

OAKTREE INSIGHTS

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LIFE SCIENCES DIRECT LENDING: JUST WHAT THE DOCTOR ORDERED



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“It’s the rare investor who achieves the sophistication required to appreciate correlation.”

– Howard Marks, *The Most Important Thing*

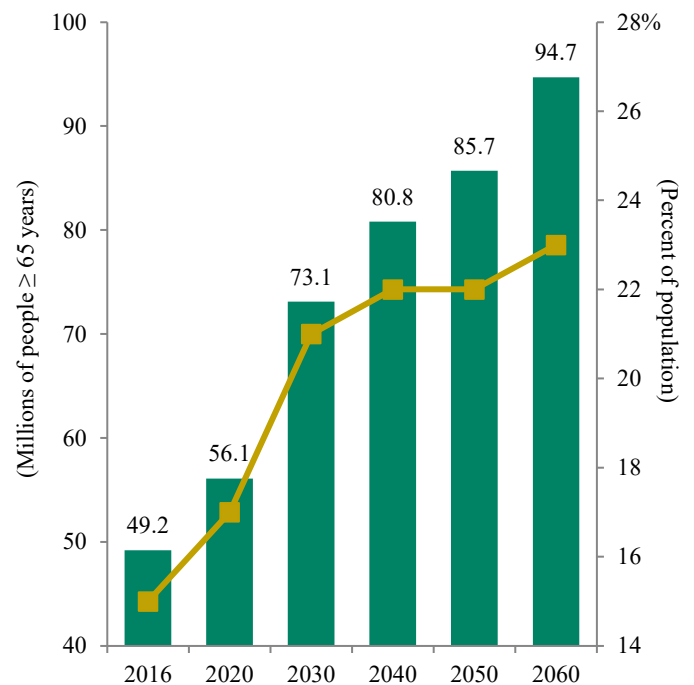
The life sciences industry has been a hero in the fight to end the Covid-19 pandemic, as vaccines developed in record time have provided hope to a locked-down world. **We believe demand for healthcare innovation will long outlast this crisis and only intensify in the coming years, as populations age, the global middle class expands and U.S. medical expenditures outpace GDP growth.** This advancement will require significant spending on technology, equipment and research and development, meaning this capital-intensive industry’s already hefty financing needs should – like the global population’s median age – just keep rising.

However, securing such financing won’t always be easy for companies that can’t access conventional equity and debt capital markets. True, these businesses – no longer start-ups but not yet mature firms – may have valuable intellectual property or state-of-the-art manufacturing facilities. Nevertheless, traditional lenders like banks often won’t lend to them because: (1) banks often lack the expertise to value complex assets, such as immuno-oncology or gene-therapy drug products, and (2) the companies aren’t suitable for traditional cash-flow-driven underwriting metrics because many of these businesses don’t have stable revenue or earnings. That’s why direct lenders with uncommon expertise can make an impact.

Direct lenders – or private creditors who make loans to businesses without an intermediary such as an investment bank – have more flexibility than traditional lenders when structuring financings. But many have been avoiding the life sciences space both because they lack industry-specific expertise and because investing in a high-growth area, where companies have nontraditional earnings profiles, is normally

considered high-risk. **However, it may be possible to generate attractive returns in life sciences direct lending while keeping risk under control by combining scientific knowledge with structuring expertise and an appreciation of correlation.** In investing, like in medicine, it’s often wise to seek out a specialist.

Figure 1: The U.S.’s Aging Population



Source: U.S. Census Bureau. Represents latest available national population projection as of September 2018.

LIFE SCIENCES: A PRESCRIPTION FOR HIGHER GROWTH WITH LOWER RISK

The investment thesis for life sciences is simple: the ceiling on growth and the floor for consumer demand are both high. Healthcare spending as a percentage of global GDP already tops 10% and represents roughly 18% of U.S. economic output.¹ Total outlays are likely to rise as the global population becomes wealthier and older. For example, U.S. healthcare spending is expected to jump by over 5% annually through 2027, according to the Centers for Medicare & Medicaid Services. Meanwhile, accelerating technological developments in areas like genomics, oncology and gene therapy suggest more groundbreaking innovations are possible. For instance, the market for orphan drugs, which treat rare illnesses, is expected to nearly double in the next five years, according to Deloitte. Additionally, global annual R&D spending on drugs is expected to exceed \$200 billion by 2022, according to Evaluate, a healthcare industry data provider. **These advancements increase the sector's overall growth potential as well as its need for alternative financing.**

