Sagard Healthcare

The Case for Investing in Healthcare Royalties[1]

Investing in healthcare royalties is a growing and innovative strategy that is gaining more attention from a variety of investors including institutional pension funds and family offices. The strategy offers low macro-economic sensitivity and provides access to technical innovation driving the biopharmaceutical sector. The Sagard Healthcare partners have been investing in this sector for more than two decades on average. They use their extensive experience to manage the Sagard Healthcare strategy, which primarily invests in healthcare royalties.

In this paper, we will explore five potential benefits for investors in this innovative space: stable income generation, uncorrelated returns, attractive risk profile, social impact, and inflation protection.

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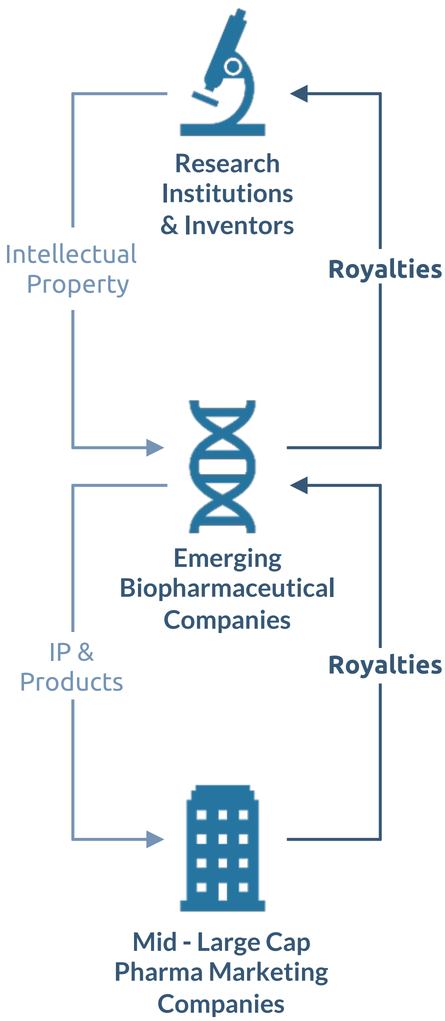
What is a Healthcare Royalty?



Most pharmaceuticals are discovered by scientists, universities and research institutions.

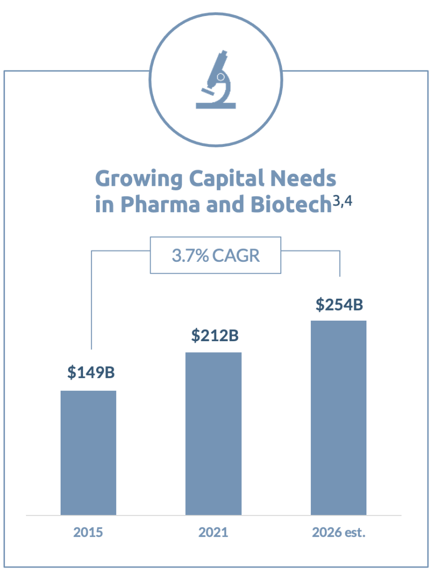
This newly discovered intellectual property is typically patented by the inventor and subsequently licensed to a biopharmaceutical company to further develop the drug. The drug may then be improved, patented and licensed yet again to a large biopharmaceutical company for commercialization. The parties in this value chain are entitled to a royalty, paid as a percentage of net sales over the remaining life of their patents.

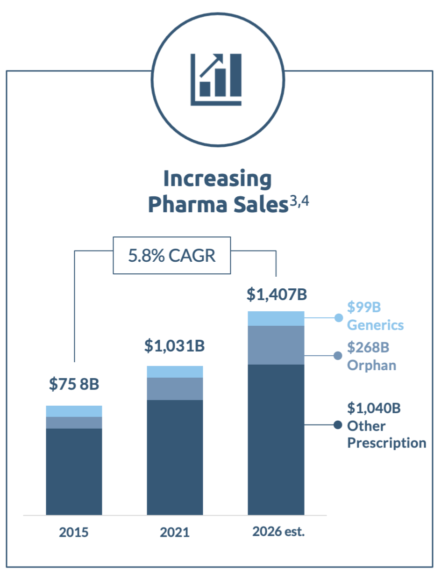
Investors, such as Sagard Healthcare, can purchase royalties on approved, medically necessary biopharmaceuticals products from any of the parties in this value chain to build a portfolio of legal entitlements to long-duration cash flows without the risks associated with drug development and regulatory approvals. Sellers of royalties, in turn, can use the proceeds from the sale for many purposes, including funding research and financing growth opportunities.

