

## Revenue Interest Financing: A Strategic Alternative To Accessing Capital Through Licensing In The Life Sciences

By John R. Leone and Louis P. Berneman

### Introduction

Out-licensing is a mainstay of life science business development and financing strategies because it can be deployed to achieve a variety of goals. Companies frequently use licensing in order to access resources (financial and non-financial) that are unavailable or insufficient within their own organizations.

Accessing capital is among the most common reasons to out-license. Up-front license fees provide cash infusions to fund operations and defer the need to obtain capital from the equity or debt markets. In addition, a successful licensing transaction provides an imprimatur on the licensed technology/IP and on the licensor itself, both of which may enhance subsequent market-based capital formation activity.

That said, while out-licensing is an important capital formation tool, licensing typically requires sacrificing all or partial control and downstream financial benefits of the licensed program or technology to the licensee. Companies considering out-licensing primarily as a near-term, direct capital formation tool may wish to consider revenue interest financing as a strategic alternative.

Revenue interest financing is a transaction that involves the creation of a synthetic royalty derived from product revenues for products that are developed and marketed internally (as opposed to by a licensee) and selling that revenue interest to a buyer (capital provider). In effect, a royalty obligation is created not for access to technology or IP rights, but for access to capital. It's a simple financial arrangement that should be considered among other capital raising strategies. Revenue interest financings are non-dilutive to equity (because no equity is sold), but are dilutive to earnings (as all or some portion of the monetized revenue is apportioned to the buyer), with revenue interest payments to a capital provider being treated as interest expense.

Furthermore, revenue interest financing—when appropriately constructed—functions more like a partnership or joint venture rather than a pure financial transaction. Because the success of the product

underlying the revenue interest typically requires the overall success of the company with marketing responsibility, the revenue interest buyer has a strong interest in seeing the seller prosper over the long-term. This teaming of buyer's and seller's interests helps to maximize the coordination of goals and enhance both the result and the experience of the transaction.

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In addition to accessing capital, revenue interest financing enables a company to transfer some of the commercial risk to a capital provider while retaining a right (if the transaction is structured appropriately) to repurchase the previously sold revenue interest in the future. Revenue interest financings can be structured to avoid many of the typical restrictive operating and financial covenants associated with commercial debt financing deals and may be used in combination with equity and traditional debt to create unique structures designed to meet multiple capital and strategic objectives.

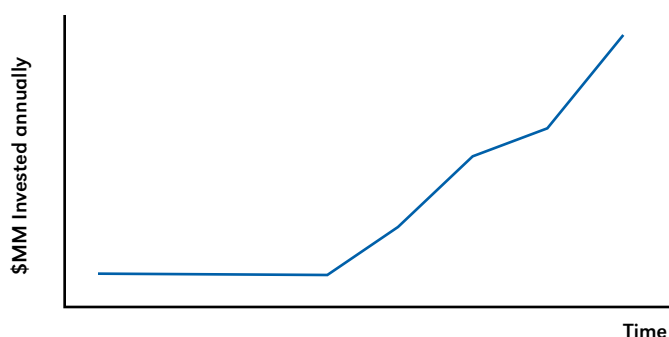
### Strategic Alternative to Out-licensing

Revenue interest financing is a strategic alternative to out-licensing that provides companies with cash to meet near-term obligations and goals, while retaining rights to and control of their valuable innovations and IP assets. Revenue interest financing may also be used strategically to advance a development-stage opportunity to a more advanced stage prior to licensing, which may yield greater participation in downstream value. Revenue interest financing is most applicable to companies with present and/or near-term product revenues, although such financings are possible for earlier stage products if revenues from other existing product sales can be used as the immediate basis of the synthetic royalty.

Over the past several years, increased awareness and acceptance of revenue interest financing has

**Figure 1. Royalty and Revenue Interest Financings\***

The market for royalty monetization and revenue interest financing transactions has been increasing over time



\*Does not include debt or equity investments.

fueled an eight-fold growth in the dollar transaction volume of these vehicles in the healthcare space (Figure 1). In this article, we discuss revenue interest financing as a strategic alternative to out-licensing when accessing capital is the priority motivation. We present a description of the structure of these transactions, and we include case studies demonstrating how companies have used revenue interest financing to access capital to fund a variety of corporate objectives.

