KEYNOTE INTERVIEW

Royalties step into the spotlight

These revenue-based, asset-backed investments are emerging as a compelling opportunity for LPs to diversify their private markets portfolios, says Partners Group managing director and head of royalties Stephen Otter

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Q What makes royalties an attractive investment strategy for private markets investors?

Royalties present a huge opportunity for private markets investors. Our estimates indicate that this is a $2 trillion investment market that is still growing.

A royalties strategy is not only relevant in established royalty sectors that people might think of – such as intellectual property (IP) rights in healthcare and music – but also across broader IP, such as film, TV, theatre rights, brands, video games, sports and wider media. Non-IP sectors can also be relevant, such as the energy transition, which includes green metals, natural gas, carbon and water.

To put this into context, ownership of mineral royalties in the US alone is worth more than $500 billion. Whenever natural gas is produced from a well, the royalty owner is getting a percentage of that gas revenue, and the royalty is like owning the land title. We also see royalties as being relevant more broadly across other sectors, which means the opportunity set is vast.

Royalties are also attractive because, as a royalty investor, you are typically an owner of assets such as copyrights, patents, licence agreements, or land or subsurface rights – hence why these investments might be considered 'asset-backed'. Despite being the asset owner, the royalty investor is not typically responsible for commercialising the underlying asset, instead leaving that and all the costs to a third-party asset operator, who in return pays the royalty investor a percentage of the asset revenue as and when it is generated.

> *"Royalties in different sectors present a range of risk-adjusted return dynamics"*

Royalty investments, then, provide investors with long-dated revenue line exposure to underlying assets and sectors that can be countercyclical, generating stable and attractive yields with low correlation to broader markets and providing an embedded inflation hedge.

Q Are there any sectors that are particularly well suited to producing royalties?

Healthcare and music are among the best-known sectors for royalty investing, and investors will usually invest in these royalties through single sector-focused funds.

There is scope, however, to invest in royalties with a cross-sector approach, which is our preferred model, because this unlocks dealflow and gives the manager the room to step back from certain sectors where valuations appear full.

Music royalty multiples, for example, went through a cycle of increasing from 5-10x cashflow to 15-20x or more. From a relative value perspective, investing at high multiples will make it more difficult to reach targeted returns. A cross-sector approach provides the flexibility to step back when pricing is high and focus on sectors where entry valuations are much more attractive.

Royalties in different sectors also present a range of risk-adjusted return dynamics. Royalties in new or unreleased music, for example, can produce upside returns, but do come with more volatility and risk. Similarly, in healthcare or energy a pre-approved drug or development gas well can produce outsized returns but can leave the investor with nothing if the drug isn't approved or the gas well doesn't produce.

There is a spectrum of risk and return that managers can invest across, depending on where in the life cycle the manager chooses to invest. Our focus, for instance, is on producing derisked assets, or to put it another way, investing as late in the asset life cycle as possible, where the volatility is at its lowest.

Q What do typical hold periods look like? Is this a yield play or is there also an exit element involved?

Royalties' returns can be driven by a mix of yield and exits, depending on return targets.

For instance, it is possible to invest in high-quality royalty assets that are effectively self-liquidating through their yield and will therefore be capable of delivering returns in the mid-teens without the manager having to exit. By contrast, some royalty strategies are predicated on exits to hit their returns targets.

In our case, we think of an exit as an upside, rather than a critical lever for hitting our return threshold. Do I expect us to have exits over the coming years? Yes. But do we enter into an investment needing to exit? No.

Q What fund structures suit a royalties investment? Do these assets lend themselves to any specific kinds of fund structure?

In the past, managers have typically invested in royalties out of closed-end structures, but we believe royalties investing is actually best suited to evergreen investment structures.

This is because royalties are by their nature long-dated assets. If you are investing in pharmaceutical IP that is post-regulatory approval, your royalty lasts for up to 15 years. Natural gas wells

Q Why would holders of royalties be interested in selling to a third-party buyer?

