Royalty Financings and Similar Revenue Monetizations Surge in Difficult Life Sciences Fundraising Environment

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IN BRIEF

- Sustained market conditions have created challenges for many life sciences companies to raise equity capital at attractive pricing, as venture investment activity, initial public offerings (IPOs), and other offerings remain at multiyear lows.
- In contrast, royalty financings have grown rapidly due to their highly flexible and non-dilutive structure, growing investor base, and economics that are less closely tethered to macroeconomic forces.
- Life sciences companies looking to fund later-stage asset development, capital-intensive clinical programs, or early commercialization efforts may consider pursuing royalty financing arrangements for fast, efficient, and less dilutive upfront capital.

Many biopharmaceutical companies are facing challenges raising cash through traditional equity markets. While venture investment activity saw a slight increase in the first half of 2024 as compared to the equivalent period in 2023, overall volume remains well off 2021 highs.[1] Global life sciences venture investment activity experienced a year-over-year drop of 24% in 2023, after 2022 saw a year-over-year drop of 35%.[2] The largely frozen IPO markets of 2022 — down 71% in number of debuts for biotech companies from 2021 — continued throughout 2023 and 2024, with only three IPOs occurring in the second quarter of 2024.[3] For biotech companies that are already public, market values remain depressed, with the sector up only 1.13% in 2024, while the S&P 500 experienced a gain of 18.5%.[4] Rising interest rates over the same period, which are now near a 20-year high, have made the alternative of debt financing less attractive to borrowers, and at the same time lenders have pulled back sharply on venture lending activities.

Royalty financings, in contrast, have provided a bright spot for the sector. These transactions involve the sale of some or all of the rights to an actual or potential royalty or other income/revenue stream in exchange for an upfront lump sum payment. Royalty transactions and similar monetizations of revenue streams have been estimated to provide approximately $14 billion in per-year deal flow, with the total value of these deals growing at a compound annual rate of 45%.[5] Their attractiveness for both buyers and sellers is due in part to their ability to offer returns and terms that are dependent

on the risk and return profile of a particular drug candidate or program rather than the macroeconomic factors generally at work in the capital markets. In addition, many deals in this sector lack a variable interest rate component, which allows buyers and sellers to add or deploy capital that is decoupled from rapid changes in the interest rate environment. Finally, shareholders view these transactions as non-dilutive and efficient sources of capital, and so generally react positively to royalty deal announcements. As royalty financing and monetization transactions gain momentum as alternatives to traditional debt and equity financing, life sciences companies may look to take advantage of these methods of fundraising to accelerate product development, launch clinical programs, or acquire additional assets.

The flexibility and variety of transactions in this sphere lead to variable and sometimes confusing nomenclature. Under the umbrella term “royalty financings,” there are two primary transaction types that we will discuss here: (1) royalty/revenue monetization transactions and (2) development financing transactions.

Royalty/Revenue Monetizations

Royalty/revenue monetization transactions involve the sale of some or all of the rights to a royalty or other income stream for an upfront lump sum payment. In practice, the seller is often an intellectual property (IP) owner who has licensed its IP to a third party in exchange for royalties on the sale of drugs utilizing that IP. These royalties are then sold for a lump sum, generally subject to a cap on total return on investments for the buyer in the range of 1.5 to 4 times the initial investment, depending on the investor’s risk analysis of the royalty stream. This allows companies to immediately realize the full value of a royalty stream while shifting some or all of the risk of poor future performance of a particular drug to the buyer. Typically, buyers do not look to encumber company assets in these transactions, providing sellers with maximum flexibility for additional debt or royalty financings down the road.

This same structure is applied where the seller owns a revenue stream other than from license fees, for example a royalty-based earnout payment from the sale of an asset or a line of business. It can also be utilized where there is no underlying license or asset/business sale, and where the transaction monetizes a product revenue stream owned directly by the company.

Historically, these monetizations have been structured as a straightforward “true sale” of an entire royalty or revenue stream or a portion thereof, with only minor differences between transactions. However, flexibility has increased as the market has matured, and bespoke deals tailored to meet a company’s needs are on the rise. Partial sales as well as sales subject to capped returns and put/call rights have become more common. In some cases, these transactions have occurred in tranches or strips over a course of time.[6]

These monetizations provide a dynamic mechanism for companies with a product at or near FDA approval to immediately realize the full value of their assets.

