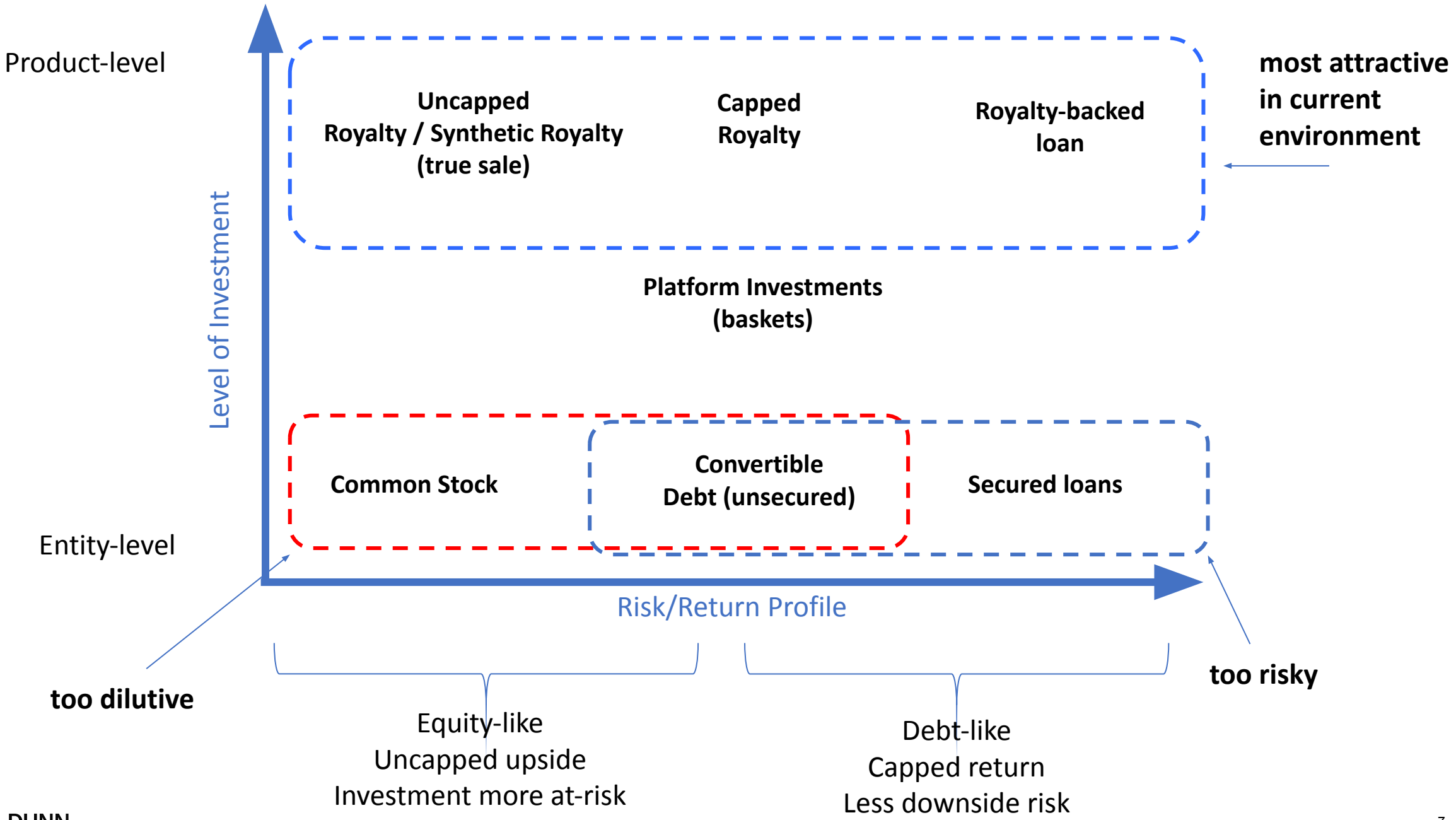
XBI Index Drop



-80%

Drop in biotech IPOs




Product-level
Uncapped
Royalty / Synthetic Royalty
(true sale)
Capped
Royalty
Royalty-backed
loan
most attractive
in current
environment
Platform Investments
(baskets)
Level of Investment
Common Stock
Convertible
Debt (unsecured)
Secured loans
Entity-level
Risk/Return Profile
too dilutive
too risky
Equity-like
Uncapped upside
Investment more at-risk
Debt-like
Capped return
Less downside risk

PRODUCT-LEVEL FINANCING OPTIONS

For product-level financing, there are three options, depending on the **nature of the product rights being monetized** and **stage of development**.

Royalty-bearing out-license

- Royalty monetization
- Flexible structures (caps, tails, etc.)