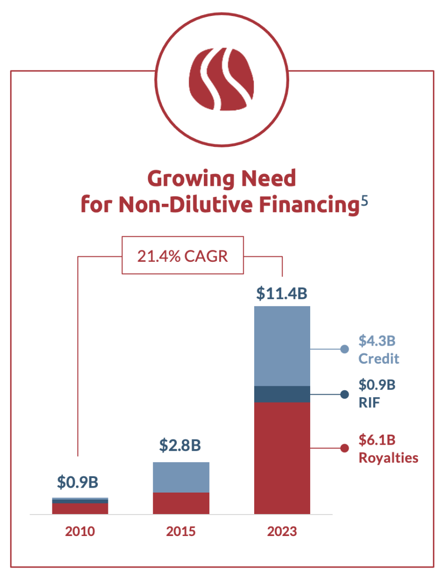
What is the Opportunity?

Each year, **50 to 60 new pharmaceutical products** typically receive U.S. FDA approval[2], the majority of which carry some royalty obligation to a licensor in the value chain. This creates new opportunities for the limited capital available dedicated for this investment strategy. Each drug, however, has distinctive pharmacological properties and associated risks, so having a skilled investment manager who can adopt a disciplined and selective approach to portfolio construction is essential.

With FDA approvals of novel medicines, improved access to healthcare, and longer life expectancies, we anticipate a continued **upward trend in pharmaceutical sales**. Nevertheless, the pharmaceutical industry will continue to be driven by innovation seeking to address unmet medical needs. Consequently, we expect the capital needed for R&D in pharma and biotech to continue to increase in the coming years[3,4,5]. This has increasingly been met by way of non-dilutive financing, such as royalty and structured credit transactions, which translates into investors maintaining pricing power.







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What is the Opportunity? (cont.)

By investing in a portfolio of healthcare royalties, we believe **that investors will access risk characteristics similar to private credit with security on the underlying patents and intellectual property**.

Also, similar to private equity and venture capital investments, healthcare royalties **retain potential investment upside**. For example, a drug could be approved for a new market or licensed for a new medical use. Given this risk/return profile, we believe healthcare royalties can be compared to asset-backed lending where the transaction is secured by collateral and the income stream is predictable. The difference is that with asset-backed lending a loan is being provided whereas with a healthcare royalty, the financial asset is being purchased.

Importantly, by investing in only fully approved and commercialized pharmaceutical products, **the key risks** of unsuccessful R&D, failed clinical trials or endless delays in obtaining regulatory approvals **are all avoided by this strategy.**