Vendor motivations to sell or create royalties will vary depending on the sector. In the healthcare sector, for example, companies that develop new drugs can be small R&D-focused businesses that generate IP but don't have the balance sheet to turn that IP into a product that can be manufactured globally. These companies will license that drug to a multinational pharmaceutical company in exchange for a royalty, and in the future may look to monetise the royalty to fund their broader R&D pipeline.

When it comes to the creation of royalties and why that may be attractive, again using healthcare as an example, a company that has developed a new compound or drug can raise capital by creating a royalty over that product. That will not negatively affect any banking covenants, financial metrics or credit ratings, as a financing raised via the creation of a royalty is not classified as debt, nor is it dilutive like selling equity or selling the underlying asset would be.

Overall, across all sectors, selling a royalty allows the vendor to bring forward long-term cashflows to the present, and there will be various reasons for wanting to do so.

produce for 20 years or more, while music IP typically lasts for 70 years after the death of the artist. The cashflows from royalties, then, are long-dated and uncorrelated to market cycles. Evergreen fund structures, therefore, match the underlying asset duration, enabling a hold-for-life underwriting.

Of course, this is still a relatively nascent asset class, and some managers will still be investing in royalties from funds predominantly focused on broader credit or special situations opportunities, rather than royalty-only strategies. Very few investors globally currently have exposure to a royalties strategy. But we see that changing, especially as the evidence of the strategy's performance and consistency is borne out over time.

Q Are royalties deals predominantly made using equity or credit?

Both. Managers can invest in royalties using equity or credit. In the case of equity deals, managers can buy the royalty outright and then clip the revenues of the assets in line with those rights.

It is also possible to lend against royalties. A vendor may not want to sell, or a buyer may feel that the equity valuation for the outright acquisition of the royalty is too high. The lender will then hold some form of security against the royalties and receive a coupon from all royalty-related cashflows until the instrument matures and targeted returns are achieved. Full royalty rights will typically then revert to the owner of the royalty.

Q Where are you seeing innovation in the royalties market?

Rather than simply buying existing royalties, it is also possible to create a royalty, which is sometimes called a "synthetic royalty". A royalty, after all, is simply a percentage of revenue, and royalties can theoretically be created in any number of different sectors. This is a very dynamic area in the royalties space and is forecast to quadruple in size over the coming decade as companies increasingly look for alternative funding sources beyond issuing equity or debt.

A royalty is attractive to a company as a financing tool as it is not dilutive like issuing equity is and, importantly, royalties are not accounted for as debt on a balance sheet. This means the creation of a royalty is balance sheet, credit rating and financial covenant accretive.

Q What makes an asset an attractive opportunity in the royalties space? And are co-investments an option?

Generally speaking, in the royalties space bigger assets are typically better quality or lower volatility investments, as the underlying asset quality is higher, the operator of the asset will usually be more experienced, there will be less competition around the products they are selling and they will face less liquidity risk.

These large royalty assets, however, do require big cheque sizes. In the healthcare market, it is not unusual to see a single royalty worth between \$500 million and \$2 billion come to market every few years.

For a single investor, it is very difficult to do a royalty investment of that scale because of the concentration risk, which opens up opportunities to partner and co-invest on these larger assets.

Q What does a royalties strategy offer that other private markets strategies do not?

A cross-sector royalties strategy can serve as a valuable portfolio diversifier and stabiliser, given its low correlation to traditional asset classes both in public and private markets. A well-designed royalty strategy can consistently deliver returns in the low teens, with low volatility, by investing in assets with high cash yields that provide a hedge against inflation and are not reliant on an exit.

This kind of strategy should also pay a consistent and attractive yield, while delivering long-term capital preservation and growth. This is an appealing dynamic for private markets investors looking for more downside protection than conventional equity can provide, but more upside than is available from credit. ■