## A Portrait of Today's Life Science Licensing Landscape

Standard licensing transactions typically involve the granting of rights from a patent owner or licensor to a licensee or sub-licensee in exchange for a variety of considerations and obligations, including, but not limited to, license fees (up-front, annual, and milestone), sub-license sharing, royalties, reimbursement of patent costs, R&D funding, and equity purchase. Non-financial considerations include intellectual property management rights and responsibilities and diligence obligations.

For early- or development-stage life science companies, access to critical resources, including intellectual, financial, and facilities resources necessary to promote and support business operations, R&D, and clinical trials is often the key driver for undertaking out-licensing transactions.<sup>1</sup> Out-licensing also enables redeployment of assets in order to maximize returns on a company's portfolio as a whole, e.g., moving resources from non-core to core programs, from low yield to high yield opportunities, or from high risk to

lower risk product candidates. In the last case, the redeployment enabled by out-licensing may also be viewed as a form of risk mitigation.

Asset redeployment frequently is a motivating driver of out-licensing for commercial-stage companies. Additionally, while commercial-stage companies may have the resources to bring products through the development continuum, they often out-license select programs to achieve greater market penetration—and correspondingly increased revenues and profits—by leveraging the commercial infrastructure of a larger and/or more capable or experienced

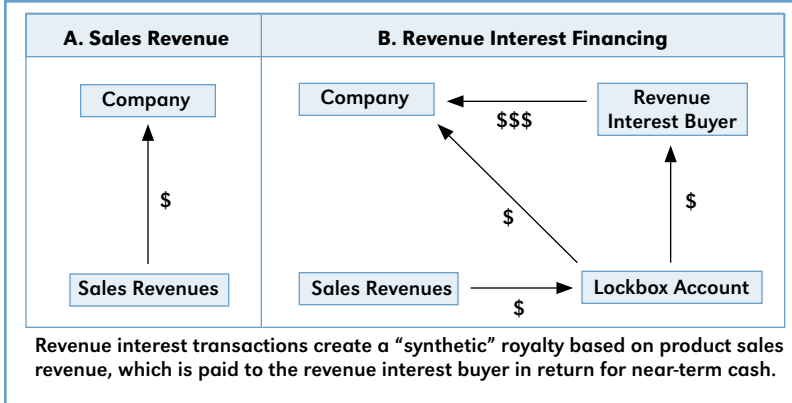
partner. Finally, commercial-stage companies also may use out-licensing to access growth capital that can be put to work on products and programs with greater financial return on investment potential. For example, capital obtained by licensing a product with modest or sub-critical annual sales revenues could be invested in a development candidate with significantly higher market potential, resulting in greater return on investment over the long term.

Despite the ubiquity and utility of out-licensing deals, these transactions are not without their limitations. Depending on terms, licensors may sacrifice all or a substantial part of the long-term upside potential of the licensed program. In some situations, a program may go from being the crown jewel in the pipeline of a development-stage company to one of a number of early stage products in the more extensive portfolio of a larger organization. Thus, while the license resulted in needed capital, transition of the program from innovator company to licensee may result in reduced visibility for the program, which may make it more difficult for the innovator company to retain investors' interest. With another company in the driver's seat, the innovator may not receive recognition for its capacity to innovate or initially develop new products or technologies. Wall Street equity analysts have also commented that as part of an overall company valuation, royalty income is valued at a lower multiple than are revenues for a product whose commercialization is controlled by the company. Additionally, the existence of licensing agreements may complicate future strategic transactions, such as the sale of the

1. Myers RA. "Licensing—A Basis for Strategic Alliances." *les Nouvelles*. September 2001, 65-72.

2. LES (USA & Canada) BioPharmaceutical Royalty Rates and Deal Terms Survey, July 2008, *les Nouvelles*.

**Figure 2. A Comparison of Cash Flow Between a Non-Monetized Revenue Stream (A) and a Revenue Interest Financing Transaction (B).**