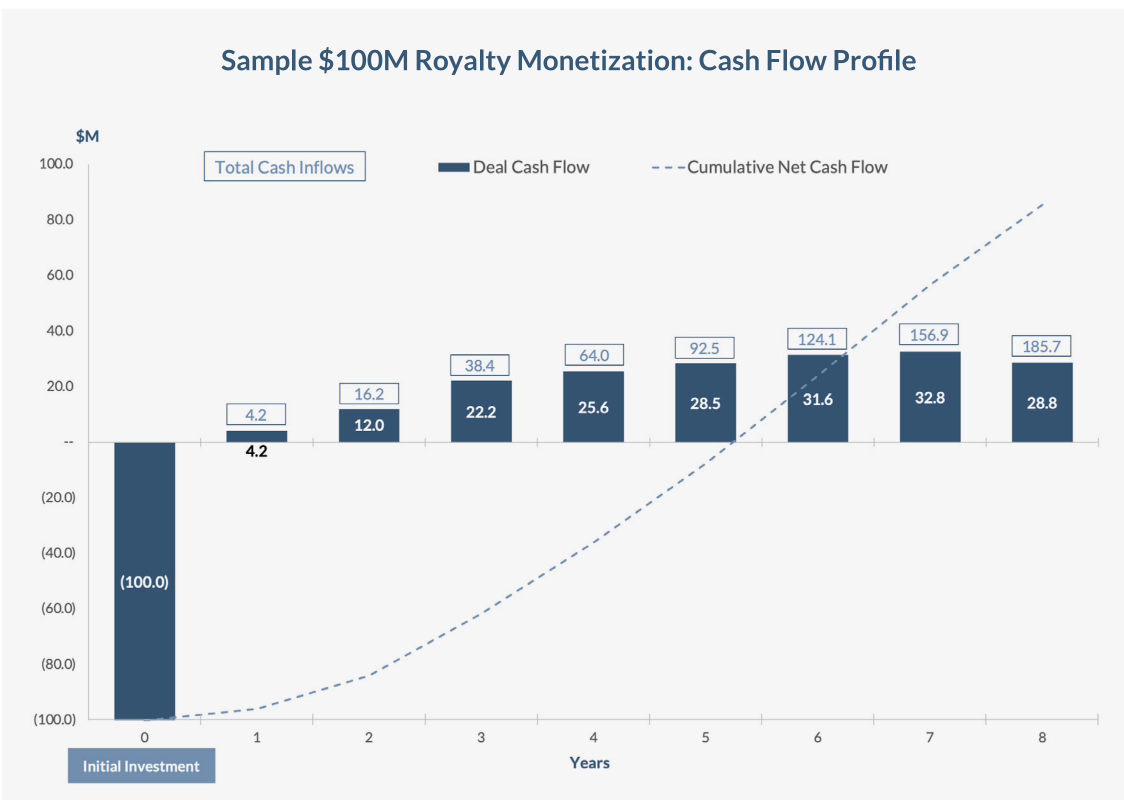
Strategy Benefits Explained

The Sagard Healthcare strategy aims to deliver a projected net IRR of 15%+[6,7] and provides investors with many potential advantages, including five benefits outlined in more detail below.

1. Stable Income Generation

Investing in healthcare royalties offers investors the potential for predictable income streams. Royalties paid by pharmaceutical companies to the owners of patents or intellectual property rights provide the potential for consistent cashflows linked to predictable top-line sales and are not sensitive to profit margins or underlying costs.

Given the resiliency of pharmaceutical product penetration and sales volume, investors in a portfolio of royalties have the prospect of receiving a reliable and growing source of cash distributions. The predictability of product sales for the remaining life of the underlying patents is a function of managerial skill, with experience and a demonstrated track record being important considerations in selecting an investment manager for this strategy. The chart below depicts a typical cash flow profile for a healthcare royalty[6].

