GOODWIN

Envisioning the New Normal:

Real Estate + Life Sciences

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Part 2: Review of Joint Ventures in Life Sciences Real Estate Deals

Over the last few years, the convergence of life sciences companies and traditional real property developers has led to the emergence of an alternative real estate asset class known increasingly as "propsci." While this is not an entirely new asset class, it does carry its own idiosyncrasies in terms of investment structuring and underwriting, asset-level operational considerations and exit strategies.

In this article, we will review:

1. Specific features of the propsci sector that make the joint venture ("JV") model an attractive proposition for market players looking to invest in or participate in the sector; and
2. The key terms that market players may wish to consider before embarking on a propsci JV.

In commercial real estate, investors, developers and operators regularly use JV arrangements as a means to manage the risk profile of investments/developments, share resources/expertise and/or apportion the significant costs associated with such transactions. The key players in propsci JVs include educational institutions, government bodies/local government authorities, private equity/venture capital funds, commercial life sciences businesses and real estate investors, and each of these participants bring something different to the table – whether capital, expertise or market knowhow into a collective undertaking. The features of the propsci market that can make JVs attractive are:

1. **Shortage of Operators**

   Building propsci space is necessarily complicated given the requirement for the space to meet complex technical standards (i.e., to enable experiments and manufacturing of products to applicable industry standards) and there is a relative scarcity of recognized specialist real estate operators in this space. This makes JVs with such operators attractive for investors as it ensures exclusive access to the operator's skills, expertise and deal pipeline, operator/investor alignment and operator incentivization while giving operators covenant strength, a secure funding source, and a potential income stream (via any asset management/development management fees).

2. **Capital Intensive**

   The cost of building propsci space tends to be high, both in terms of the costs of building the specialized space that prospective tenants will need and high land prices in sought- after locations in or around "knowledge clusters" such as Cambridge and Boston, Massachusetts and London, Oxford and Cambridge, UK. Accordingly, the ability to pool significant capital (and de-risk) by introducing one or more partners in a JV is appealing to market players.

3. **Scale of Projects**

   Propsci developments tend to be large-scale, mixed-use schemes which may include residential, retail and social spaces (in keeping with the prevailing "live, work and play" concept of mixed-use real estate development). These schemes require long-term investor commitment and significant capital outlay, which can be more easily sourced via a JV arrangement.

4. **Marriage of Capital and Expertise**

   Key for any specialist real estate asset class, including propsci, is the requirement for a marriage of capital and expertise with each party having a particular role in the transaction/project, e.g., funding, asset/development management, market creation, etc. Well-known and skilled operators also serve as a draw for tenants who have directly experienced or heard positive testimonials from other industry players with respect to projects managed by such operators. This makes JV arrangements a natural investment vehicle.

5. **Public and Private Partnerships**

   For obvious reasons, the life sciences sector is a key area of focus for government and public sector bodies (in the U.S., U.K. and E.U.) who are keen to encourage the growth of these knowledge and innovation clusters. There are numerous opportunities for private-sector players to partner with government and public sector bodies via public/private JVs. For example, public universities may have the required land, endowments and life sciences talent to entice tenants to join their campus; however, such universities may not have the development or operational experience to make a propsci property a success.

In many respects, propsci JVs have similar terms to standard commercial real estate JVs. However, certain JV terms may require a more nuanced approach in the context of the propsci sector, including the following:

1. **Transfer Rights**

   In JVs between real estate investors/funds/capital providers and operators of propsci developments, from the investor's perspective, the identity of the operator is critical (perhaps even more so than in standard commercial real estate JVs) with fewer specialist operators available in this sector than, for example, in the office or retail real estate space. The investor may be well advised to restrict any change of control/ownership of the operator without the investor's consent or otherwise restrict any changes in control/ownership to a pre-determined (and limited) list of persons. Additionally, the investor may also wish to restrict any transfer of the operator's equity interest in the venture without the investor's consent (outside of any investor default scenario) to maintain investor and operator alignment. All of these may be further bolstered with "key person" protections in the relevant operating agreement to ensure that individuals with the correct skill set and experience for this specialized market segment are managing the operation/development of the assets – noting that the growing interest in this sector from traditional real estate market players is fuelling demand and clamour for talent.

   On the other side, the operator may be well advised to resist 100% ownership requirements to give themselves flexibility, e.g., by bringing in third-party investors into their business or awarding equity to key personnel. A compromise is usually an ownership level that gives the investor comfort that the relevant key person(s) in the operator business have sufficient "skin in the game" to ensure alignment, which probably does not need a 100% ownership stake as long as it is a majority controlling stake. The operator may also wish to carve out transfers of the management function or its JV interest to affiliated entities as well as the ability to appoint/delegate to service providers/advisers to assist it with the delivery of its services and give it some operational flexibility.