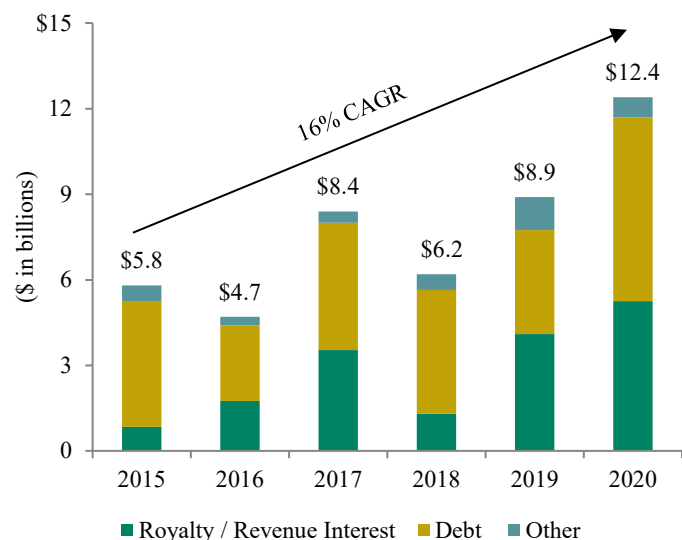
Providing such financing may not only create the potential for attractive returns, but also help reduce overall portfolio risk. That's partly because healthcare spending has historically had a low correlation with economic cycles. People require medical treatment during both recessions and recoveries, so when an economy is in a slump, healthcare providers may still do well. Just look at 2009, the nadir of the Great Recession: sales for the S&P 500 Index sank by over 9%, yet they jumped by more than 10% for the S&P Healthcare Sector (see Figure 3). Similarly, EBITDA for the overall index fell by 18.5% the same year, but the index's

healthcare segment reported a slight bump in this measure of adjusted earnings.

Moreover, healthcare is a broad and diverse sector, including biopharma, devices and services. So while investing in a sector-specific strategy like oil & gas might leave one highly vulnerable to a shift in macroeconomic conditions, that's rarely the case with life sciences because each company is unique and targeting specific disease areas. Consequently, their financial results aren't highly correlated. Furthermore, while oil companies might stop drilling during an economic downturn, healthcare companies can't easily stop spending because new treatments and devices often take years to move through the various phases of the development cycle. This further reduces the correlation between healthcare and the wider economy.

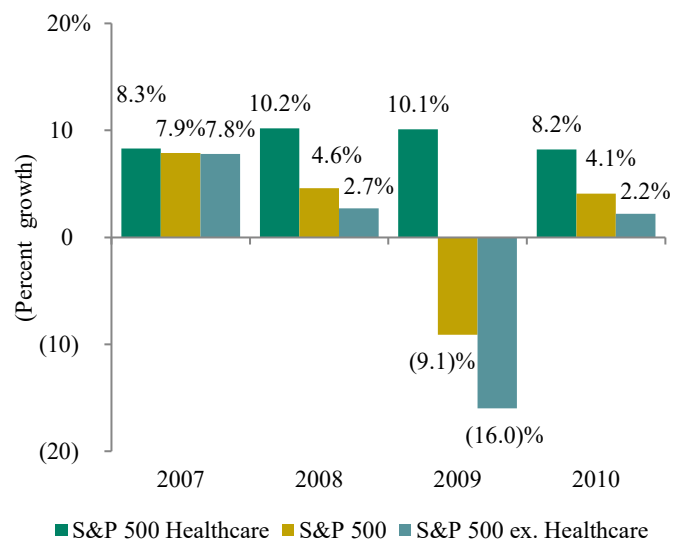
Additional risk reduction may also be possible if one invests in life sciences companies through debt. True, venture capital investors or other private equity players have the potential to enjoy uncapped returns with healthcare portfolios, but they are also dependent on the openness of the IPO market and have, in comparison to creditors, fewer protections against risk, especially that associated with regulatory approvals. As such, the risk-adjusted return for debt could potentially be higher than that for equity. That's because small- and mid-capitalization biotech companies with less than \$2.5 billion in enterprise value are increasingly driving innovation and disruption in life sciences, and they're often more focused on the certainty of capital rather than simply the cost of capital. This dynamic may allow debt investors to charge higher rates and thus generate the types of returns normally associated with equities, while maintaining