Clinical-stage program

- Clinical funding arrangement
- Typically late-stage development
- Form of synthetic royalty with R&D risk for buyer

Commercial drug

- Synthetic royalty or royalty-backed loan
- Can be equity-like or debt-like in terms

ROYALTY FINANCE
OVERVIEW

02

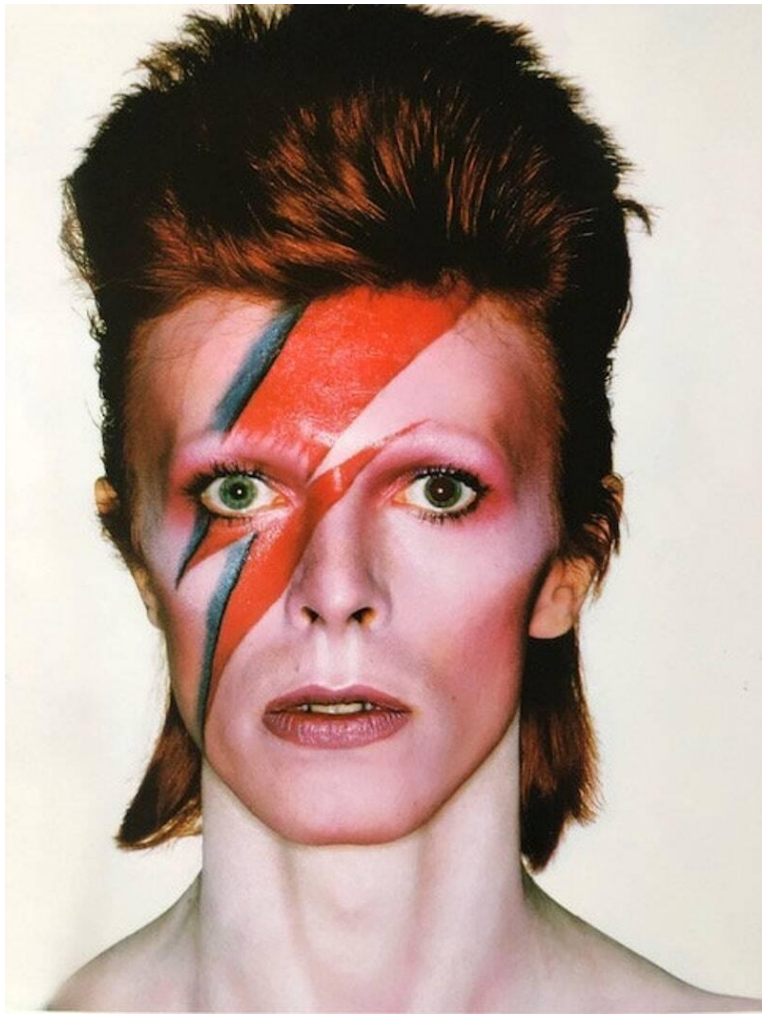
Royalty Finance | Overview

Royalty / Revenue Interests:

Rights to royalties under a license agreement or revenue from future product sales.

The term "**Royalty Finance**" broadly describes: a sale/financing of Royalty / Revenue Interests (derived from IP)

Royalty Finance
Overview



Royalty Finance | Overview

- Bowie Bonds
  - In 1977, David Bowie securitized his intellectual property rights
  - Bowie issued $1,000-denominated bonds for $55 million.
- The bonds carried a 7.9% interest rate, maturing in 15 years, and were backed by his assets:
  - the masters,
  - the publishing catalog, and
  - royalties streams from:
    - a $30 million 15-year licensing deal with EMI
    - future album sales; and
    - live performances

Royalty Finance | Overview

Traditional Royalty Finance:

A sale by a licensor of rights to receive royalty payments **under a license agreement** for sales of licensed products by the licensee.

Synthetic Royalty Finance:

Financing structure where payment to the buyer/ investor is funded by a percentage of future product sales by the seller/borrower, **where no license agreement is in place.**

Royalty Finance | Overview

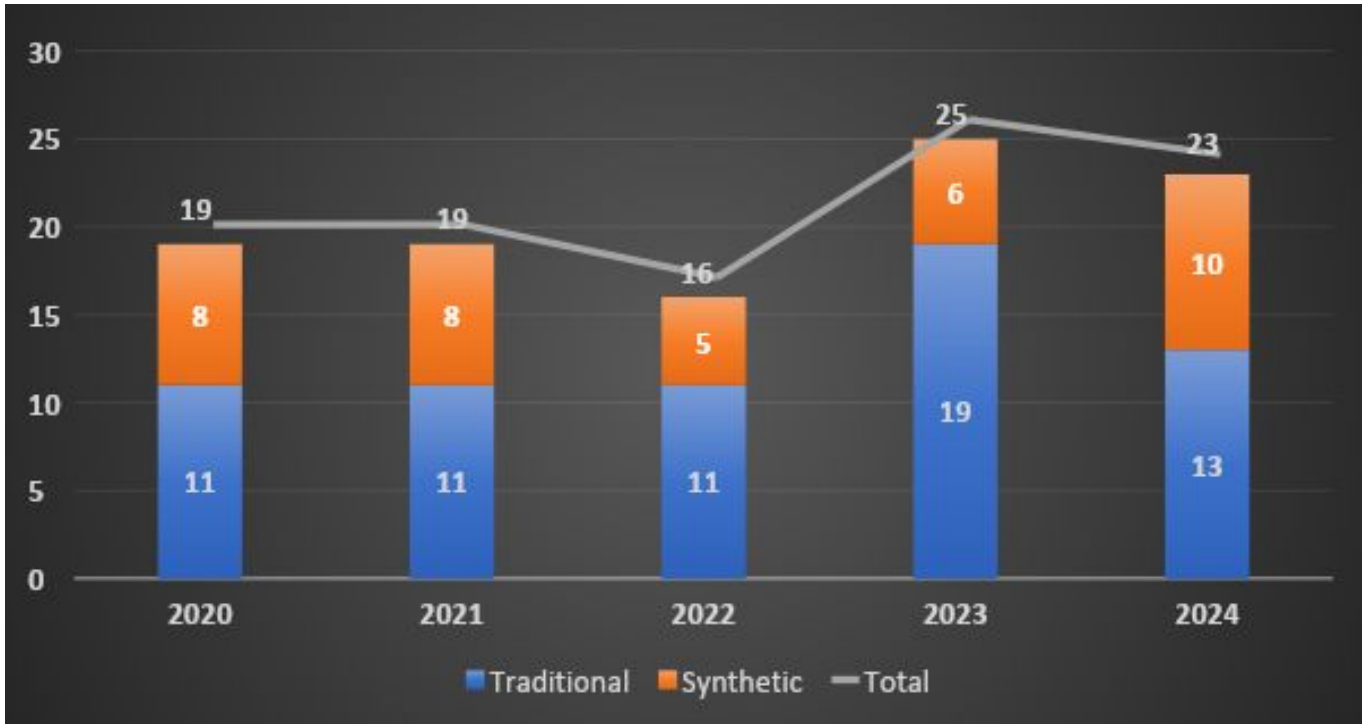
- From 2020-2024, while biotech stocks saw increased volatility, the aggregate deal value and number of Royalty Finance Transactions have increased
- Royalty Report* Key Trends (2020-2024):
  - Rising Use of Synthetic Royalties: Emerging as a viable alternative to debt or equity financing transactions, with an average annual growth rate of 33% over the five-year period.
  - Increased Activity in Recent Years (2023 and 2024): Driven in particular by high-value deals and late-stage product transactions.
  - Milestone-Heavy Transactions: Growing preference for performance-linked payments, allowing buyers to lower their risk profile and allowing sellers to lower their cost of capital

