Healthcare and Life Sciences Private Debt and Royalty Opportunities

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Marathon calculates the size of the life sciences debt, royalty-backed credit, and royalty opportunity to be $25 billion of potential deal flow per annum. Healthcare private loans, royalty-backed credits, and royalty streams can be a compelling component of an investor's portfolio. They offer higher returns than typical middle market lending, risk that is often uncorrelated with the overall market, and significant structural protections.

Private life sciences loans and royalties may provide idiosyncratic and attractive risk-reward characteristics. This comes from such companies having limited alternatives as compared to more traditional, EBITDA-generating, middle market companies. Life sciences private loans are often priced at a spread of 400 basis points or more above that of corporate middle market direct-lending first lien loans.

Investors can reduce risk through structural characteristics and tight covenants. Other debt and equity in the capital structure can be made subordinate. These deals are often highly covenanted with low loan-to-value (LTV) ratios and have a cash interest component with additional upside, often through warrants or royalties.

Based on Marathon's and its team's experience in this strategy, if held to maturity, life sciences private debt and royalties can often realize 10-15 percent gross unlevered IRRs with a cash-on-cash multiple of 1.5x or more during an average holding period of five years.

The aging demographics of the U.S. population and the increasing pace of healthcare innovation have resulted in an ever growing need for capital by pharmaceutical firms. This capital takes the form of equity and debt. Equity capital has historically focused on financing research and development and getting drugs to FDA approval. Credit investors, unlike equity investors, largely have capped upside and a lower expected rate of return. As a result, these investors typically avoid unapproved products that are still in clinical trials, as these investments generally carry binary approval risk and are not as well-collateralized. Instead, lenders tend to focus on companies with approved pharmaceuticals and medical devices that may generate immediate revenue in order to mitigate the aforementioned risks.

Large, highly profitable pharmaceutical and device companies can typically access bank financing and bond markets. However, many small companies with newly approved medicines and medical devices require a significant amount of capital for marketing and distribution, but may lack positive EBITDA, and, therefore, access to traditional sources of debt financing. Many of these companies are also reluctant to raise new equity as it is typically more expensive capital and dilutive to existing shareholders. Consequently, small and medium-sized biopharma and medical device companies have increasingly embraced alternative financing options beyond traditional venture capital and public equity. These products include private loans, royalty-backed credit, and royalties.

To successfully invest in a healthcare private credit and royalty monetization strategy requires expertise in credit/legal structuring, life sciences investing, and deal sourcing. These areas of expertise are necessary in order to properly originate, diligence, structure, execute and monitor the portfolio. Investors need to ensure that they have the requisite knowledge as well as the financial capability to potentially generate equity-like returns under debt-like risk.

Legal structuring includes putting the appropriate covenants in place (e.g., opex and capex covenants, minimum liquidity requirements, etc.). It also entails putting security on the collateral appropriately and making sure that collateral is of sufficient value to ensure a low LTV. Making sure that the loan is senior to all other debt in the capital structure is also very important.

Life science investing expertise includes having the requisite medical understanding in-house both through members of the team as well as through an exclusive medical advisory board. It generally entails having a deep understanding of drug commercialization, including methods of sizing the market, analysis of expected reimbursement trends, and development and deployment of the company's salesforce.

Deal sourcing is typically driven by the proprietary relationships of the team and the firm. The team's tenure in the healthcare markets combined with added relationships from the medical advisory board is often a source of deal flow. If the firm has a strong presence in the public capital markets, this too can be a source of deal flow (as relationships in that market sometimes translate into opportunities for private investment). Deal flow comes from a variety of relationships from those with company management teams, to healthcare bankers and investor relations firms, to venture capitalists and family offices invested in the companies.

Marathon believes there is currently limited competition and sustained idiosyncratic risk-reward opportunities in healthcare private lending and royalty monetization. In order to try to capitalize on this opportunity, Marathon has built out an experienced private healthcare finance team and is actively looking at senior secured financings as well as loans against royalty streams of approved products. We have recently closed two sizeable transactions and have a strong pipeline of potential deals.

The information contained in this report is an extract from Marathon's Q1 2018 White Paper entitled "Healthcare and Life Sciences Private Debt and Royalty Opportunities". In order to receive the comprehensive White Paper and for a more in-depth discussion about this strategy please contact your Marathon Investor Relations representative.

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