Figure 2: Trends in the Healthcare Credit Market



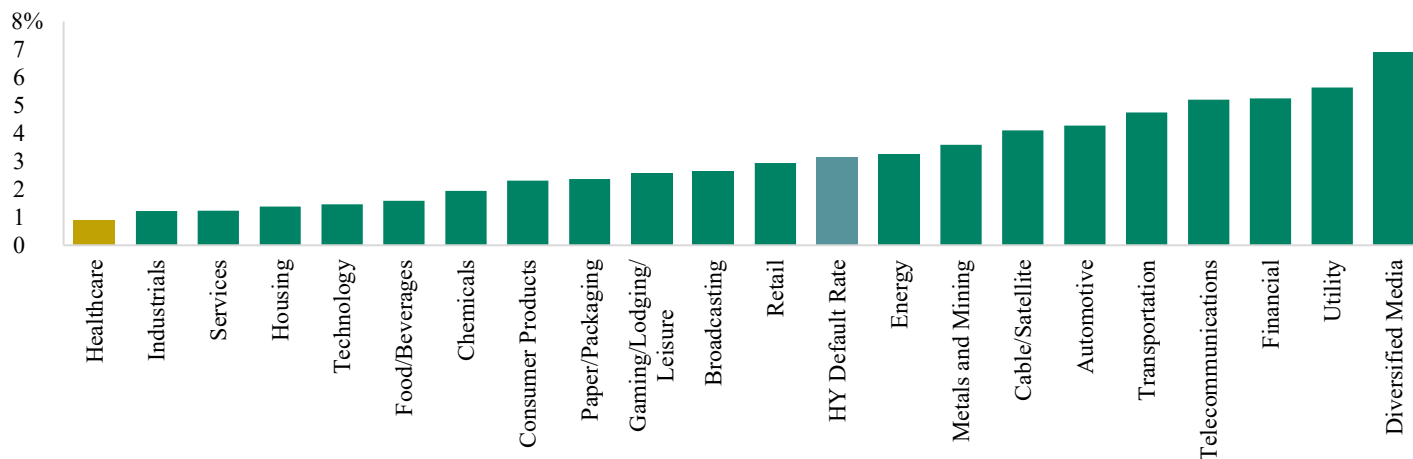
Source: Morgan Stanley, Cowen, internal estimates based on discussions with sell-side brokers.

Figure 3: Sales Growth Comparison



Source: Bloomberg.

Figure 4: High Yield Default Rate by Industry



Source: JP Morgan Default Monitor, January 4, 2021.

the security that comes with being senior in the capital structure, including being first in line to collect if the borrower files for bankruptcy. **In other words, direct lenders can use fixed-income instruments, with their customary protections, to provide borrowers with the capital they need to grow and create equity value. If the deal is well structured, the direct lender can participate in this upside without sacrificing downside protection.**

Thankfully, default rates in healthcare have historically been lower than in many other sectors. In fact, the 20-year-average default rate for high yield bonds issued by U.S. healthcare companies is under 1% – the lowest for any sector – according to JP Morgan (see Figure 4). Additionally, most healthcare bankruptcies have occurred in one part of the industry: facilities and services. Biotech and pharma have accounted for a much smaller percentage of U.S. bankruptcy filings since 1995, with only two companies reporting insolvencies during the 2007–2008 Global Financial Crisis.² We believe the low correlation between different biotech companies and between different segments of the overall healthcare sector reduces the chance that a life sciences portfolio’s holdings would struggle simultaneously. **So while one can never eliminate credit risk, and historical patterns may change, a savvy healthcare investor can identify those areas with a lower probability of default.**

DIRECT LENDING: A CURE FOR THE COMMON FUNDING GAP

The thesis for life sciences direct lending is also simple: it fills a funding gap in a part of the market with less competition to lend. Direct lenders can provide the financing innovative firms need to move from FDA approval to successful product commercialization. It’s true that certain parts of the healthcare sector have recently had little trouble securing capital. Around 80 biotech initial public offerings were held in 2020, raising roughly \$13 billion, and last year

also featured blockbuster deals like Gilead’s \$21 billion acquisition of antibody-drug conjugate maker Immunomedics.³ But not all companies are riding this wave – especially those that aren’t yet mature enough to access the capital markets. **Many may be loath to dilute owners through additional equity financing, but they may also struggle to acquire funding from traditional lenders like banks that are often required to use a simple multiples-based valuation approach when determining borrowing capacity** (e.g., the value of the company might be calculated as a multiple of EBITDA). But younger companies often won’t have earnings to report because they’re still reinvesting revenues into their portfolio pipelines, R&D or commercialization strategies.