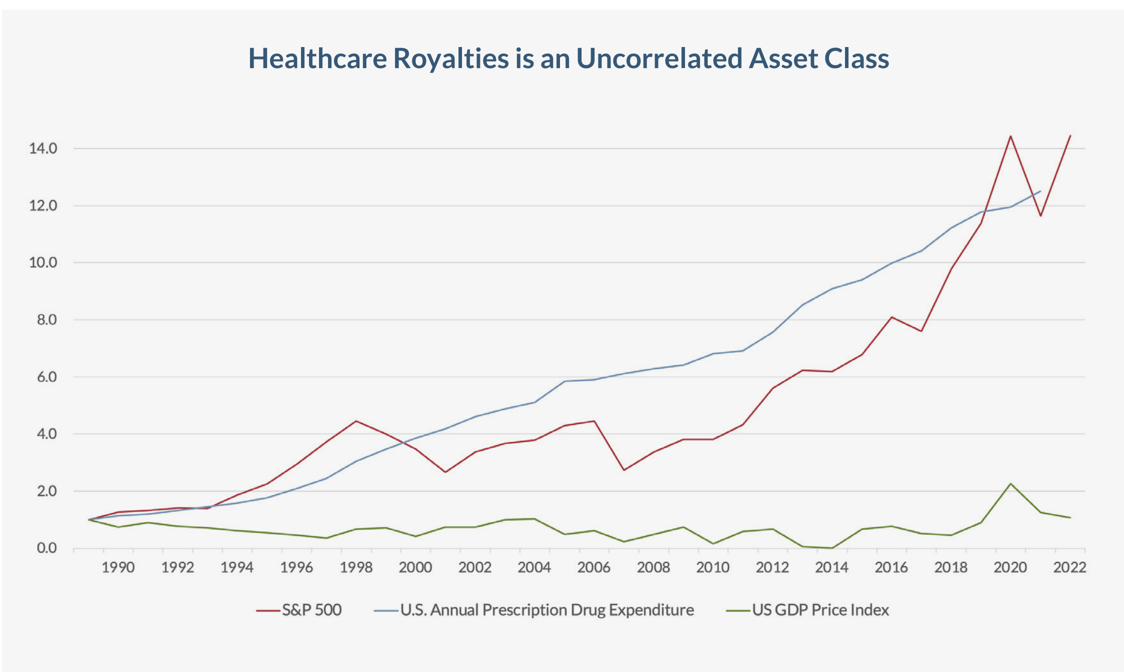


Strategy Benefits Explained (cont.)

2. Uncorrelated Returns

Healthcare royalty investments have the potential to **diversify portfolios** and **mitigate risks associated with economic cycles and market volatility**. The healthcare sector has a reputation for resilience during economic downturns given healthcare expenditure is not generally discretionary. The timing of most diseases is not linked to the performance of equities, bonds, or the growth of the economy.

Healthcare royalty returns, therefore, have low correlations to fixed income and equity capital markets and have qualitatively different risk factors when compared to other alternatives, such as private credit. These characteristics can make healthcare royalties an ideal complement to either fixed-income or private-market investments when seeking to create a balanced portfolio.



Bloomberg Intelligence and Bureau of Economic Analysis (U.S. Personal Consumption Expenditures Price Index). As of January 2024.

Strategy Benefits Explained (cont.)

3. Attractive Risk Profile

We believe that a royalty investment offers **lower risk access to life-changing innovation** with potential upside and mitigates the downside associated with traditional VC approaches to investing in biotech. Investment in healthcare royalties is designed to mitigate the key risks associated with the sector, including:

- Clinical trials
- U.S. Food and Drug Administration (FDA) approval risk or timeline
- Profit margins of the pharmaceutical industry
- Cross-subsidization of unsuccessful research efforts
- Fixed income market credit spreads or rates
- Exposure to equity market earnings multiples
- Exit timing or price, as these are self-liquidating with a finite term

Investments are made only in **fully approved drugs that have demonstrable market demand and are secured on well-protected, enforceable intellectual property rights**. Accordingly, no binary risk is taken on the success or otherwise of initial clinical trials nor the unpredictable timelines associated with regulatory approvals.

Investments will be in products that have well-established rights, are licensed to be distributed by multinational pharmaceutical industry participants, and from which an income stream can already be evidenced.

A further important factor is that **investors are subject to highly resilient top-line (gross) sales revenue**. There is no downside exposure to risky research expenditure, regulatory approval costs and risks, no exposure to net profit margin erosion due to inflation, and no MTM (mark-to-market) exposure resulting from moves in industry credit spreads or P/E multiples.

Strategy Benefits Explained (cont.)

The residual risks that remain relate to the accuracy and conservatism of the royalty forecasts. To mitigate these risks the Sagard Healthcare strategy employs a highly experienced team with a conservative style and a suitably diverse portfolio of underlying products. Moreover, these are typically buy-and-hold investments, whereby we aim to collect the initial investment capital plus investment return during the period that the product in question continues to have patent protection.

To some extent, the creditworthiness of the distributor is a secondary risk, although most are investment-grade issuers and we feel this risk is more than adequately remunerated when compared to bonds issued by the same companies. This is somewhat mitigated by the ownership of transferrable intellectual property rights, which can be exploited through other channels.

