E X P E R T Q & A

An asset class to watch

Investors that are early to recognise the huge growth potential of royalties are well positioned to reap the benefits of innovation in the space, says Partners Group's head of royalties, Stephen Otter

Q Can you start by telling us about how the royalties space is developing, and the new subsectors you see emerging?

There is perhaps a slight misconception that royalties is a niche strategy that only really covers healthcare and music. In our view, royalties represents a $2 trillion market and growing, and is applicable across many different sectors, with healthcare and music just being the most well-known and established.

As an example, energy royalties in the US alone is a market exceeding $500 billion and growing. There is also the broader entertainment universe to consider beyond music, including film and TV, the music used in film and TV, content creators, intellectual property (IP) in theatre, brands IP and franchising, plus video gaming, software and broader technology. It's a vast market.

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And it's not just the buying and selling of royalties that is of particular interest right now – we are seeing more and more opportunities to lend against royalties and importantly to create "new" royalties over assets or companies.

What is particularly interesting about the creation of new royalties is that the counterparty is not selling their asset, issuing equity or diluting their governance or ownership. Royalties, if structured accordingly, are also not accounted for as debt on balance sheets. So, if a company is looking for a non-credit, non-dilutive source of financing, royalties is one of the few options available to them, hence why this space is expected to grow materially across sectors in the coming years.

Q How does a typical royalties investment work?

There are three main things to consider when it comes to investing in royalties. First, you are typically an asset owner owning intellectual property like copyright, patents or licensing agreements. Second, you are not typically operating the assets directly yourselves – there is an independent third party responsible for operations and importantly funding all the costs. Finally, when those assets generate revenue, you receive a

"Royalties have demonstrated their resilience as a strategy"

How can royalties be accretive to LPs with credit-focused portfolios?

We have seen people put royalties into real asset buckets as well as income buckets, alternatives and credit buckets. This can work in a credit-focused portfolio because it is not reliant on exit, it is cash-yielding and it is fairly high up in the waterfall structure.

Our portfolio management analysis shows that when you allocate royalties into broader credit portfolios, they not only enhance returns but also help to reduce correlation. There is also the benefit of diversifying the risk profile of the underlying portfolio, which can be very attractive.

percentage of that total revenue, which gives your investors top-line revenue exposure.

Royalties are therefore typically associated with IP-protected, long-dated and recurring cashflows in resilient sectors. They can also generate attractive returns, with yields north of 10 percent.

For these reasons (and more), Partners Group recently launched royalties as its fifth asset class – marking the first new asset class added to our platform in 20 years – to sit alongside our private equity, private credit, infrastructure and real estate offerings.

Historically, royalties investors have tended to focus on single sectors, such as music, energy or pharmaceuticals. At Partners Group, however, we run a cross-sector royalties strategy encompassing all royalty sectors, which we believe to be the first of its kind at this scale. This cross-sector approach is a differentiated proposition within the market and one where we see meaningful future growth opportunities for the asset class.

We have made 15-plus investments over the past 18 months and have just gone live with dedicated royalties evergreen funds for both institutions and individual investors.

What types of transaction structures are used for royalties investments, and when might each one be appropriate?

The most popular – and perhaps most obvious – approach is to purchase existing royalties in the market. The key consideration for investors focused on these transactions should be to understand the downside risk and get comfortable with what that could mean for the returns being derived. If we are uncomfortable with that downside risk, or the seller is unwilling to sell at the price we are buyers at, then we are also happy to lend against their royalties.

In this case, the seller would remain the owner, and we would provide capital with a term duration, cash pay and maybe an element of payment-in-kind or an equity kicker. We like that approach because it brings a different sort of investment structure into our portfolio, albeit without the same upside potential but more downside protection. We have executed several such transactions in the past 12 months.

The other structure we utilise is the creation of a royalty. When you buy a royalty, you are inheriting a commercial contract and accepting the terms of that contract around items like information rights, audit rights and so on. When you create a royalty, you can draft exactly what you need into that contract, including access to data or access to management or audit rights, for example, and you can build in the economic structures you think are appropriate to protect your capital.

As an example, if an investment has a 20-year duration, you might structure it to get your capital back much quicker to then have longer-term tail exposure – you can craft it with your counterparty to make sure it works for you and their needs. It is essentially structured finance on the revenue line of an asset or pool of assets.

The final, smaller element of our strategy is to identify some of the smaller, single-sector royalty investors out there and occasionally invest into their funds as an LP.

Q What role can royalties play as part of larger traditional investment portfolios?

Royalties can act as a portfolio diversifier and stabiliser within a wider private markets portfolio, providing exposure to underlying investments in sectors that are fairly resilient and counter-cyclical with strong cash yields. We look to invest as late as possible in the asset lifecycle so that the volatility is as low as possible.

We underwrite on a hold basis and we are not reliant on exits to generate returns; exits are therefore purely an upside case. We want to generate uncorrelated long-dated yield without relying on the exit market for our returns. This strategy has paid off: over the last five-plus years, when compared against most traditional asset classes, we have had either negative or low positive correlation, while reliably delivering against our return targets. It is also because we invest on a perpetual hold basis that we only offer these investments via evergreen offerings.

Royalties also represent an inflation hedge because they are not typically impacted by cost inflation. This is one of the few asset classes that can act as an inflation hedge as part of broader portfolios.

Finally, if investors want exposure to sectors like music, healthcare and energy, the only other way to really get that exposure is through equity investments, which offer a very different risk proposition as a result of factors like drug approval risks and drilling risks. We see our strategy as giving investors exposure to those sectors in the most de-risked way possible.

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"We have seen an increase in interest in royalties financing as a result of macro uncertainty"

Q How has broader market volatility impacted demand for royalties this year, and do you see that demand growing over time?

When we look at how our portfolio is performing, it has had a strong first half of the year, as it has for the past five-plus years. Despite the broader market volatility, royalties have demonstrated their resilience as a strategy and continue to deliver the consistent returns that we have come to expect.

Given the volatility in the markets more widely, investors are increasingly looking for alternative asset classes to help them manage through volatility and be even more diversified, which we expect to lead to increased demand for royalties.

On the investment side, the perception of royalties as a niche single-sector-focused asset class is also changing, which will lead to more investment flow.

In fact, we have seen an increase in interest in royalties financing as a result of macro uncertainty. It has not led to a slowdown in the investment pipeline – if anything, the opportunity set has increased.

In 10 years' time, our expectation is that we will be looking at a very different royalties landscape to the one we see today. There will be much better understanding of royalties and it will be a more institutionalised asset class, in line with other segments of the alternatives universe.

We would like to get to the point where any chief financial officer who is looking at their balance sheet or hoping to fund new investments is not simply considering the traditional use of debt and equity, but also thinking about royalty financing as another tool that can help them achieve their financing goals for the business alongside the use of debt and equity. ■

Stephen Otter is a managing director and head of the private markets royalties business at Partners Group