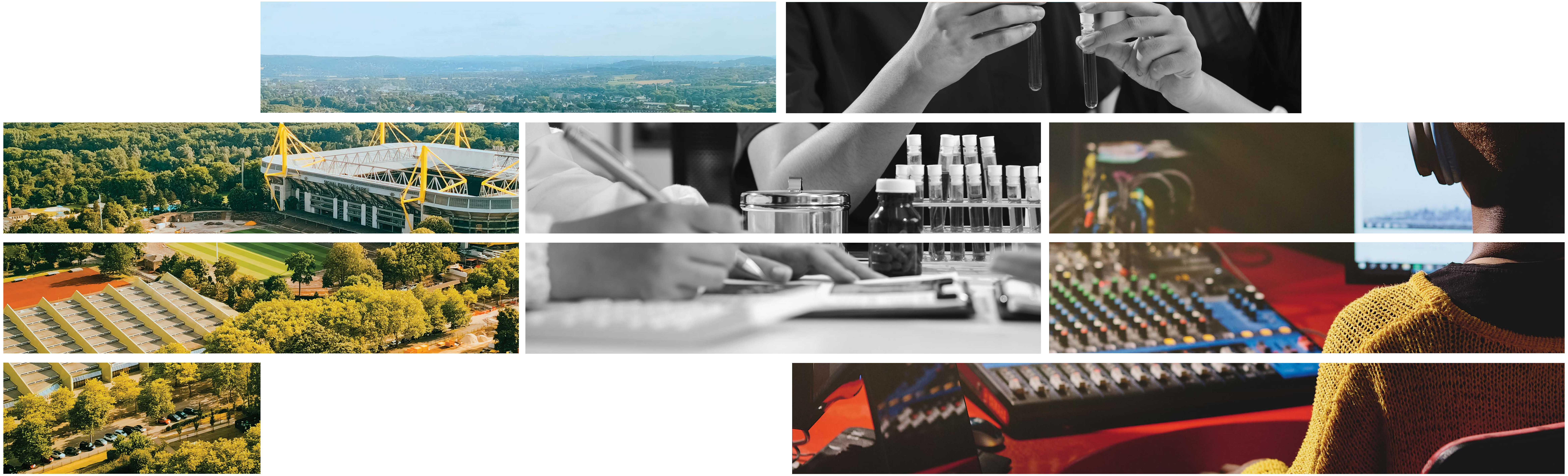
Royalties: A Primer

An introductory guide to royalty investing and its potential to enhance portfolio stability and risk-return profiles



Executive summary

- **As private markets strategies continue to expand and specialize, royalties have emerged as an asset class with an estimated market size of USD 2 trillion and growing.**
- **Ranging from the ownership of rights to future revenues in music and pharmaceuticals to interests in carbon credits, this diverse asset class has distinctive characteristics including low correlation with financial markets, predictable and attractive income streams, and exposure to high-growth sectors.**
- **Integrating royalties into a diversified portfolio strategy and carefully considering risk-return profiles can benefit investors seeking long-term capital preservation, growth and attractive yields.**
- **Prudent structuring and documentation are essential to ensure that royalties provide downside mitigation, similar to credit instruments, while still retaining attractive upside potential linked to asset outperformance or an exit at higher multiples than underwritten.**
- **New evergreen fund structures may offer investors an attractive entry point to royalties, through improved alignment with the duration of the underlying portfolio and liquidity provisions.**

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Royalties global opportunity set

Selection of established sectors:

Pharmaceuticals	Music	Green Metals	US Natural Gas
USD 185 bn [1]	USD 70 bn[1]	USD 260 bn[1,2]	USD 140 bn[3]

Selection of emerging high-growth royalty sectors:

Carbon Offset	Sports	Brands	Other Sectors /Opportunistic
USD 186 bn[4]	USD 36 bn[5]	USD 320 bn[1]	Areas offering substantial potential, such as agriculture, video gaming, water entitlements and others

[1] Partners Group estimation reflecting a compilation of various industry resources. [2] Refers to royalty interests in mining operations for production of green metals, which are used in the development of renewable energy technologies and the manufacturing thereof. [3] Kimbell Royalty Partners (December 2023). Midpoint of market size estimation rage. Based on production data from US Energy Information Administration (EIA) and spot price as of 11 November 2023. Assumes 20% of royalties are on Federal lands and there is an average royalty burden of 18.75%. Assumes a 10x multiple on cash flows to derive total market size. Excludes NGL value and overriding royalty interests. Public Company Enterprise Value reflects KRP, BSM, STR, and VNOM as at 25 October 2023. [4] Based on royalties being 20% of carbon need as estimated by MSCI Trove. [5] Deloitte 2023 Sports Outlook, PwC Global Sport Survey, and Sports Global Market Opportunities and Strategies to 2030: COVID-19 Impact and Recovery Report.

Introduction

Private markets have become an essential component of the modern global investment landscape, offering investors an opportunity for diversification and attractive returns.