4. Social Impact

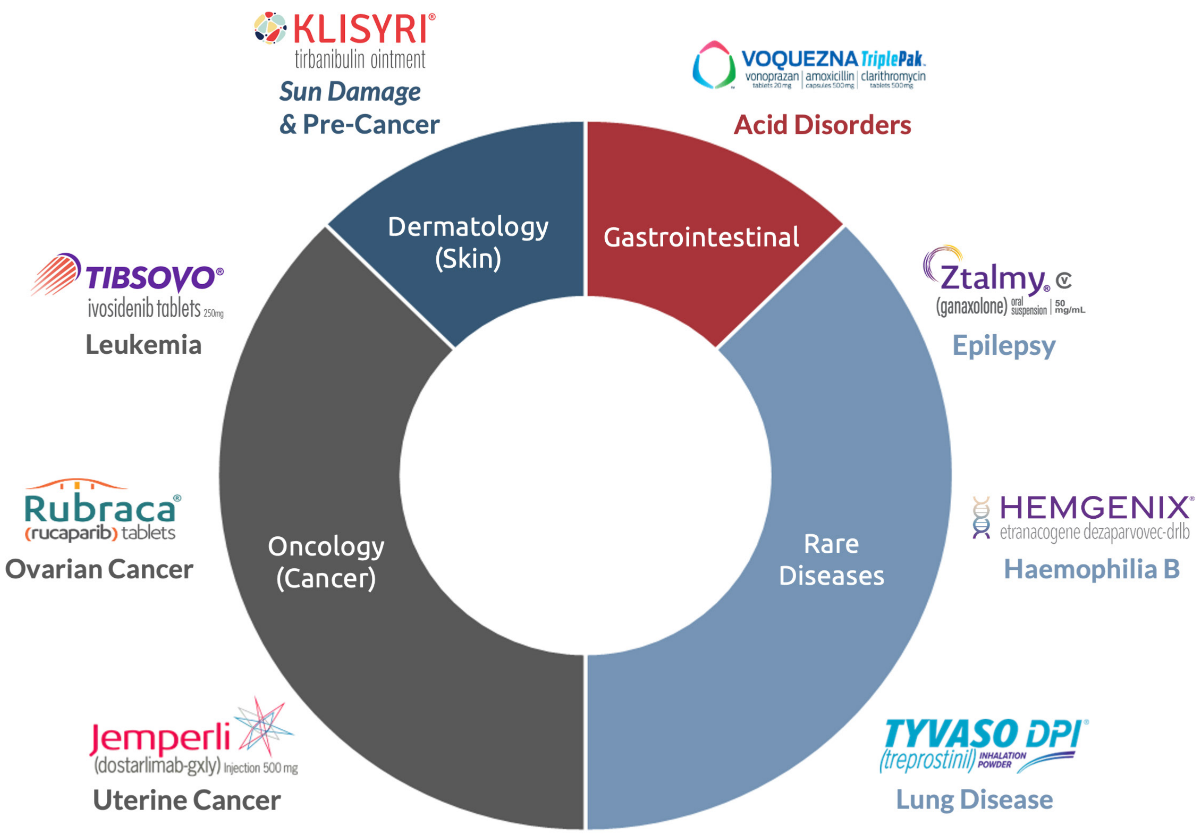
The pharmaceutical industry is driven by innovation. For example, small biotechnology companies continuously strive to develop ground-breaking drugs and treatments to address unmet medical needs. The payoff for a successful product delivery can be huge, but there are many failures along the way and exits from 'traditional' investment routes have uncertain timing and price points. This leads to a potentially volatile and idiosyncratic return profile, which can end up correlated to equity markets.

Investing in healthcare royalties allows investors **to be part of this innovation cycle without assuming risk on the success of clinical trials or regulatory approval timelines**. As new drugs or medical technologies gain regulatory approvals and enter the market, the monetization of royalties from their sales can accelerate the return of capital back to innovators.

These investments are squarely focused on new medicines, facilitating access for patients and supporting the cycle of innovation.

Strategy Benefits Explained (cont.)