**Table 1: Revenue Interest Transactions Are Highly Flexible**

**Flexibility in deal structure and payment terms allowing the seller to retain upside revenue potential**

- License a single product
- License a basket of products
- License an existing revenue stream
- License a future revenue stream
- Ability to select the percentage of revenue stream to be sold
- Revenue interest can be repurchased

**Straight sale**

- A sale of all or a portion of the revenue stream

**Structured sale**

- Percentage/tier of revenue stream
  - Up to a cap on aggregate payments, either over the life of transaction or annually, with excess (or portion of excess) retained by the seller
  - Of certain specified products
  - From certain countries/regions
  - Over a specified period of time

company or larger and more lucrative partnerships. Further, deferral of licensing and partnering may result in substantially higher royalty rates as shown in the most recent LES survey of biopharmaceutical royalty rates and deal terms.<sup>2</sup>

Thus, while out-licensing is an important financing tool, there are other financing options that should be considered in the context of an individual company’s strategic financial and growth objectives.

**Revenue Interest Financing: As Innovative as You Are**

As demonstrated by Figure 1, the market for healthcare product financing transactions has grown substantially in recent years. This corresponds with an increase in the number of companies with commercial or near-commercial products that have

used revenue interest financing as a strategic alternative to licensing. Revenue interest financing accomplishes many of the financial objectives of licensing, while retaining full rights and control of the product, a greater portion of long-term value and revenues, and mitigating a portion of risk.

Revenue interest financing transforms a commercial asset that is currently generating, or is soon expected to generate, revenues into up-front capital to fund corporate activities. Public and private companies can use revenue interest financing, regardless of their capital structure, so long as they have current or near-term revenues.

Revenue interest financing is a transaction that creates a synthetic royalty. In effect, a patent holder ‘borrows’ funds against current and expected future revenues, which are used to ‘repay’ the debt in the form of a royalty created for the purpose of the financing transaction. Under a revenue interest financing agreement, the buyer provides the seller with cash, typically as up-front and milestone payments. In return, the buyer receives an agreed upon portion of sales revenues. In these transactions, it is customary for

the complete revenue stream to be directed to a holding account (lock box) rather than to the seller directly, and funds are then seamlessly apportioned to the buyer and seller according to the terms of the transaction (Figure 2).

The financing may also include equity and traditional debt as complementary financing elements. Earlier-stage companies that generate a continuous revenue stream through licensing of a platform technology, products, and research tools may also be able to utilize revenue interest financing as a mechanism for accessing capital.

A key benefit to revenue interest financing is flexibility in deal structure and payment terms (Table 1). This flexibility enables companies to tailor deal terms to meet immediate financial needs and long-term strategic growth objectives. Although most

out-licensing transactions focus on specific therapeutic areas or defined technology platforms, revenue interest transactions may be structured to include revenue from more diverse product portfolios. These vehicles can be structured around a single product or a basket of products and can be applied to an existing revenue stream, a potential future revenue stream or a combination thereof. Companies also have the ability to select the percentage of a revenue stream that will be monetized, allowing them to fine-tune the balance between near-term financial need and long-term growth objectives.

A significant difference between revenue interest financing and out-licensing is that the former transfers rights to all or part of a revenue stream without touching the revenue-generating asset, while the latter necessitates giving up some or all rights to the source of revenue generation. With revenue interest financing, companies retain control over their products; with out-licensing, varying degrees of control are transferred to the licensee. One of the most compelling features of revenue interest financing is that it allows companies to off-load a portion of commercial risk to the buyer while retaining full control of the product itself. Moreover, companies are typically permitted to repurchase the previously sold revenue interest if and when additional capital becomes available. Again, this increases a company's flexibility in accessing various forms of capital to best meet near-, mid- and long-term goals.

Revenue interest financing also provides flexibility from a purely financial standpoint. When undertaken as the sole financing vehicle, revenue interest financing transactions are non-dilutive to equity and typically avoid the restrictive covenants that are usually part of debt financings. Numerous examples, however, demonstrate that revenue interest financing can be combined with other equity and/or debt vehicles to create unique structures designed to meet multiple strategic objectives.