*Royalty Report: a Gibson Dunn survey looking at 102 publicly announced royalty transactions over the last five years (2020-2024) involving the most active funds in the space, consisting of the following: Royalty Pharma, HealthCare Royalty Partners (HCRx), Blackstone, OMERS, XOMA Royalty, CPPIPB, Oberland Capital, and DRI Capital. Survey data are based on publicly reported information, including in SEC filings, as well as data from 27 financing transactions executed by Gibson Dunn (representing approximately 30% of the total transactions reviewed during this

Royalty Finance | Overview

Royalty Report (2020 – 2024)

Number of Transactions by Transaction Type and Year

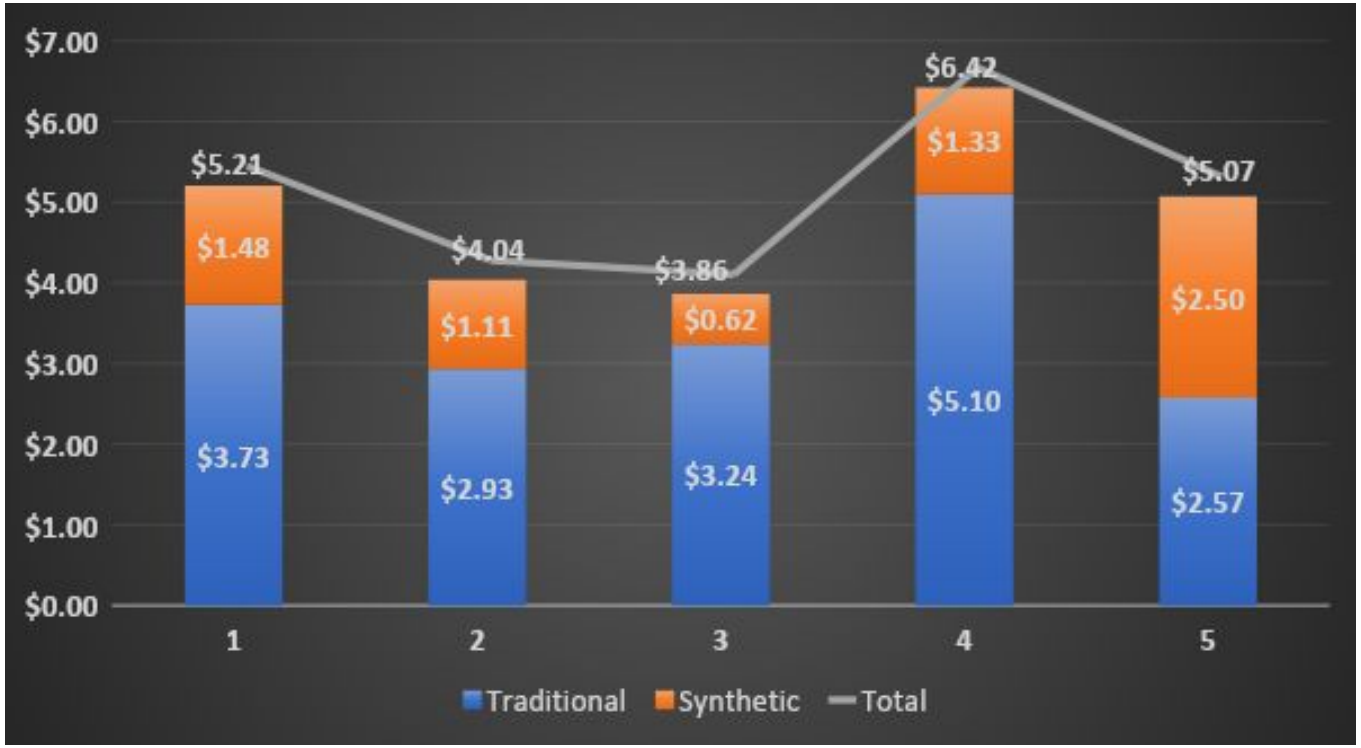


102
Total Transactions

Traditional royalty financings, with less risk and more consistent returns, account for the majority of royalty finance transactions across all years. Synthetic royalty financings are leveraged for innovative financing structures with potentially greater upside due to the heightened risk, and have been steadily climbing since a dip in 2022, which coincided with the Fed beginning to raise interest rates to moderate inflation, as well as a significant sell-off in biotech stocks.

