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Key Lessons on Royalties too Often Learned the Hard Way

by Nigel Borshell, Director of Consultancy, PharmaVentures Ltd, Oxford UK

As the patent cliff looms the pharmaceutical and biotechnology industry is undergoing considerable change requiring greater innovation and a strong need for successful partnering. Royalties can represent the most valuable component of a deal but are often couched in remote and desensitized terms whereas the upfront and milestone values often grab the headlines in the deal announcement. Understanding the true value of your asset and how royalties are inextricably linked with overall deal value can help you negotiate on the things that really deliver value. You stand to lose more of your hard earned value through royalty percentages and tier adjustments than any other component of the deal.

The pharmaceutical and biotechnology industry is undergoing considerable change as the patent cliff looms, fostering invention and change, and a strong need for successful partnering. There are also new opportunities to develop in emerging and emerged new markets. What impact are these changes having on companies as they seek to partner, to strike the best deal? How can companies be sure that the deal terms they achieve, and associated royalties, are the best possible? Does the often quoted 25% rule of thumb really work? And what are 'Effective Royalty Rates' anyway?

While much of the methodology and context on royalty rates is available, there are key lessons to be learned by the aspiring deal maker in the smallest biotech to the largest pharma company.

Deal making is as much an art as it is a science

If you are tempted to flip through a royalty rate report to find the bar charts and data tables holding 'standard' royalty rates that you dearly wish and need to discover so that you can define your own deal term limits and expectations, then go right ahead, a fool and his money are easily parted. However, if you invest your time in understanding royalties, you will come away with a better understanding of what royalties are, and how and why they are inextricably linked with overall deal value. Context is everything. Without a full understanding of the value in your product and of other contributions to deal value, you cannot determine a suitable royalty rate, no matter how many tables you read.

It's as much about 'what you can live with' as about meeting specific industry norms

Deal making is as much about 'what you can live with' as it is about meeting specific industry norms. If either one party feels - or both parties feel - that the terms set out do not meet expectations, then there is no rosy future, even if the terms that you propose meet the industry norms. Only by an in-depth analysis of a programme's value, and of the split of that value among deal components (upfront payments, development milestones, sales milestones, royalties) will you be able to answer that 'what can I live with?' question. 'Living with' involves envisioning the future in both the short and long term. Can we afford it? It could seem like a blindingly good deal long term from a business development perspective, but the short-term impact on the licensee's bottom line or company cash flow from the CFO's (and shareholders') perspective might just be the deal breaker.

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More can be gained through effective knowledge-backed negotiation

The third lesson is that there is more to be gained through effective knowledge-backed negotiation skills than there is from reading tables of royalty data or calculating value on a spreadsheet. Beyond the obvious impact of prevailing market conditions, actual value is fundamentally a function of a product's net present value enhanced by a licensee's strategic need for that product. Understanding the estimated 'actual' value that a product may have does not automatically translate into knowing how big a share of it you will get. That share comes from a skill-based activity called negotiation, and, unsurprisingly, it is a professional activity that is built on information, not on anecdote.

A great deal of time and effort is spent in negotiating deal terms, but is the time spent on the various value components in line with their relative values? Negotiate hardest on the things that really deliver value!

You stand to lose more of your hard earned value through royalty percentages and tier 'adjustments' than on any other component of the deal. Small changes in small numbers can represent millions in dollar values.

Apart from royalties, deal components tend to be described in absolute cash terms, millions of US Dollars or Euros, whereas royalties are couched in somewhat remote and desensitized percentage terms. The difference between $125M proposed and $100M offered is perceived by all as $25M, money at least when expressed in currency terms, talks. The human brain would recognize the value of $25M with recourse to convert it into a percentage of the original $125M. But what is the difference between 12.5% and 10%? Just a couple of percent of sales! Or for that matter what value might a royalty difference of just 0.5% constitute when the decimal place disappears in the counter term sheet?

Keeping a clear and informed head and an eye on maximising the deal value, while living with any consequences, is the fine line trodden by deal makers today. And when this all happens across cultural and language divides, it makes for interesting times.