The potential downsides of revenue interest financing include the potential for discount over the life of the product and the costs (both time and money) of executing the transaction. However, these downsides also are inherent to out-licensing transactions. In some cases, a potential licensing partner's due diligence process may actually be more complex than that of a revenue interest buyer because it must comprise not only the product, its technology, market potential and competitive landscape that a buyer would undertake, but also cultural issues that relate to how the two companies will collaborate going forward. Similarly, an innovator company may have more

complex and substantive concerns around "sharing" its goose than for selling part of a golden egg.

## Putting Revenue Interest to Work for Your Organization

While the flexibility of structures and terms available in revenue interest financing transactions are attractive, these vehicles are neither feasible nor appropriate for all life science companies. First and foremost, these transactions require current or near-term revenues. In most cases, the revenue streams derive from products already on the market or very close to commercialization. Oftentimes, a product may already be on the market for a specific indication or in certain geographic regions, with expansion into additional indications or territories expected in the near term. The source of the revenue interest and the use of proceeds do not need to be tied to each other. For example, revenues from a marketed product can be used to generate capital to fund an earlier-stage development program.

Although it is technically possible for any company with a product revenue stream to undertake a revenue interest financing, experience shows that these transactions are most successful when they are used to generate capital to support clearly defined, near-term objectives. It is important to recognize that out-licensing and revenue interest financing each will produce a discount over the life of the product and that it is the magnitude of the discount that needs to be considered, rather than the discount itself. If funds raised through revenue interest financing enable the company to make substantive progress in enhancing or establishing new revenue streams, the discount will be well worth the cost. Achieving such substantive returns on investment requires a clear and compelling strategic plan. Activities that may successfully be financed through revenue interest transactions include:

- Expanding a sales force to increase commercial competitiveness or market penetration of an existing product;
- Acquiring a new product that allows additional revenue generation from an existing sales force;
- Offsetting R&D and/or commercial launch expenses;
- Funding clinical development of pipeline products as a way to defer partnering until product valuation is increased;
- Extending a product's life cycle by funding line extensions, new indications and re-formulations of established brands;
- Advancing and/or expanding a product pipeline; and

- Unlocking value of an asset that is un(der) appreciated by traditional sources of capital (i.e. investment bankers and investors).

In contrast, while it may be possible to use revenue interest financing to provide capital to support clinical trials, risks associated with clinical development and regulatory approval and time-value of money considerations often make revenue interest financing a less appropriate strategy for funding clinical trials. This is because the additional risk will translate into a larger discount, increasing the cost-basis of the capital.

## Revenue Interest Financing in Action

There has been substantial growth of the market for healthcare product revenue interest financing since 2000. Consequently, there are numerous recent examples of how these financing vehicles have been deployed to achieve a variety of objectives. The following case studies highlight just a few of the ways in which life science companies have utilized revenue interest financing to access transformative growth capital (see Sidebar).

### Financing a Product Acquisition

A publicly traded biopharmaceutical company was seeking capital to acquire U.S. rights to an FDA-approved drug. Financing the entire acquisition cost through an equity transaction would have been unacceptably dilutive to per-share earnings, while a full revenue interest financing would have had an undesirable impact on cash flow. Leveraging the ability to combine revenue interest financing with other vehicles, the company structured a deal that included revenue interest, equity and debt components. The revenue interest portion of the transaction included a percentage of revenues from an existing product in the company's portfolio, as well as the product that was to be acquired. With financing in place, the company successfully executed a transformational acquisition that

dramatically expanded its revenue base, leveraged its existing sales infrastructure and accelerated its path to profitability.

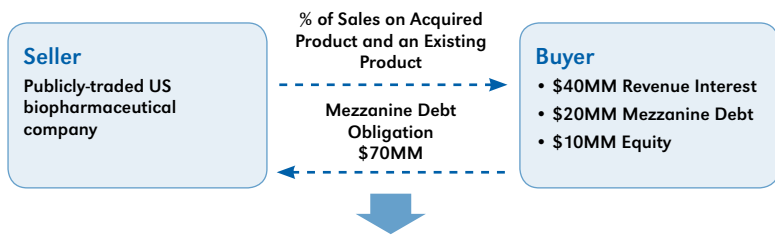
### Expanding a Sales Force

A privately held biotechnology company was conducting Phase III trials of a promising new therapy for a chronic disease and planning for an initial public offering. The company was generating a revenue stream from sales of an in-licensed product in the same therapeutic area as its Phase III compound. Research suggested that a larger sales force would drive an increase in revenue for the marketed prod-