At the same time, the range of strategies within the space has expanded significantly. Investors today can diversify their portfolios across a wide range of asset classes, such as private equity, private credit, infrastructure, commodities, real estate and venture capital – each of which is further segmented into distinct sub-strategies.

As private markets expand and become increasingly competitive and institutionalized, new asset classes are emerging. One such asset class that has garnered increased attention and popularity is royalties. With an estimated total market size exceeding USD 2 trillion[6], this strategy encompasses both established and emerging, high-growth sectors with global diversification.

With this paper, we aim to bring clarity to this historically opaque asset class, which has so far only been accessible to select industry participants mainly via closed-end funds or equity ownership in publicly listed royalty companies.

Our objective is to demonstrate how investing in royalties can be a logical part of a broader allocation strategy, particularly via evergreen fund structures, considering the longer-term nature of investments in this asset class.

[6] Based on Partners Group estimates.

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"Royalties offer a long-dated, low correlated and attractive return profile across a diverse range of sectors, offering investors cash yield and material diversification to more traditional asset classes"

The mechanics of royalties

In its simplest form, a royalty investor receives a percentage of revenue generated by an underlying asset. The asset can include rights to intellectual property (IP), such as patents, trademarks or copyrights, as well as exclusive rights over natural resources like gas or minerals.

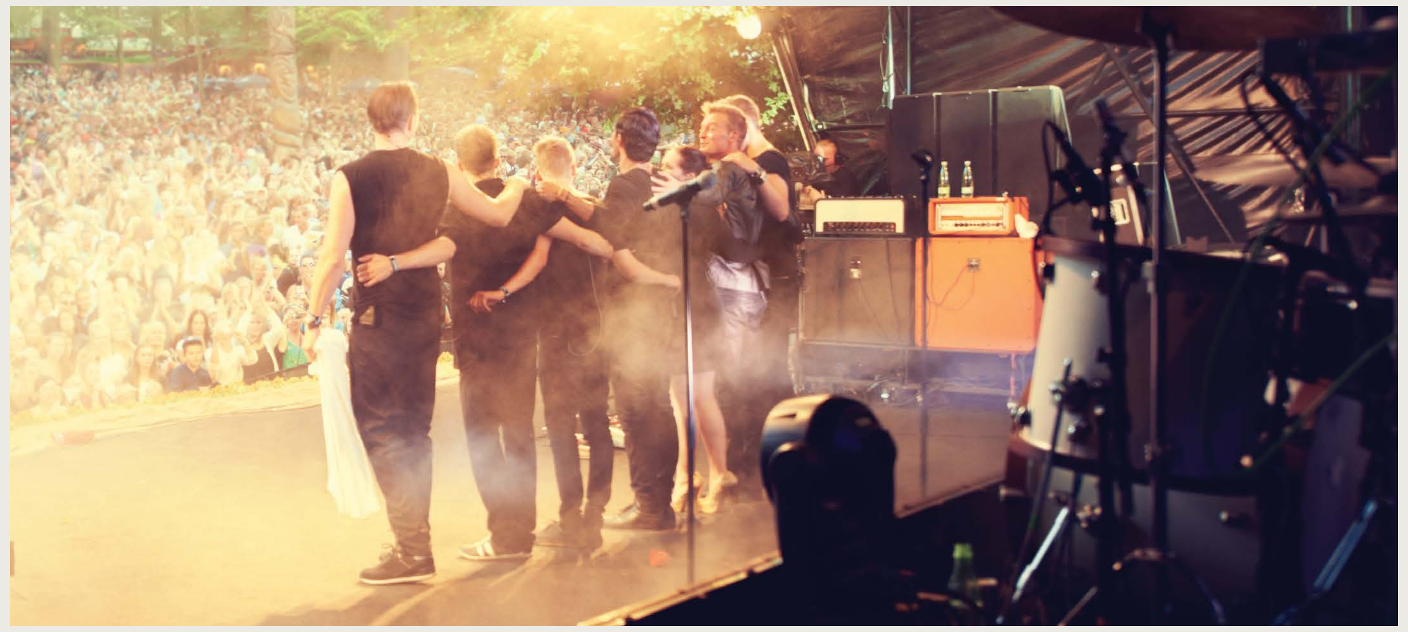
The terms of a royalty contract are negotiated between the owner of the asset and the operating company. The contract grants the operating company the right to use the asset, and, in exchange for this, the owner receives a royalty payment (i.e. a percentage of the revenue).

Examples of this include the revenue generated from the sale of a pharmaceutical product, the use of a musician's song catalogue, or the sale of gold from a producing gold mine. These rights, or simply, these royalties, can then be sold to third party investors.

As a royalty investor, the investor can either buy royalties that are already in existence (like the examples provided above), or, alternatively, a royalty investor can "create" a royalty by providing capital to the owners or operators of an asset in exchange for a portion of the revenue that the asset generates.

Such transactions create a synthetic royalty that mirrors the economics of a traditional royalty for the royalty investor.

Royalties investing step-by-step



Below, we provide an overview of the key steps involved in a typical royalty investment.