Royalty Finance | Overview
Royalty Report (2020 – 2024)

Aggregate Transaction Size (billions) by Transaction Type and Year



$24.6 billion
Aggregate Value

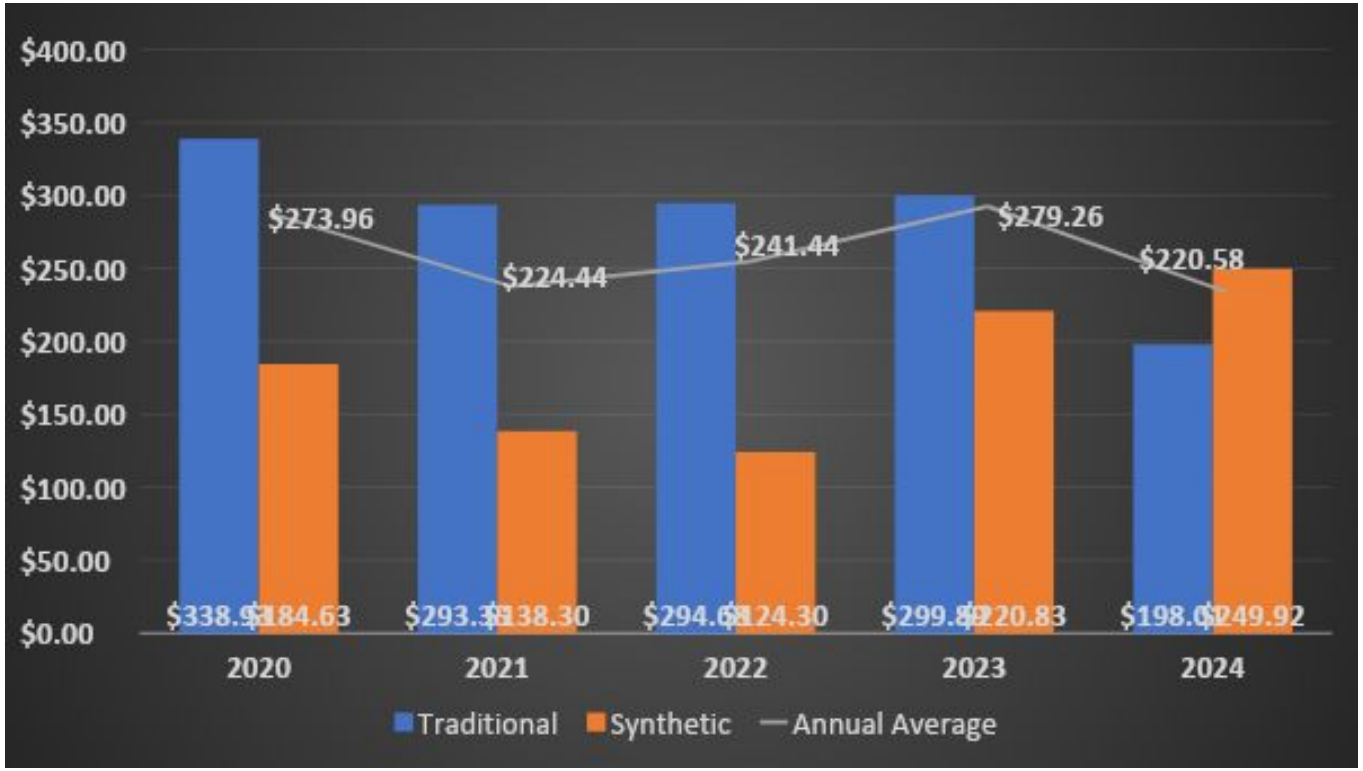
$4.92 billion
Average Annual Aggregate Value

The aggregate value of traditional royalty financings has been steadily increasing since 2021, but then saw a meaningful dip in 2024. At the same time, **the market saw significant growth in synthetic royalty financing transactions, with an average annual growth rate of 33% over the five-year period**. The growth in synthetic royalties as a portion of the royalty finance market is a significant trend that we expect will continue in the coming years.

Royalty Finance | Overview

Royalty Report (2020 – 2024)

Average Transaction Size (millions) by Transaction Type and Year



$249 million
Average Transaction Size

$1.2 million to $1.61 billion
Range of Transaction Sizes

Traditional royalty financings historically have accounted for higher average transaction sizes. While the average size of traditional royalties has trended down over this five-year period, **we have seen a 14% average annual growth rate in the average size of synthetic royalties**.

