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The Private Equity Firm That Quietly Profits on Top-Selling Drugs

By RANDALL SMITH JULY 8, 2017

Cashing in on rising drug prices often unleashes an outcry from consumers and politicians.

But a little-known private equity investor, Royalty Pharma, has built an unusual investment portfolio valued at \$15 billion — it buys up the rights to royalties on future drug sales — while largely avoiding public controversy. By its own count, Royalty Pharma owns partial rights to seven of the 30 top-selling drugs in the United States, including giants like Humira, the arthritis treatment that is the single biggest-selling medication in America. And its deals have been getting larger.

Outrage over outsize drug-price increases has dogged some pharmaceutical companies. Turing Pharmaceuticals raised the price on one anti-infection drug by more than 5,000 percent in 2015, and Valeant Pharmaceuticals International adopted a strategy of buying up drug companies and increasing prices. Both companies' chief executives have since resigned. Mylan executives have come under fire after Mylan raised prices on its lifesaving EpiPen injector by 400 percent over seven years.

While Royalty Pharma has benefited by riding the rising tide of drug prices, the

drug companies play the largest role in setting prices. George Lloyd, Royalty Pharma's executive vice president and general counsel, said: "Royalty Pharma has no influence over how drugs in which it invests are priced. These prices are set by the marketer of the product, and we play no role in that process."

To make big money on promising drugs, investors like venture capital firms and biotechnology funds typically place long-shot bets on drugs that are still in the development stage. Royalty Pharma, based in New York, steps in later in the game: It generally buys rights to the royalties on drugs that have already been approved for sale by regulators. It buys them from patent holders, often hospitals or universities, that want to convert their future royalties into cash right now.

In addition to Humira, Royalty Pharma has partial rights to sales of Remicade, which is No. 4 in overall drug sales in the United States. Other drugs in its portfolio include Lyrica, which treats pain associated with diabetes, shingles and fibromyalgia, and Januvia, which treats diabetes. In all, the firm owns royalty rights to more than 30 drugs, which typically yield 3 percent to 5 percent of the drugs' total sales revenues.

Royalty Pharma has successfully created "a new segment of the investment management industry," which has helped offset a decline in other types of funds for drug investments, said Andrew Lo, a finance professor at the Massachusetts Institute of Technology's Sloan School of Management, in a 2014 study written with Sourya Naraharisetti of M.I.T. and Duke University.

The firm as currently structured is largely the creation of its co-founder Pablo Legorreta, 53, a former Wall Street investment banker from a prominent Mexican family who keeps a low profile. Mr. Legorreta declined to be quoted for this article. The firm is run by a small cadre of staff members in Midtown Manhattan, deploying money from outside investors, including university endowments and wealthy individuals. Royalty Pharma's revenues have risen an average of 30 percent annually, from \$161 million in 2005 to \$2.47 billion in 2016, according to company material.

Royalty Pharma has also made big payments to a number of scientists at major universities who helped discover the drugs in question, as well as to their

institutions, which share in the royalty rights.

Among the beneficiaries were three researchers at Emory University, who together in 2005 reaped 40 percent of a \$525 million sale of the rights to the anti-H.I.V. drug Emtriva.

Richard Silverman's work at Northwestern University on the nerve-pain drug Lyrica earned him an amount estimated at more than \$100 million when he and Northwestern sold some of the rights in 2007 for \$700 million. Dr. Silverman shared the proceeds with colleagues and helped finance a \$100 million laboratory center on the campus.

In recent years, Royalty Pharma's deals have grown larger. In 2014, it agreed to pay \$3.3 billion to an affiliate of the Cystic Fibrosis Foundation for rights to the drug Kalydeco and other treatments for cystic fibrosis marketed by Vertex Pharmaceuticals. Last year, Royalty Pharma paid \$1.14 billion to the University of California, Los Angeles, and co-owners of the rights to Xtandi, which treats advanced prostate cancer. This year, it agreed to pay up to \$2.85 billion to Perrigo for rights to the multiple sclerosis drug Tysabri.

Royalty Pharma had tried in 2013 to acquire rights to Tysabri with an audacious but unsuccessful \$8 billion hostile takeover bid for Elan Corporation. Elan, an Irish company whose stock had fallen after an Alzheimer's treatment failed in trials, sold itself to Perrigo a few months after Royalty Pharma dropped its bid.

While Mr. Legorreta was still a mergers banker at Lazard Frères in the early 1990s, he spotted a 1987 investment by wealthy clients of PaineWebber in rights to a chemotherapy drug. It opened his eyes to the amount of royalties held by potential sellers. He left Lazard in 1996 and, with the former PaineWebber banker Rory Riggs, raised \$60 million to start what became Royalty Pharma.