1: Finding the right asset
Investors can either buy an existing royalty, or create a royalty against an asset that generates revenue. Both require an upfront payment to the owner of the asset in exchange for the right to receive royalty payments (a percentage of revenues) on an ongoing basis.

2: Understanding royalty duration
Royalties can vary in length, from 10-15 years for pharmaceuticals, to decades for mines, and over 100 years in the case of music.

3: Monitoring payments and revenues
Payments to the royalty investor are scheduled on a regular basis (typically monthly or quarterly). The royalty payor is required to provide regular sales reports, ensuring transparency and accountability. Royalties typically come with periodic audit rights to ensure correct payment.

4: Exploring liquidity options
Depending on the specific arrangement, royalties can offer potential liquidity through buy-back clauses or secondary market opportunities. This can provide flexibility to royalty investors looking to potentially sell their interest in the future.

A different asset class

Royalties possess distinctive traits that set them apart from traditional investment strategies.

Low correlation to the broader economy

A royalty investment is directly tied to the underlying revenue performance of specific assets. These can be in sectors resilient to broader economic and market factors, such as music and pharmaceuticals, and therefore offer potential non-cyclical economic exposure and predictable cashflows. As a result, royalties tend to have a low correlation to traditional financial markets and asset classes. While not all sectors demonstrate non-cyclical behavior, investors can prudently hedge against some cyclical factors (such as price exposure).

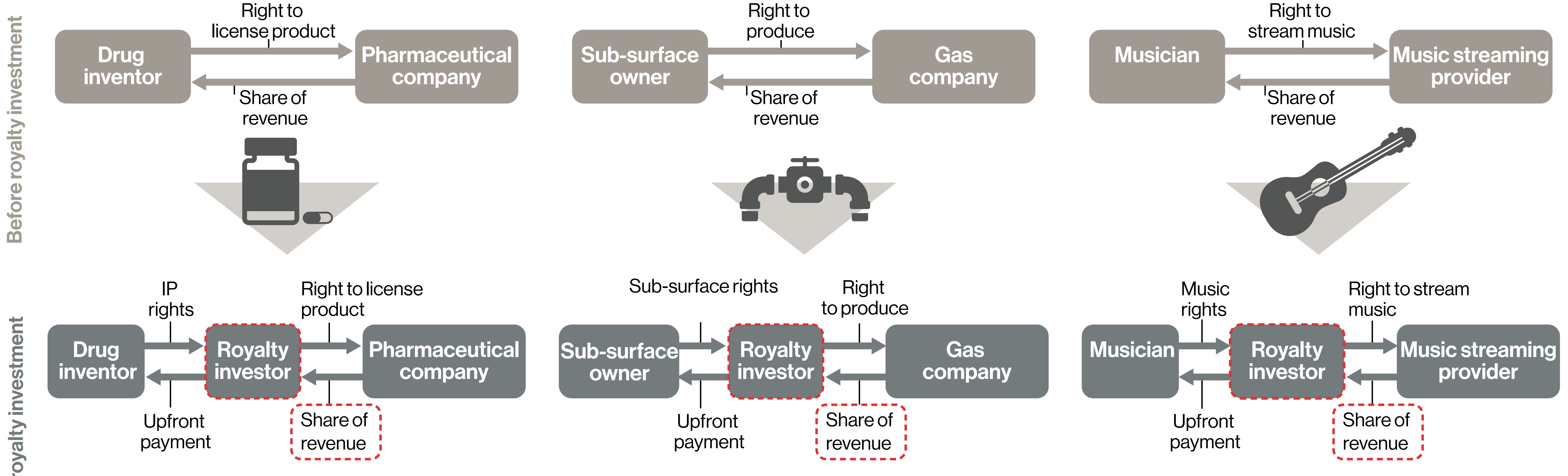
Stable income streams, exposure to growth and inflation hedge

As royalties are typically linked to the revenue line of assets, the royalty investor is not responsible for funding asset costs, such as opex and capex, and therefore royalty investments are not sensitive to cost inflation or profit margins. A royalty investment therefore provides exposure to revenue growth drivers, such as price and volume. As a result, royalties have historically served as an effective hedge against inflation, as the royalty payments rise in line with price, and the royalty investor is not exposed to cost inflation.

Self-liquidating with attractive cash yields

Royalty investments generate an ongoing cash yield and are largely self-liquidating (i.e. not reliant on an exit to meet target returns), which substantially reduces their risk profile. This is unlike some other asset classes where targeted returns require a liquidity event. It should be noted that royalties do have potential to outperform via exits as an upside case.

Simplified examples of royalties across sectors



Royalty investor acquires the drug royalty from the drug inventor and receives the inventor's share of the drug sales going forward.

Royalty investor acquires sub-surface rights from a sub-surface owner and grants the rights to conduct production operations to a gas company, receiving royalty payments in return.

Royalty investor acquires the ownership of music rights from a musician and grants the right to stream the music to a streaming provider. The royalty investor receives a share of the streaming revenue generated.