ROYALTY FINANCE
FINANCING TYPES

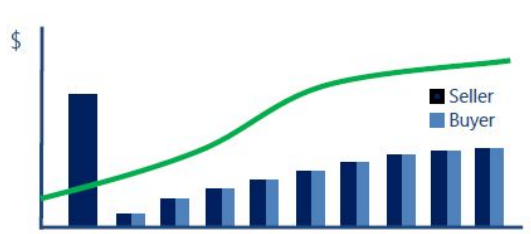
03

Royalty Monetizations Overview

“True” Royalty Monetization

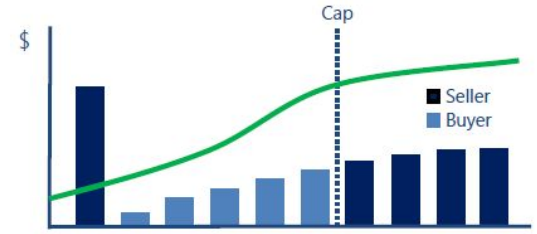
Purchasing an existing royalty entitlement from an innovator who has licensed IP to the marketer of a pharmaceutical product.

Sale of “Strip”



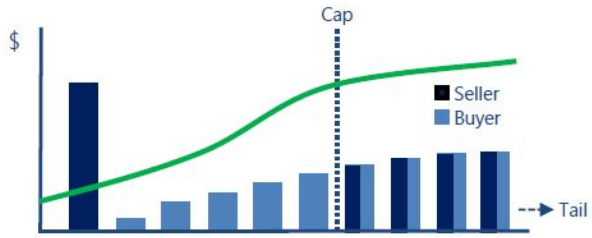
- **Sale of a shared portion of future royalties**
- A “Strip” structure sells downside risk that the longer-dated Net Sales of the underlying drugs fall short of expectations
- Seller can continue to enjoy near-term cash flows if it executes a partial sale (versus selling entire Interest)
- Unsold royalties can be monetized at a future time

The “Capped Sale”



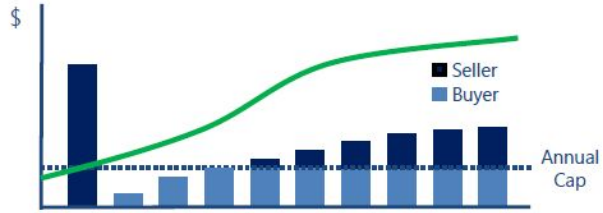
- **Sale of royalties up to a predefined aggregate threshold (the “Cap”)**
- Royalty stream pays off the instrument until it hits the Cap amount
- Pledged royalty portion is returned to seller once the instrument is paid off
- A Capped Sale structure will protect the potential upside of the later, more robust commercial years of underlying drug

The “Cap and Tail”



- **Portion of future royalties pledged steps down after reaching predefined aggregate amount (the “Cap”)**
- Royalty stream pays off the capped portion
- Once threshold amount has been reached, the buyer and seller share the royalty stream until the end of the royalty payment term (the “Tail”)
- Unsold royalties can be monetized once cap has been reached, provided there is enough term left in the tail

The “Annually Capped Sale”



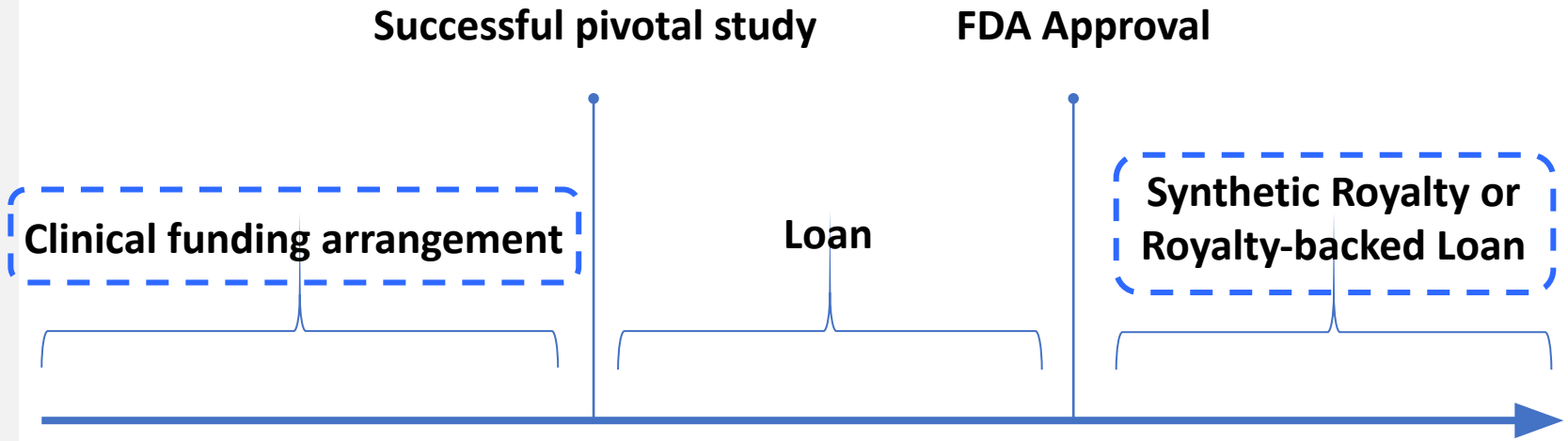
- **Sale of royalties up to a predefined *annual* threshold (the “Annual Cap”)**
- Royalty payout is capped on an annual basis. Seller retains upside each year
- Annual Cap resets every year until the end of the royalty term
- Seller “eats second”; since seller is selling the safest annual cash flows, the structure should attract a lower imputed cost of capital
- More challenging to execute a subsequent monetization in the future

Financing Types by Development Stage

Pre-Approval Considerations

Pre-approval funding takes on **development risk and commercial risk**. Post-approval funding assumes **only commercial risk**. This difference accounts for different funding sources and different costs of capital.