## A Flexible Approach to Financing a Product Acquisition

### Flexible financing required:

- All equity would be too dilutive
- Full revenue interest financing would have heavy impact on cash flow



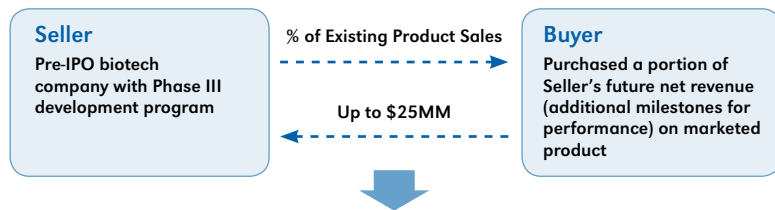
### Result

- Transformational acquisition resulted in expanded revenue base, accelerated path to profitability, and leverage of existing sales infrastructure
- Flexible multi-security structure satisfies Seller's objectives and ensured that Buyer's interests area aligned with equity and debt investors

## Expanding a Sales Force

### Situation:

- A biotech company conducting Phase III trials on lead pipeline product and planning IPO to fund ongoing development spend
- Actively marketing an existing product through small sales force
- Additional funding needed to expand sales force and supplement pre-IPO balance sheet without dilution of ownership stake



### Result

- Financially stronger pre-IPO position
- Successful IPO 2 months after close of revenue agreement
- Revenue interest financing agreement seen as validating the commercial potential of the Seller's marketed product

uct while building the sales infrastructure to support the launch of its development candidate, assuming FDA approval. Given its pending IPO and sensitivity to diluting its ownership stake, the company sought an alternative to equity financing. The company sold a portion of future revenues from its marketed product for cash to fund expansion of the sales force.

Importantly, the financing left the company's development candidate unencumbered, allowing it to retain the upside potential of its R&D investment. Additionally, the buyer's interest in the marketed product was seen by others as a validation of the phase III product's commercial potential thus facilitating a successful IPO several months later.

## Delaying a Partnership to Maximize Value

A publicly traded drug development company had a late-stage product in development and needed capital to fund Phase III clinical trials. Although the company ultimately intended to seek a partner to commercialize the product, the preference was to partner upon regulatory approval, rather than during clinical development, in order to maximize license economics. The company structured the financing to include a basket of products, including the Phase III development candidate. The funding enabled the company to complete clinical development of the candidate. In delaying a licensing/partnering arrangement until Phase III trials were completed, the company received significantly improved license economics (increases in up front payment, milestones and royalty rate) compared with what could have been achieved with Phase II data.

## Unlocking the Value of an Asset

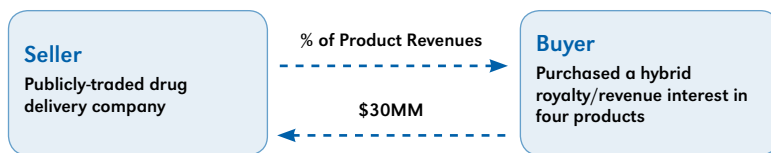
A publicly traded biopharmaceutical company had developed an enabling technology with broad utility. The company was using this asset to generate revenue (fees, milestone payments and royalties) by broadly licensing the

technology. While licensees —biotechnology and pharmaceutical companies—recognized the value of the technology and were willing to pay to gain access to it, “Wall Street” assigned it no value. In need of capital to fund product development, but its low stock price making an equity sale undesirable, the company was looking for an alternative capital formation approach.