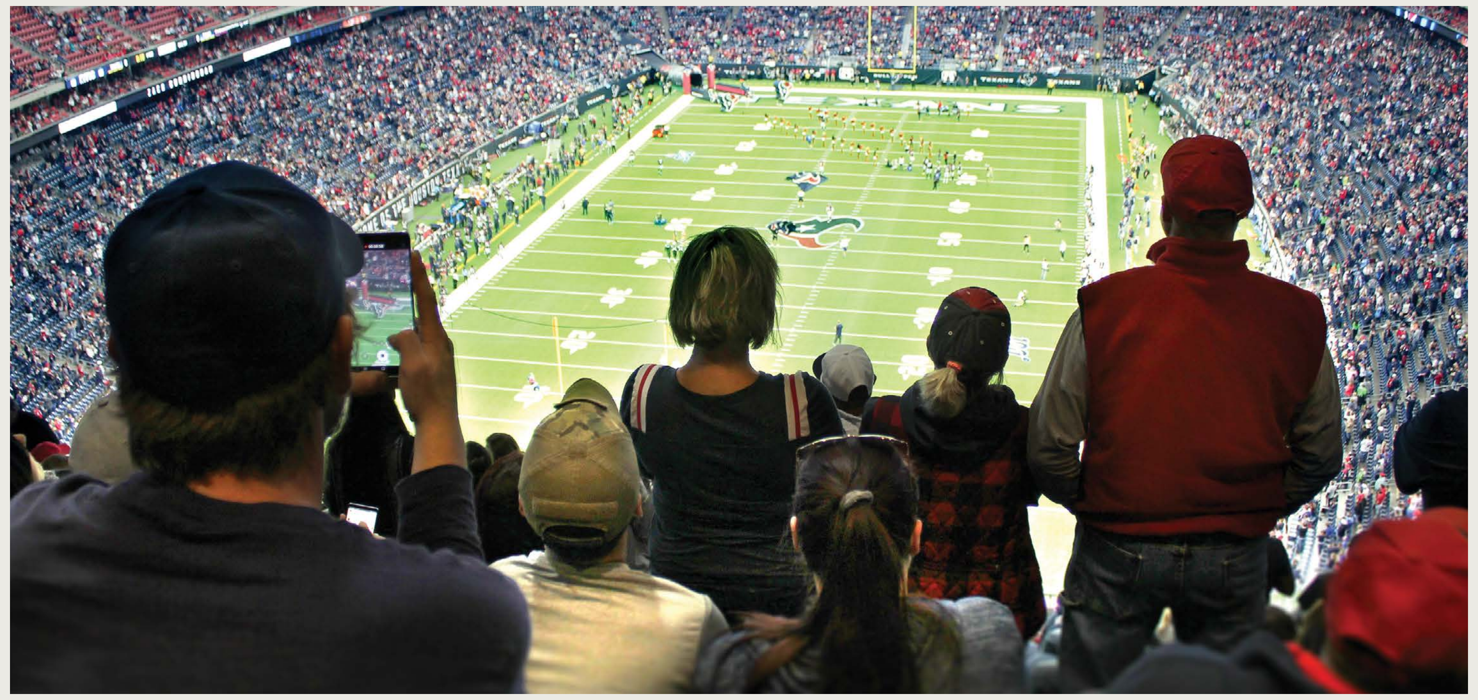
Valuation assessment: Underwriting a royalty investment

The valuation of royalties is typically conducted using a discounted cashflow (DCF) approach, taking into account the entire life of the asset. For example, in the pharmaceutical industry, cashflows are assessed until the expiration of IP rights, while in the mining or gas industry, until the depletion of the resource.

The discount rate is determined by considering market risk factors as well as idiosyncratic risk factors. This approach is then corroborated by comparable market and listed transactions.

The process is similar to valuing credit or real assets, although the relative importance of each factor may vary.

Typically, an independent valuation provider will analyze changes in the swap rate that best aligns with the investment's duration (e.g. 10, 15, 30 years), rather than looking at short-term swap rate fluctuations, which are more volatile and primarily relevant for short-dated credit investments.



Framing the asset class

The structured nature of many royalty investments provides clarity and control over payment terms and durations, akin to private credit instruments. However, unlike private credit, royalties also offer potential upside driven by the underlying asset's performance. This places the risk-return profile of royalty investments between that of private credit and private equity.

Moreover, royalty investments are typically cash yielding from day one as the investor receives a portion of the asset's revenue stream. This increases the multiple on invested capital (MOIC) over the holding period. In cases where royalty investments have long-term IP exposure (such as music) or sub-surface ownership, there is also the potential for long-term NAV accretion to complement the yield generated by the royalty investment.

In contrast, a typical private equity buyout often sees most of its value creation after two-to-three years of implementing operational initiatives, followed by a sale that ultimately realizes the value. This places the return profile of royalties closer to that of private credit. Yet, the royalty investment's initial and final internal rate of return (IRR) are expected to be higher over the long term.