Product-level financing options potentially available vary by stage of development (pre/post pivotal study and pre/post FDA approval).



- at-risk development capital
- investor take development risk
- higher potential cost of capital

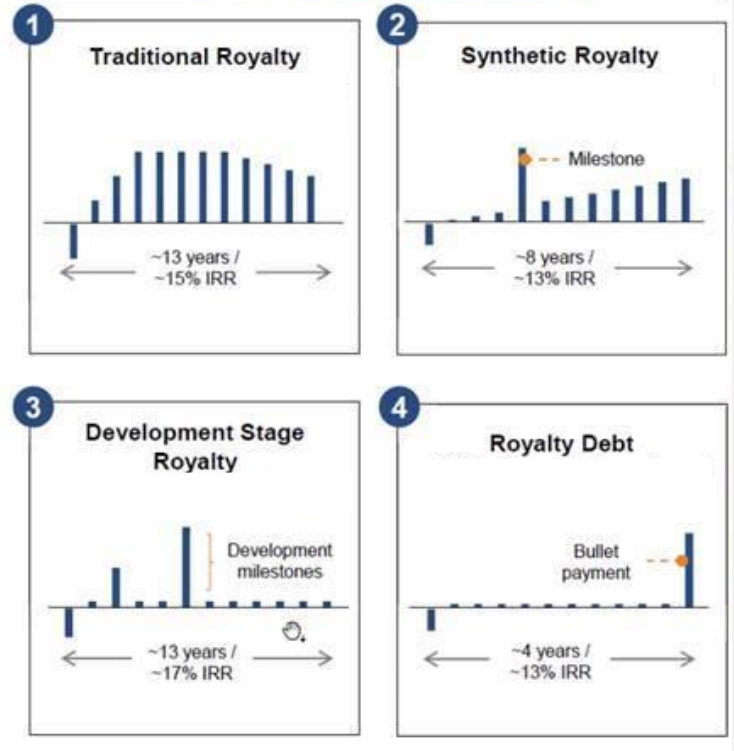
- accelerated repayment on CRL
- may or may not flip to royalty
- bridge to approval and launch

- can be debt or equity like
- equity-like only after approval
- larger universe of investors

Abingworth Life Science Investing · Avillion · Blackstone · NovaQuest Capital Management · Royalty Pharma · SFJ Pharmaceuticals Strategic Funding and Joint-Development

Blackstone · CPP Investment Board · DRI · HealthCare Royalty Partners · OMERS · Royalty Pharma

Spectrum of Synthetic Funding Arrangements



Financing structures vary from debt-like to equity-like, depending on risk/return profile. Covenants (e.g., incurrence covenants, negative pledges, and need for potential intercreditor agreements) also affect transaction structures and return profiles.

- Counterparty risk is greater in a synthetic royalty arrangement, which creates greater focus on downside protections, depending on the size and stability of the counterparty
- Upside can be capped (more debt-like) or uncapped (more equity-like)

Debt-like ⟵ ⟶ Equity-like

Economic return	Capped return (e.g. 2.0x invested capital)	Uncapped return
Protections	Debt-like covenants (including incurrence covenants) Possible use of SPV to hold product assets	Light covenants and fewer protections
Economic terms	Possible catch-up payments (e.g., 1x by 5 years) Make-whole payment at maturity date	Simple payment of royalty Possible step-up in royalty rate based on return
Examples*	SPERO THERAPEUTICS, CTI, La Jolla Pharmaceutical	ADC THERAPEUTICS, biocryst

* Gibson Dunn transactions

Royalty Finance Monetization

Xtandi

Developed at UCLA in early 2000s

Licensed to Medivation (later sold to Pfizer)

