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ValueInvestor INSIGHT

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Royalty Treatment

Royalty Pharma wants to benefit from the high-risk, high-return innovation in the pharmaceutical industry without bearing all the risks. Torray Investments' Shawn Hendon thinks the firm deserves more credit for doing that well.

It's not always easy in starting research on an investment idea to understand the company's reason for being. That is not the case with Royalty Pharma. It invests in others' developmental and approved pharmaceutical products in return for royalties on those products' future revenues. Given the escalating cost and risk involved in developing and launching drugs, it's not surprising product owners welcome funding to share the burden without the complications of issuing equity or taking on debt.

Founded in 1996, Royalty Pharma is now the top global provider of royalty-based funding for pharmaceuticals. Its 50 current "investments" span a range of treatment areas, with 30% in development-stage products and 70% in those already approved and on the market. More than 85% of the development-stage products it has funded have made it through to commercialization, and of those now on the market, 15 are blockbusters with at least $1 billion in annual sales.

Royalty Pharma tends to favor longer-dated streams, with the average duration for its portfolio today at 13 years. For its biggest money maker, on Vertex Pharmaceuticals' cystic fibrosis treatments, the agreement first signed in 2014 runs out to 2037 and pays a royalty on revenues of around 9%. As is the case in most such companies, a high percentage of royalty receipts flow to the bottom line. Its operating costs are less than 10% of revenues, which last year resulted in free cash flow of some $2.7 billion available for reinvestment or return to shareholders.

While seemingly a business with much going for it, the company's shares – at around $30.40, only 7.8x consensus forward earnings – don't reflect that today, says Shawn Hendon of Torray Investment Partners. Investors seem concerned, he says, that higher interest rates will increase the company's cost of capital without a commensurate increase in returns on newly signed royalty deals, and that Vertex's development of a new combined treatment for cystic fibrosis will result in lower-than-expected royalties from that franchise. On the first point, he says, all indications are that the company today is acquiring royalty streams at a similar

INVESTMENT SNAPSHOT

Royalty Pharma
(Nasdaq: RPRX)

Business: Invests in commercialized and in-development pharmaceutical products in return for royalties on future revenues.

Share Information (@3/28/24):

Price	**30.37**
52-Week Range	25.92 – 36.78
Dividend Yield	2.8%
Market Cap	$13.57 billion

Financials (TTM)

Revenue	$2.35 billion
Operating Profit Margin	102.8%
Net Profit Margin	48.2%

Valuation Metrics
(@3/28/24):

	RPRX	S&P 500
P/E (TTM)	12.0	23.5
Forward P/E (Est.)	7.8	21.6

Largest Institutional Owners
(@12/31/23 or latest filing):

Company	% Owned
Morgan Stanley Inv Mgmt	8.8%
Vanguard Group	8.5%
Fidelity Mgmt & Research	6.9%

Short Interest (as of 3/15/24):

Shares Short/Float	3.3%

RPRX PRICE HISTORY

THE BOTTOM LINE

Despite having a business with much to commend it, says Shawn Hendon, the market values the company's shares at a 20% discount to his NPV estimate for its existing royalty streams, ascribing zero value to at least $2.5 billion in prospective investments per year.

Sources: S&P Capital IQ, company reports, other publicly available information spread over its cost of capital as before. On the second point, he argues the downside scenario to net present value from the cystic fibrosis royalties, around $2 per share, is a manageable amount already discounted in the share price.

Hendon estimates that the net present value of Royalty Pharma's existing royalty streams on its 35 drugs on the market is close to $36 per share. That exceeds the current share price and assumes no value from the at least $2.5 billion per year the company expects to deploy into new royalty agreements – capital that it has historically deployed at 13-14% average rates of return. “The nature of this business we think already makes it a lower-risk way to benefit from all the innovation going on in the industry,” he says. “That we can get that at what appears to be a bargain price is even more attractive." VII