Asset class comparison

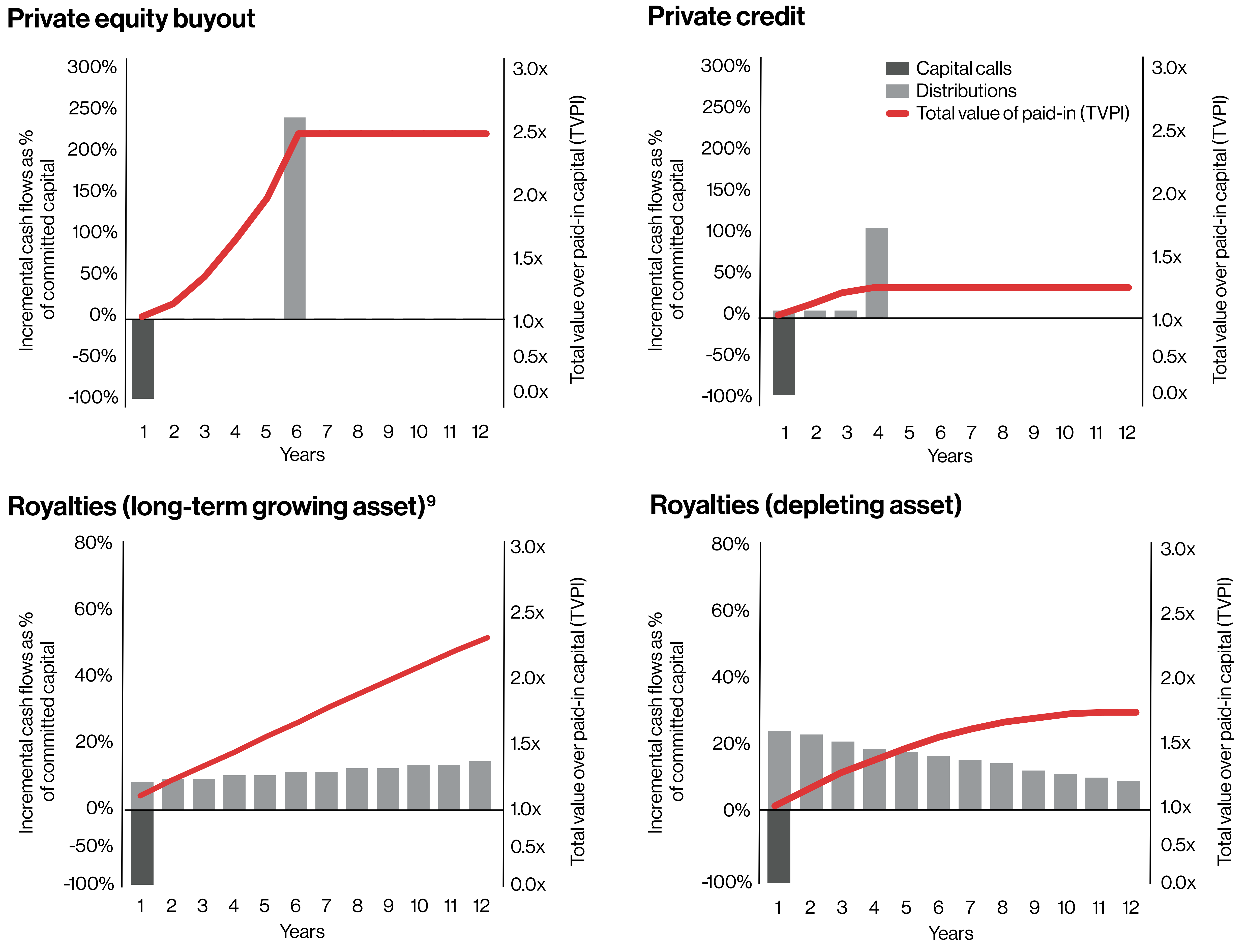
Royalties share a unique mix of characteristics with private equity and private credit

	Private equity	Private markets royalties	Private credit
Investment horizon	4-6 years	Long term >10 years	3-4 years
Investor exposure	Profit	Revenue	Interest + amortization
Return generation	Reliance on capital appreciation and exits	Share of revenue stream of an asset	Interest and capital repayments
Upside gearing	Yes	Yes, from outperformance of underlying asset and/or an exit, like equity	Limited
Downside mitigated	No	Can be structured to provide downside mitigation, like credit	Yes
Reliance on exit for returns	High	Can be underwritten on "hold-for-life" basis and therefore self-liquidating, like credit	Low
Cash distributions (yield)	Limited	Yes (for producing assets)	Yes
Gross returns[7]	18-22%	10-14%	8-12%

[7] **Figures presented relate to typical market gross returns.**

"In cases where royalties have long-term IP exposure, there is also the potential for long-term NAV accretion."

Typical cash flow and return profiles across asset classes[8]



[8] Figures presented are typical market gross returns and anticipated metrics are taken from Partners Group forward-looking market-wide assumptions. The information is used for illustration purposes only.
[9] The TVPI figures include any residual NAV of the underlying investment.

Identifying potential key risks

As with any asset class, it is essential to recognize the potential risks associated with royalties. Specific sector-related risks, including regulatory changes, technological advancements, and shifts in consumer behavior must be carefully considered and addressed through prudent underwriting and sector selection.