Approved by FDA in 2012

Cornerstone of prostate cancer treatment

2024 sales of $6 billion

Royalty Finance | Monetization

Licensor

Licensed Rights →

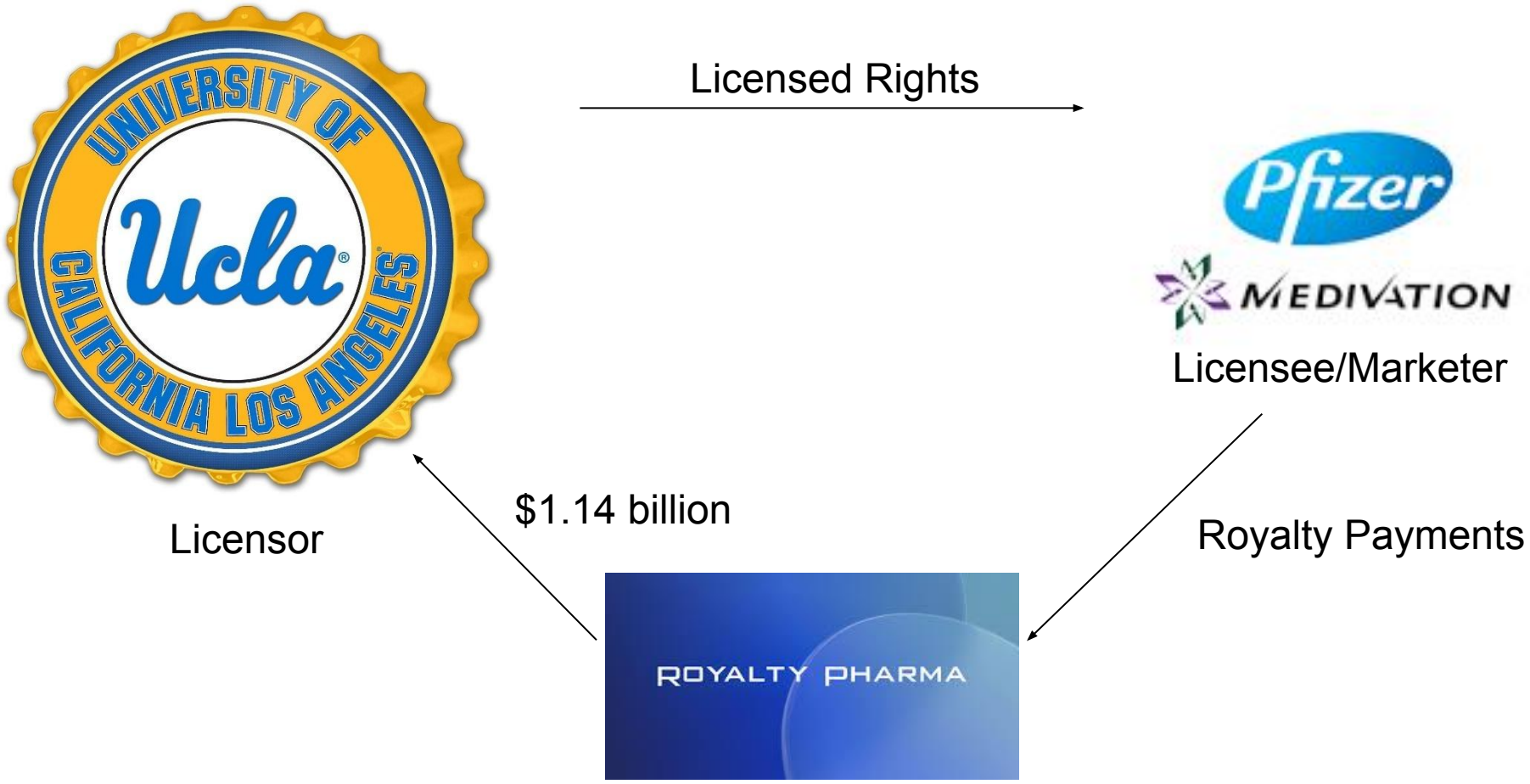
← Royalty Payments

Pfizer

MEDIVATION

Licensee/Marketer

Royalty Finance | Monetization



Royalty Finance
Synthetic Royalties

Financing structure where payment to the buyer/investor is funded by a percentage of future product sales by the seller/borrower.

- Synthetic, as there are no current royalties owed under a license agreement
- Counterparty risk is greater in a synthetic royalty arrangement
- Greater focus on downside protections
  - minimum catch-up payments (debt)
  - product collateral
- Upside can also be capped (more debt-like) or uncapped (more equity-like)

Synthetic Royalty | Equity-like

$125 million purchase price

Funded on NDA approval

- 8.75% royalty (declining) on Orladeyo sales in major markets
- **Uncapped economics with no catch-up payments**
- “True Sale” with intercreditor agreement with Athyrium (loan provider)

Synthetic Royalty | Debt-like

SPERO THERAPEUTICS

- Up to $125 million purchase price
- $50 million on close*
- $50 million on approval
- $25 million commercial milestone (with Spero's approval)

HEALTHCARE ROYALTY PARTNERS™

12% royalty (declining) on tebipenum sales worldwide

Capped at 2.5x invested capital

Catch-up payments:

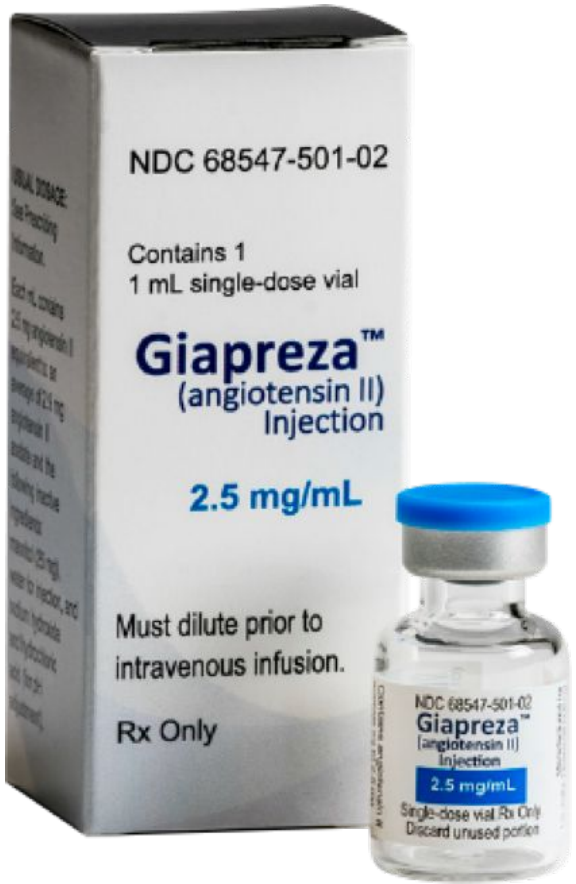
- 0.6x by 2025; 1x by 2027; 102% IRR by final maturity date
- 2.5x on change of control