After assembling a diversified royalty portfolio — including the popular anticancer drug Rituxan, which helped triple the value of early investments — Mr. Legorreta raised \$190 million in debt in 2003. As Royalty Pharma's investment fund has grown, the annual revenue growth rate has slowed to a still-heady 17 percent for the past five years.

Royalty Pharma's use of low-cost debt financing helped the fund outbid competitors, said Neil Kumar, chief executive of BridgeBio Pharma, a start-up with backing from the private-equity giant K.K.R. that aims to discover and develop drugs for genetic diseases. "Pablo won the arms race for a lower cost of capital," Mr. Kumar said.

While it is pharmaceutical companies that generally set drug prices, some of the drugs in which Royalty Pharma owns royalty rights have been criticized for their high prices.

Last year, Democratic lawmakers, led by Senator Bernie Sanders of Vermont, called on the National Institutes of Health to override the patent on Xtandi because the drug was being sold wholesale for \$129,000 a year in the United States, triple the price in Japan, Sweden and Canada. Mr. Sanders also criticized the high prices for Humira. The cystic fibrosis drug Kalydeco costs \$311,000 a year.

A March report by Moody's Investors Service noted that Royalty Pharma's portfolio "has benefited from high price increases in the U.S. pharmaceutical market" and could be "adversely affected if the environment for U.S. pricing dramatically changes or if new legislation is passed that targets U.S. drug pricing."

Royalty Pharma's top three drugs have had average annual price increases of 15.7 percent over the past three years, according to Elsevier's Gold Standard Drug Database. That number is slightly above the average of 14.4 percent for branded drugs tracked by the TruVeris drug index.

Royalty holders who sell to Royalty Pharma are like lottery winners who choose the upfront cash option over future annual payouts. The sellers accept a discount to the cash expected to roll in over the 20-year patent life, in part reflecting the built-in uncertainty of future drug sales, but can use the upfront dollars to diversify their investments or for capital projects.

Memorial Sloan Kettering Cancer Center, for example, used part of its \$400 million proceeds from sales in 2004 and 2005 of rights to two drugs used in cancer chemotherapy to build a \$500 million research center.

Eugene Sunshine, former senior vice president for business and finance at Northwestern, said the university took a discount of roughly 10 percent to estimated future sales of Lyrica and hedged its bets by selling only a little over half of its rights initially. Proceeds were used for undergraduate financial aid, graduate fellowships and research.

In the case of Humira, the top-selling drug that was released in 2003, Royalty Pharma paid \$700 million for a royalty interest of less than 3 percent, which helped the pharmaceutical giant AstraZeneca finance a \$1.3 billion purchase in 2006 of the drug developer Cambridge Antibody Technology.

One reason Mr. Legorreta won the financing arms race was that he kept all his investments in one “evergreen” fund, unlike most private equity firms, which raise new funds every few years, according to bankers and investors.

“They just kept putting everything in one ever-increasing pool whose growing size and diversification helped lower its borrowing costs,” said Lionel Leventhal, who ran similar funds at Paul Capital for 15 years starting in 1999. Mr. Leventhal estimates there are more than 15 competing drug royalty funds that together manage about as much as Royalty Pharma alone.

Royalty Pharma has financed the growth of its assets by raising more money from investors and from debt. It raised \$1.1 billion in equity in 2015, and recently increased its debt level to fund the Perrigo deal by refinancing \$3.4 billion in debt with a new \$4.5 billion loan, the report by Moody’s said. Investors, however, may sometimes face waiting periods of several years to cash in and exit the fund.

As the deal sizes have grown, so have the risks. While Moody’s lauded Royalty Pharma’s “strong product portfolio” and “excellent track record,” it also warned of its “moderately high” debt level and an approaching revenue “cliff” in the scheduled expiration in 2018 of royalties on “several major products,” including Humira, Remicade and the multiple sclerosis drug Tecfidera.

In recent years, Royalty Pharma has diversified its sources of financing. In addition to the recent \$4.5 billion loan led by Bank of America, a Royalty Pharma affiliate, BioPharma Credit, raised \$762 million in an initial public offering in March

on the London Stock Exchange.

Royalty Pharma has also taken greater risk by occasionally funding late-stage drug trials before they win regulatory approval. It has invested \$1 billion for trials for drugs including Soliqua, a new Sanofi diabetes drug approved for sale last year, and possible new uses for Ibrance, a Pfizer drug for advanced breast cancer. And it has invested in Avillion, a company that helps drug companies with testing and regulatory approval.

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