Additionally, counterparty risk, legal and regulatory risks, and lack of diversification are important factors to be aware of and actively managed when investing in royalties.

At the investment level, factors such as asset impairment, operational issues within the operating company, unexpected leadership changes, and other specific risks can all impact performance and returns.

While it is challenging to completely avoid these risks, steps can be taken to mitigate them to the greatest extent possible. Protection mechanisms can include economic structures that have “step-up” or “step-down” features to protect the investor once certain IRR or MOIC hurdles have been achieved.

In some cases, royalties can also include “make-whole” payments to the royalty investor in the event of asset underperformance or early repayment, and investors may opt to use hedging strategies to mitigate pricing risk.

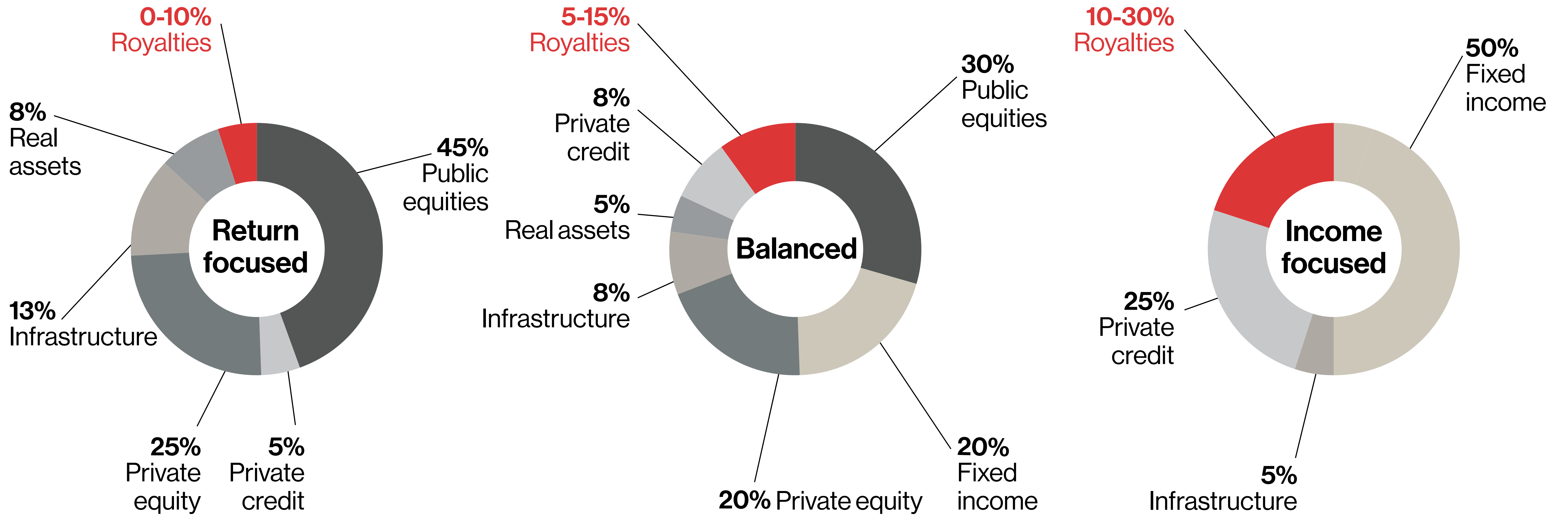
It is important to note that the stage of an asset’s life cycle in which a royalty investor chooses to invest will significantly impact the investment’s risk profile. It is crucial for investors to conduct thorough due diligence, negotiate favorable terms, and diversify their investments across multiple transactions and sectors to help mitigate these risks.