### Delaying a Partnership to Maximize Value

#### Situation:

- Drug delivery company in need of commercial partner for lead development program and \$30MM of capital to fund Phase III trials
- Preference was to partner upon approval, rather than during clinical development, in order to maximize license economics



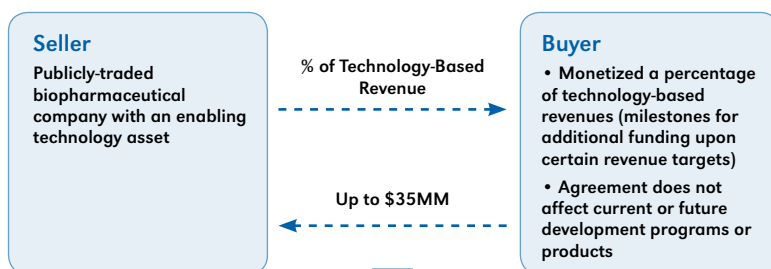
#### Result

- Investment allowed Seller to defer partnering until late stage trials for lead development program were completed
- Improved license economics compared with what could have been achieved with Phase II data

### Unlocking the Value of an Asset

#### Situation:

- Publicly-traded biopharmaceutical company using an enabling technology to discover pipeline opportunities
- Enabling technology generates fees, milestones and royalties through agreements with >75 partners but is not valued by public markets
- Ongoing need for cash to develop various product candidates, low share price prohibitive to raise equity



#### Result

- Investment represented a fraction of technology-based revenue net present value; Seller retained most of the upside
- Monetization enabled Seller to finance internal pipeline without dilution
- Wall Street recognized the value of the transaction—and the enabling technology platform—to shareholders

The company structured a sale of a portion of its technology platform licensing revenue in return for cash upfront. The transaction allowed the company to fund its pipeline without further equity dilution. Importantly, the sale represented a fraction of the technology's long-term value, and the company retained most of the long-term upside potential. While "Wall Street" recognized the value of the transaction from a corporate development perspective, the willingness of the buyer to assign value to the underlying technology helped investors appreciate the value of this revenue-generating asset.

## Is Revenue Interest Financing Right for Your Organization?

A host of factors contribute to the assessment of if, when and how to incorporate revenue interest financing into a company's strategic and capital formation plans. Key among them are the legal considerations around such transactions and the other options that exists for raising capital.

### Legal Considerations

1. Defining the purchased interest—First and foremost, a company needs to determine which revenue streams will be monetized. In some cases it may be a revenue stream for a single product, while others may comprise revenue from a basket of products. It should be noted that the risk of product failure or underperformance (delayed or slow launch, poor market penetration or uptake, withdrawal from market, etc.) is greater with a single product, which may increase the discount on the transaction. This risk is reduced when the interest comprises revenues from multiple products, which may result in a reduction in the discount required by the buyer and, consequently, improved overall deal economics.

2. Collateralizing the seller's obligation—In revenue interest financing, the revenue interest buyer provides cash upfront in return for a defined percentage of future net sales. As with other debt-like transactions, the buyer requires some form of collateral to protect against loss in the event that the seller becomes unable to meet its payment terms. Such scenarios can arise if the seller goes out of business or discontinues its sales and marketing efforts for the product(s) underlying the purchased revenue interest. Consequently, revenue interest buyers take a senior interest in the assets underlying the related revenue streams. This includes relevant intellec-

tual property, in-licensing agreements, marketing authorizations and manufacturing and distribution agreements.

3. Intellectual property verification—A revenue interest buyer's due diligence encompasses a thorough evaluation of the intellectual property underlying the relevant product revenue streams.<sup>3</sup> Prior to undertaking a revenue interest financing, potential sellers should consider the strength, breadth and validity of the relevant patents, including issued and pending patents. Similarly, buyers also will evaluate potential competing patents or patent challenges. While the potential for competition or challenge in the patent arena does not necessarily preclude successful revenue interest financing, such risks are likely to impact the discount and overall economics offered by the buyer.

4. Tax considerations—From a tax perspective, revenue interest financing transactions typically are structured as debt, comprising principal and interest components. Each component has a different impact on a company's income statement. The higher the portion of principal, the greater the increase in income reported on the income statement. Higher interest components reduce income but also reduce corporate tax burdens. These competing impacts should be considered when structuring deal terms.

### Alternative Financing Options

The merit of undertaking a revenue interest financing also must be considered in the context of other fundraising options and the ultimate strategic objective that any transaction might help to achieve.

1. Out-licensing—Licensing may provide the greatest amount of capital over the near-term, but could result in loss of control of the product and substantially limits future upside potential. Moreover, in a straight out-licensing deal the innovator company takes on the risk that the licensee may lose interest in the program at a future time due to changes in the competitive landscape or their own internal priorities. This again potentially limits the long-term value that an innovator company may receive in return for its initial investment in the product or technology.