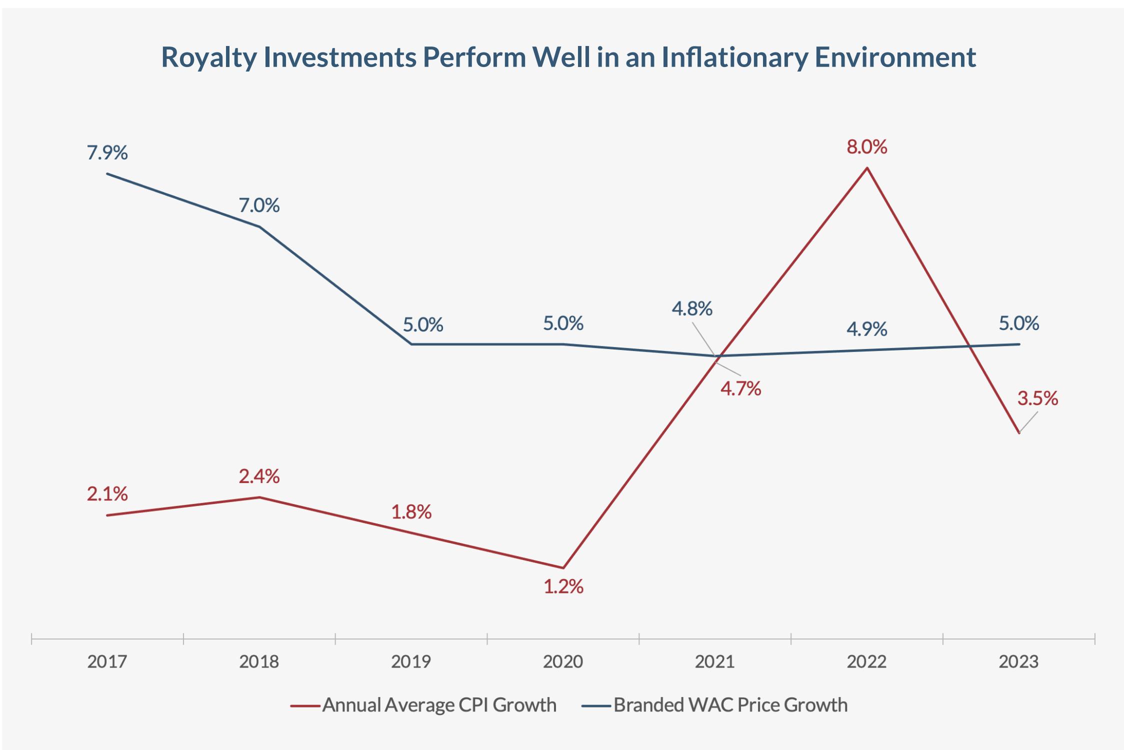
A well-constructed portfolio consists of many important drugs treating a variety of illnesses and continues to fund the development of more. For example, see below a selection of the pharmaceuticals that form part of the Sagard Healthcare portfolio.



Strategy Benefits Explained (cont.)

5. Inflation Protection

Medical advancements, increasing demand for healthcare services, and the essential nature of healthcare create a hedge against inflation[8]. Healthcare royalty streams have a positive correlation to inflation, with product price increases historically outperforming US CPI. However, we maintain there is little exposure to the risk that cost inflation erodes investor returns, as this is a top-line-only investment that is driven by revenues and broadly indifferent to profitability.



Source: U.S. Bureau of Labor Statistics and 46Brooklyn Brand Drug List Prices as of January 2024

Conclusion

*In our view, **healthcare royalties provide low macro-economic sensitivity and access to technical innovation**.*

*We believe that investing in healthcare royalties offers an opportunity for investors seeking the **potential for stable income, uncorrelated returns, an attractive risk profile, social impact, and a hedge against inflation**.*

*The Sagard Healthcare strategy has a **highly experienced team**, a **proven track record,** and an investment vehicle structure that allows for a patient, **highly selective deployment of capital**.*

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2. FDA – Number of Drug Approvals (link) as of January 2024.
3. Estimates are inherently uncertain and subject to change. Actual results may vary.
4. EvaluatePharma (link). July 2021. All values, including estimates, are from the report.
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