Portfolio construction

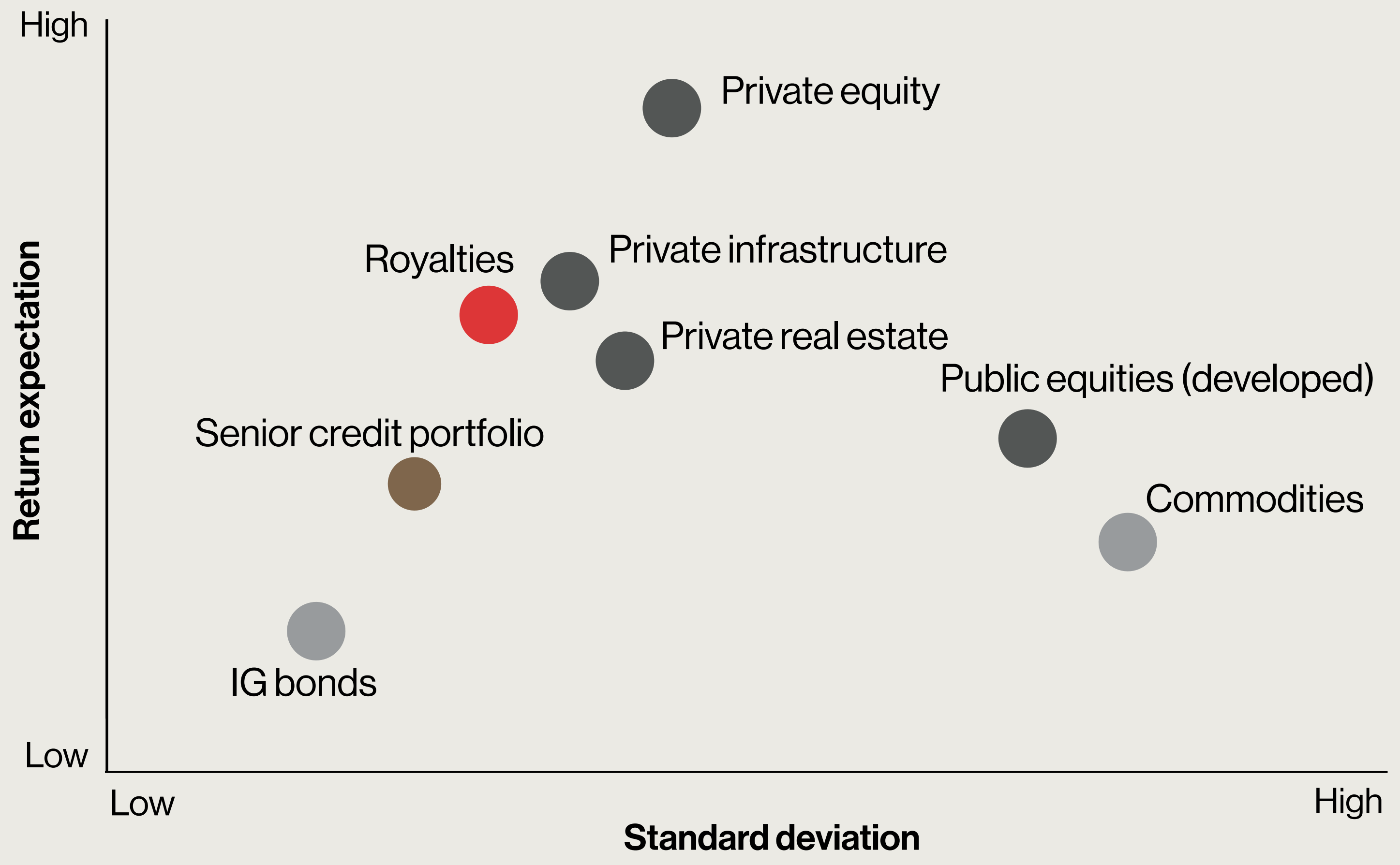
When contemplating an allocation to royalties, investors must carefully consider their preferred risk-return profile. As their desire for capital protection and stable yield in their portfolio increases, royalties become increasingly suitable. Conversely, for investors focused on maximizing return potential, royalty investments may not align with their objectives. Prior to employing any portfolio optimization models, investors should have a holistic understanding of the benefits royalties may add to an existing portfolio. For instance, music streaming demonstrates somewhat non-cyclical characteristics. While not all sectors may demonstrate the same non-cyclical qualities, having a multi-industry approach to royalties can provide investors with the means to reduce their exposure to market cycles.

The chart below illustrates how royalties may fit within the strategic asset allocation for different investor profiles. Our analysis shows that adding the strategy to a balanced portfolio can enhance its risk-return profile.