2. Development partnerships—Partnerships allow innovator companies to retain some control over a product's development and commercialization, but typically require retaining some risk and sacrificing a part of a product or program's long-term upside potential. Another challenge in undertaking a development partnership is assuring effective collaboration between the innovator company and the licensee. Experience has demonstrated that some partnerships

3. Roman D. Sarlitto M. "Risks to Consider When Purchasing Technology Based IP For Securitization." *les Nouvelles*. June 2007, 413-417.

that look effective on paper may be anything but when scientists, regulatory teams and sales forces from different corporate cultures and with different decision-making processes are forced to work together. Moreover, even in the best-case scenario—when both companies' needs and objectives for a partnered program are aligned—there are likely to be substantial differences in overarching corporate objectives that will impact the ultimate success of the partnership.

3. Equity financing—Companies with strong stock performance may seek to raise capital through the equity markets. However, many life science companies—even some with products on the market—consider their companies undervalued and believe that the negative impact of dilution over the long-term outweighs the benefit of selling shares for cash today. The relative attractiveness of equity financing fluctuates over time depending on corporate performance and overall market trends. Fluctuations in share price may make equity financing more or less attractive than other financing mechanisms at particular moments in time.

4. Debt vehicles—Debt financing transactions avoid the issue of dilution, but they typically come with restrictive covenants that may limit future strategic transactions or fundraising efforts. As with equity financing, the long-term downside of debt may outweigh the near-term benefit of accessing additional financial resources. Given the covenants and costs of debt, it may also be difficult to structure a transaction in which the objectives of the company and the debt provider are aligned.

There is no one-size-fits-all approach to balancing the pros and cons of licensing versus other methods for accessing capital. However, revenue interest financing can provide significant near-, mid- and long-term value to companies that want to minimize dilution, maximize their flexibility, and retain control over their innovative products and programs. The features and benefits of revenue interest transactions are summarized in Table 2. In any market—but especially in the context of the current volatility in

**Table 2: Features and Benefits of Revenue Interest Financing**

<p><b>Overall</b></p> <ul style="list-style-type: none"> <li>• Provides funds now for broad range of uses</li> <li>• Risk sharing and mitigation</li> <li>• Flexibility to license all or part of a present or future revenue stream</li> <li>• Innovative deal structures enable seller to retain upside</li> <li>• Compatible with and complementary to subsequent financing efforts (public/private equity, debt, other)</li> </ul>
<p><b>Comparison with equity</b></p> <ul style="list-style-type: none"> <li>• Non-dilutive</li> <li>• Lower cost of capital</li> <li>• Overall public market indicators and total company valuation play less significant role</li> </ul>
<p><b>Comparison with debt</b></p> <ul style="list-style-type: none"> <li>• Financing terms not dependent on current credit market conditions</li> <li>• No restrictive operating or financial covenants</li> </ul>

the equity market and limited availability of debt—revenue interest financing is a strategic option that should be considered by companies with existing or near-term product revenue streams.

## Conclusions

Out-licensing has been a successful part of life science capital creation strategies for many years, and is likely to remain a mainstay of the industry. However, the growing number of successful revenue interest financing transactions in recent years validates the utility of this strategic funding alternative. The ability to monetize all or part of a revenue stream provides greater flexibility than a straight out-licensing or partnering transaction. Revenue interest financing allows companies to retain both the long-term value and upside of their investment in innovation. Significantly, revenue rights can be repurchased when additional capital becomes available, further preserving revenue-generating potential.

Revenue interest transactions can be done in conjunction with other financing vehicles to provide tailored licensing and fund-raising strategies that meet an individual company's needs. A growing pool of knowledgeable buyers with a track record of structuring transactions that are win-win for both buyer and seller offers sellers a competitive and attractive market. When considering out-licensing primarily as a mechanism for accessing capital, companies with product revenue streams should also evaluate their revenue interest financing opportunities.

## Conflict of Interest Disclosure

Dr. Berneman is a paid consultant to Paul Capital Healthcare.