Development Financings

Development financings, which include many synthetic royalty transactions, traditional development

financing deals, and royalty-backed debt financings, generally involve an investor providing an upfront lump sum amount and/or commitments to fund future amounts needed for development and commercialization of products, in exchange for all or a portion of an existing or future income that a product or group of products may generate, usually coupled with a lien on the assets underlying those products or group of products. Repayment terms may share attributes with those of a traditional loan. For example, if the acquired royalty streams do not meet certain milestones, sellers may be obligated to provide “gross-up” payments that ensure buyers receive a particular rate of return on their investment. As with a traditional secured loan, failure to make these payments may result in an acceleration of existing investment amounts and all future payments owing to the buyer as well as a subsequent sale of the collateral if the seller is unable to make the accelerated payments. These financings are typically in play earlier in a company’s life cycle, with availability usually opening up around the time of a positive Phase 3 data readout.

In short, these transactions live somewhere among equity financings, traditional asset sales, and secured debt financing. While it may leave some (or most) company assets unencumbered, the lien and covenant package required by buyers in development financings will usually, by its nature, severely limit a seller’s ability to layer in additional third-party debt or royalty financings down the road, and in some cases can even create impediments to partnering activity for other products in the pipeline. Great care should be taken at the term sheet stage with these transactions to clearly delineate lien and covenant scope in order to avoid surprises at the documentation stage, and companies should be aware that lenders may struggle to find viable ways to step into intercreditor relationships with development finance partners.

By not necessarily requiring a preexisting royalty stream, development financings allow companies to avoid out-licensing transactions prior to monetizing development assets. This provides life sciences companies with the unique opportunity to retain more control over their IP and the production and commercialization of their products while still obtaining necessary investment capital. Furthermore, the non-dilutive nature of these transactions makes them generally popular with shareholders (though, as with royalty/revenue monetizations, the prospective effect of these transactions on stock price should still be examined diligently). In all events, companies should be keenly aware of the limitations that may be placed on their ability to do future debt or royalty financings without investor consent during the life of their development financing facilities.

The Takeaway

The cost for research and development of new products has increased significantly over the past decade, while at the same time traditional debt and equity markets for life sciences companies have tightened. For companies with late-stage or commercialized drugs, royalty/revenue financings and development financing transactions may provide the upfront financing needed to fuel research and development, pay off expensive capital, bridge operations to approval of the next product in the pipeline, or avoid out-licensing of late-stage products to maintain more control and economics when those products reach commercialization. Streamlined documentation and diligence (as compared to traditional secured debt financings) allow for accelerated timelines to closing and lower transaction costs. Not to be overlooked, however, is how covenant packages and lien grants

(or negative pledges on assets) can hamper future financing flexibility, particularly in development financings with broad lien grants and extensive covenant packages. Life sciences companies interested in these types of bespoke financings should look to engage a legal advisor with substantial, targeted experience navigating this complex landscape to structure the transaction, lead diligence efforts, and draft and negotiate the deal documentation in order to maximize the benefits offered by royalty financing transactions.

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1. See http://www.DealForma.com database; financials based on disclosed figures through 6/30/2024.

2. See Cushman & Wakefield, *Life Sciences Funding in View & 2024 Outlook* (January 2024), https://cushwake.cld.bz/Life-Sciences-Funding-in-View-2024/4/.

3. See footnote *1 supra*.

4. Based on iShares Biotechnology ETF (IBB) performance through June 30, 2024.

5. See Cody Powers, et al., *Royalty financing: A growing alternative to traditional biopharma fundraising* (December 12, 2022), https://www.zs.com/insights/royalty-financing-alternative-traditional-biopharma-fundraising.

6. See *WilmerHale Represents PTC Therapeutics in $1.5B Evrysdi Royalty Agreement with Royalty Pharma* (October 25, 2023), https://www.wilmerhale.com/en/insights/news/20231025-wilmerhale-represents-ptc-therapeutics-in-15b-evrysdi-royalty-agreement-with-royalty-pharma. The 2023 PTC transaction and the transactions that preceded it demonstrate innovative use of monetization transactions to suit a company's evolving capital needs over time.

Authors

George W. Shuster Jr.

PARTNER

george.shuster@wilmerhale.com

+1 212 937 7232

Nathan J. Moore

PARTNER

nathan.moore@wilmerhale.com

+1 720 598 3462

Emily Powers

ASSOCIATE

emily.powers@wilmerhale.com

+1 720 598 3408