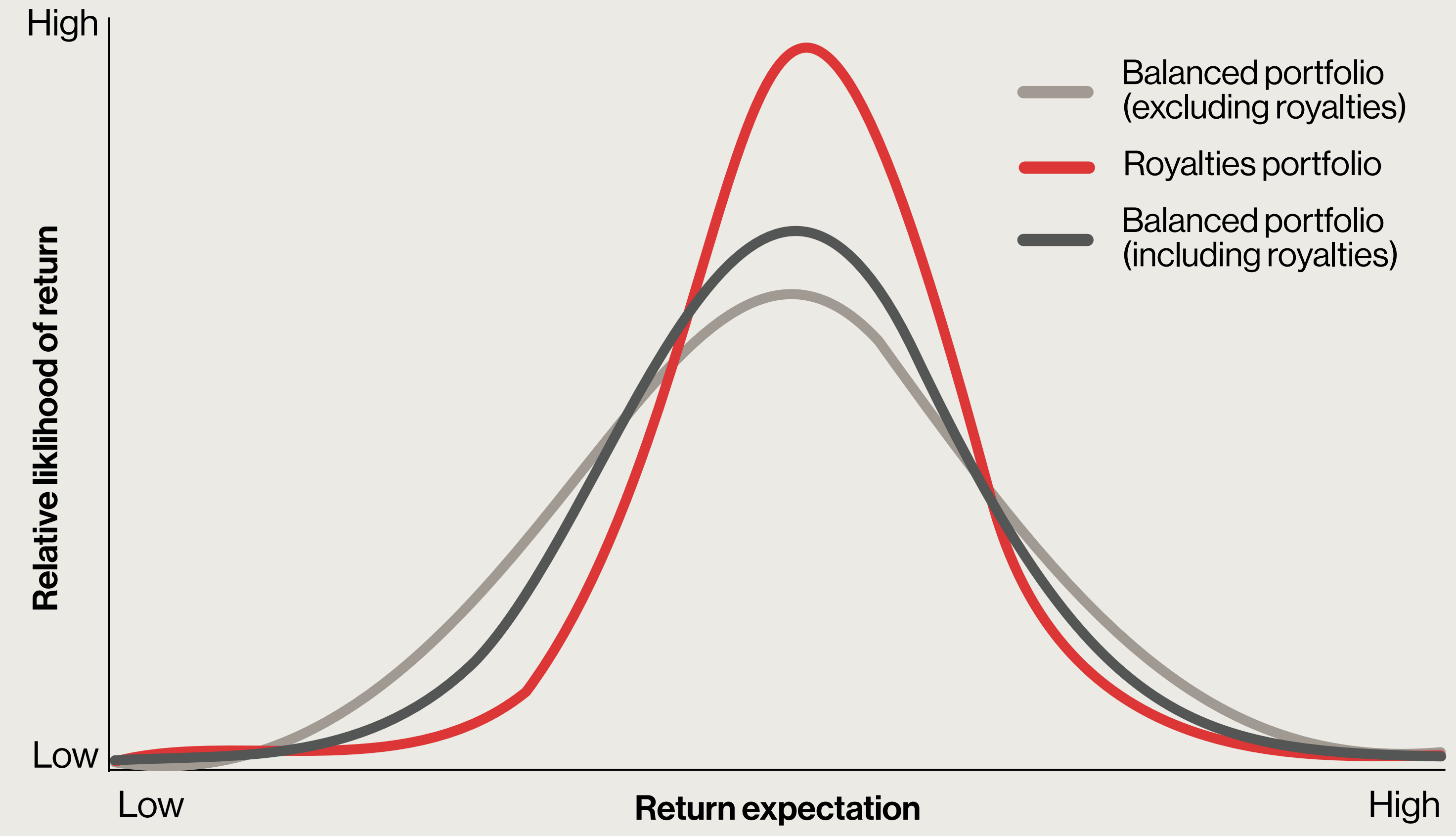
Suggested royalties allocation for three investor profiles



Risk-return expectations across the asset class spectrum[10]



Stability boost[11]



[10] Expected risk and return metrics of other asset classes based on Partners Group Capital Market assumptions.

[11] The chart displays the relative likelihood (Y-axis) of investment return outcomes (X-axis) for various portfolios, fitting a normal distribution (bell curve shape). Public sectors are represented by the following public indices: public equities (MCSI World Equities, NDDLWI Index), fixed income (Morningstar LSTA US Leveraged Loan Index, SPBDAL Index), real estate (FTSE NAREIT, TENHGU Index), infrastructure (Dow Jones Brookfield Global Infrastructure, DJBGIT Index). Private equity and private credit returns based on proprietary Partners Group track record. Private credit includes 1st lien, 2nd lien and mezzanine instruments as well as distressed and special situations. Royalties track record calculated using annual returns of comparable private markets funds where available and public comparables otherwise.

Evergreen fit

Within the private markets space, investors have typically tapped into royalties through closed-end, commingled fund structures, like those used in private equity and private credit. While these structures have their benefits, their standard 10-12-year fund life often does not match the typical duration of royalty investments.

This misalignment can bring about challenges and undesirable outcomes, such as funds being forced to sell off investments prematurely or having limited flexibility in allocating across different sectors. For investors seeking to align the lifetime of their investments with the underlying assets, evergreen fund structures may offer a viable solution.

These funds are not restricted in their investment horizon, or tied to a fund-end date, more easily matching the duration of the underlying investment portfolio. Additionally, they often offer regular liquidity events (typically quarterly), allowing investors to adjust their exposure to the asset class.

Conclusion

Royalties present an attractive investment opportunity, blending potential for equity-like returns with increased stability and downside protection.

When implemented effectively, they can serve as a hedge against inflation and demonstrate non-cyclical qualities.

As investors evaluate opportunities in royalties against their risk-return profiles, it is important to carefully assess the trade-offs associated with the asset class.

Thoughtful integration into a diversified portfolio strategy, can make royalties advantageous for long-term investors seeking capital protection and yield.

Above all, understanding the benefits that royalties offer to an investment portfolio is crucial for aligning with broader investment objectives.

Andrei Vaduva
Managing Director, Head
Portfolio Management

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Important Information

About Partners Group

Partners Group is one of the largest firms in the global private markets industry, with around 1’800 professionals and approximately USD 150 billion in assets under management (inclusive of all Partners Group affiliates). The firm has investment programs and custom mandates spanning private equity, private credit, infrastructure, real estate, and royalties. With its heritage in Switzerland and its primary presence in the Americas in Colorado, Partners Group is built differently from the rest of the industry. The firm leverages its differentiated culture and its operationally oriented approach to identify attractive investment themes and to build businesses and assets into market leaders.

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