This means private investors willing to lend may be in a strong negotiating position. We believe they can secure more protections, or covenants, that give them the ability to intervene before a company gets into serious trouble. They can also insert terms that limit the impact of binary risks common in this industry – like whether a drug receives regulatory approval. Only around a third of drugs ever make it from Phase II to Phase III clinical trials.⁴ So a prudent lender would either focus on companies with products later in the regulatory lifecycle that carry far less risk of failure or structure deals so that one could assume control of valuable intellectual property that could be monetized in a restructuring scenario.


But, first, the investor must have the capacity to value this industry’s complex intellectual property. This challenge may be a major reason why many direct lending funds have shied away from the life sciences. In order to answer seemingly simple questions like, “what would a buyer pay for these assets, and what could change that underlying value?” an investment team would need to include or have access to professionals with significant scientific expertise. And in order to use these answers to consistently make sound invest-

ment decisions in this complicated industry, the investor would also need to possess a sophisticated understanding of risk. Partly because of these more onerous requirements, this segment of direct lending is far less competitive than others.

This creates a tremendous opportunity for direct lending teams who combine structuring experience with in-house scientific knowledge. Being able to accurately identify the most significant inflection points in a company's value during its life-cycle – such as the timing of meaningful clinical data releases or commercial milestones – can allow a lender to secure attractive deal terms even when deploying capital into a de-risking event. This offers those with exceptional expertise the ability to achieve potentially robust risk-adjusted returns while supporting the development of the next generation of life-saving treatments.

OAKTREE: A SECOND OPINION ON LIFE SCIENCES INVESTMENT

Oaktree's global analyst team has worked on over 100 public and private debt and royalty financings across the healthcare sector, so we've seen how it reacts during different parts of the cycle and thus understand the importance of downside protection and structuring expertise. Our history has also taught us the value of scientific knowledge, which is why our life sciences team is co-led by Aman Kumar, a physician and former surgeon with Britain's National Health Service.

Ultimately, we believe there are no simple checklists one can follow to ensure success in any form of investing – and that's especially true in an evolving industry with complicated products like life sciences. Instead we believe it's important to engage in what our co-founder Howard Marks calls second-level thinking – or eschewing easy answers in favor of complex and unconventional questions. In direct lending, this "second opinion" can be a lifesaver. 

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Mr. Panossian is a managing director and Oaktree's Head of Performing Credit, as well as portfolio manager for Oaktree's Strategic Credit strategy. His responsibilities include oversight of the firm's performing credit activities including the senior loan, high yield bond, convertibles, structured credit, emerging markets debt, mezzanine and direct-lending strategies. Mr. Panossian also serves as co-portfolio manager for Strategic Credit's Life Sciences Direct Lending platform, which focuses on investment opportunities across the healthcare spectrum from biotechnology and pharmaceuticals to medical devices and healthcare services. Mr. Panossian joined Oaktree in 2007 as a senior member of its Distressed Debt investment team. In January 2014, he joined the U.S. Senior Loan team to assume co-portfolio management responsibilities and lead the development of Oaktree's CLO business. Mr. Panossian joined Oaktree from Pequot Capital Management, where he worked on their distressed debt strategy. Mr. Panossian received a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa. Mr. Panossian then went on to receive an M.S. degree in health services research from Stanford Medical School and J.D. and M.B.A. degrees from Harvard Law School and Harvard Business School. Mr. Panossian serves on the Advisory Board of the Stanford Institute for Economic Policy Research. He is a member of the State Bar of California.



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Mr. Kumar is a managing director and investment professional on Oaktree's Strategic Credit team. Additionally, he serves as co-portfolio manager for the strategy's Life Sciences Direct Lending platform, which focuses on investment opportunities across the healthcare spectrum from biotechnology and pharmaceuticals to medical devices and healthcare services. Prior to joining Oaktree in 2014, he spent three years at Deutsche Bank in London working in the Global Credit team, most recently as a vice president on the European High Yield trading desk. Mr. Kumar received an M.B.A. from the Wharton School at the University of Pennsylvania and holds a Bachelor of Medicine, Bachelor of Surgery degree from King's College London. Prior to Wharton, he worked as a surgeon in the UK National Health Service (NHS). Mr. Kumar is fluent in Hindi.

END NOTES

- ¹ World Health Organization; Centers for Medicare & Medicaid Services.
- ² Bloomberg Bankruptcy Monitor.
- ³ Evaluate.
- ⁴ U.S. Food and Drug Administration.

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