Debt-like covenants with acceleration on events of default

- Termination fee of either 15% IRR or 2.5x cap
- First priority lien on product assets

* To be repaid if NDA approval is not achieved by an outside date.

Synthetic Royalty | Hybrid



La Jolla Pharmaceutical

$125 million purchase price

- Post-approval transaction
- Early in launch (limited sales history)

HEALTHCARE ROYALTY PARTNERS™

10% royalty (increasing) on Giapreza sales

- **Total return capped at 1.8x of invested capital**
- **No catch-up payments**
- Gradual step-up in royalty rate (e.g., 10 ->14%) based on rate of return

Debt-like covenants with acceleration on events of default

- Requires SPV holding company structure
- First-priority lien on product assets

ROYALTY FINANCE
DRAFTING CONSIDERATIONS

04

Drafting Considerations | Synthetic Royalty Finance

- **Scope of Collateral**
  - Acquired royalty payments
  - Product-related assets
    - Patents, know-how, and other IP
    - Regulatory materials (filings, applications, and approvals)
    - In-license and future out-licenses.
- **Reps and Warranties:**
  - **Focus on IP**
- **Covenants:**
  - **Focus on information sharing and maintenance of IP**
  - **Debt**
    - **More extensive covenants generally**
    - **Negative covenants; non-incurrence covenants**
    - **Acceleration upon Event of Default or a Change of Control**

Drafting Considerations | Synthetic Royalty Finance

- **Structure of Transaction / Tax Considerations**
  - Debt
    - true-up payments: borrower guarantees a certain return
    - capped
  - Sale
    - buyer takes on full risk of downside scenario
    - uncapped

Drafting Considerations | Synthetic Royalty Finance

- **True Sale of a Synthetic**
  - **There is no currently-existing contractual right to a royalty stream**
  - **What is the asset being sold?**
    - **Future product sales**
  - **Account under the UCC**
    - Article 9 of the New York Uniform Commercial Code (UCC) defines an account, in relevant part, as follows: “Account" … means a **right to payment** of a monetary obligation, whether or not earned by performance, (i) **for property that** has been or **is to be sold**, leased, licensed, assigned, or otherwise disposed of.
  - **Sale of Accounts**
    - "Account" … means a **right to payment** of a monetary obligation, whether or not earned by performance, (i) **for property that** has been or **is to be sold**, leased, licensed, assigned, or otherwise disposed of.
  - **Sale vs. Loan: Risk of Recharacterization**
    - **Example, a “true sale” of a synthetic royalty interest that includes mandatory true-up payments.**

ROYALTY FINANCE
GDC LIFE SCIENCES PRACTICE

05

Royalty Monetizations | Life Sciences Practice

Gibson Dunn is one of the leading law firms in the world representing clients in complex life sciences matters.

We are consistently recognized for achieving excellent results in life sciences transactions, regulatory matters, enforcement actions and litigation, with particular breadth and depth in the following areas:

- Capital Markets & Finance
- Intellectual Property
- FDA Regulatory Matters
- Licensing and Technology Transactions
- Generic Drug/ANDA Litigation
- Product Liability Litigation
- Securities Litigation
- Securities Regulation & Corporate Governance
- Royalty Finance
- Mergers & Acquisitions
- Regulatory and Compliance
- Antitrust & Lifecycle Management
- Business Restructuring & Reorganization
- Executive Compensation
- Tax & International Tax Planning

60+

Life sciences partners

220

Life sciences attorneys globally

25

Life sciences lawyers with technical degrees in areas such as molecular biology and chemistry

Royalty Monetizations | Life Sciences Practice

We represent clients across the biotechnology, pharmaceutical, medical device and diagnostics industries, with our clients ranging from global pharmaceutical giants to emerging biotechnology companies.

We also represent leading investment funds (including private equity, venture and hedge funds), investment banks and academic institutions across the life sciences sector.

Chambers USA (2024)
Recognized Nationwide and in California for Life Sciences

Legal 500 (2024)
Ranked in the 2024 edition of The Legal 500 – United States for Life Sciences

Law 360 (2020 - 2023)
Winner, Life Sciences Group Of the Year

LMG Life Sciences (2024)
Highlighted six practices – Antitrust, Corporate, General Patent Litigation, Mergers and Acquisitions, Hatch-Waxman Patent Litigation, and White-Collar/ Government Investigations in the area of Life Sciences

U.S. News - Best Lawyers©
Ranked Gibson Dunn's Intellectual Property practice Tier 1 nationally in its "Best Law Firms" survey

IFLR1000
Recommends Gibson Dunn in the area of Mergers and Acquisitions


GIBSON DUNN