2. **Control**

In investor and operator propsci JVs, we would expect day-to-day operational control over the management of the assets to rest with the operator (this is usually restricted by reference to an annually agreed business plan and budget) with certain pre-agreed key decisions (e.g., the business plan, budget, asset acquisitions and disposals and raising any further equity or debt) requiring unanimous approval from all JV parties. The parties should carefully consider the reserved matters as there is usually a balance to be struck between flexibility/efficiency in allowing the operator to have control of asset-level operational decisions (as it is, after all, the specialist) and a minimum level of control to safeguard the investors' interests. In the context of 50:50 JVs between two large investors or investors and commercial life sciences businesses, both parties may have joint control with suitable deadlock resolution provisions (e.g., ability to refer the deadlocked matter to senior management and/or a third-party arbiter, and/or in the event of a prolonged impasse, divorce mechanisms to terminate the JV).

3. **Default Remedies**

In investor and operator propsci JVs, a considerable amount of time can be spent discussing and negotiating the investor's rights to remove the operator from the venture if the operator is in material default under the JV agreement or fails to meet certain performance standards. However, in a specialized sector like propsci, removal of the operator mid-stream may not be possible or desirable as the investor may not have the capability or capacity to deal with the operational elements or there may not be any readily available and suitable replacement operators (in what is a nascent sector). Investors may wish to consider alternative default remedies such as the right to offset losses against the operator's distributions and/or fees, disenfranchisement and/or synthetic dilution of the operator's interest in the JV. From the operator's perspective, it may also wish to consider default remedies in the event of a material default by the investor (a good example of which is a funding default committed by the investor), e.g., the ability to offset any losses against the investor's distributions (although note that the operator should be mindful of any negative impact of doing so on the operator's performance fee/carried interest, and that there are potential workarounds to address this), the automatic loss of the investor's exclusivity rights and/or the ability to exit the JV by compelling the investor to buy the operator's interests at fair market value (or, for added alignment, at a premium to fair market value to compensate the operator for the opportunity cost of missed investment opportunities).

Similarly, in the context of 50:50 propsci JVs between two large investors or investors and commercial life sciences businesses, where removal of the JV partner is not feasible, the above alternative default penalties may be similarly applicable in these types of JVs. Note that disenfranchisement of voting rights can, however, breach restrictions under the laws of certain jurisdictions or inadvertently bring the vehicle within the scope of financial services regulations, and it may be necessary to consider practical workarounds.

4. **Exit**

The parties to propsci JVs may have different expectations on hold periods for the underlying real estate and, accordingly, the JV arrangements between such parties will need to provide an exit mechanism to enable any party with a shorter-term hold profile to exit the JV whether by way of a sale of its interest to a third party or to the JV partner wishing to continue holding the assets and include tools (such as pre-emption rights, rights of first offer/refusal) to help create alignment between the parties. In extreme scenarios (i.e., where the party desiring an exit is struggling to dispose of its interest, whether to its JV partner or to a third party), it may also be appropriate to have market exit provisions enabling it to force a market sale of the underlying assets and a termination of the JV.

5. Exclusivity

In investor and operator propsci JVs (particularly those which are programmatic/long-term capital deployment vehicles), the investor may want to ensure that there are robust exclusivity and/or right of first refusal provisions that compel the operator to present any propsci investment opportunities either exclusively to the JV or to the JV in priority over any other vehicle operated by the relevant operator. Conversely, the operator may want to argue that outside of any conflicts of interest, the operator should be free to enter into other arrangements independent of the investor so long as the relevant key persons are devoting sufficient business time to the JV.

The features of the propsci market lend themselves to JV/co-investment/partnership arrangements that enable market players to combine resources, expertise and opportunities. The shape and structure of these arrangements will be familiar to most commercial real estate market players, but it is worth bearing in mind the particular quirks of this evolving and sought after asset class and, as discussed herein, there are useful tools available to parties to address these nuances and align JV participants.

Goodwin's propsci practice is positioned at the forefront of both the real estate and life sciences markets and provides market players with global reach, local market insights and strategic advice to allow them to navigate the challenges and opportunities in this evolving space. Please contact us should you wish to discuss any aspects of our propsci practice.

Part 3 Preview:

The next article in our Propsci series will focus on trends and opportunities in the life sciences real estate market. In particular, we will examine the role of "clusters" in key US and UK locations, and discuss how life sciences real estate can provide a competitive advantage for life sciences companies looking for strategic access to talent, funding, innovation, and shared resources.

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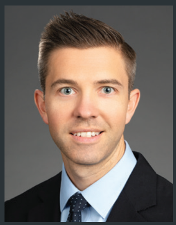

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