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Envisioning the New Normal:

Real Estate + Life Sciences

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Part 4: Underwriting Life Sciences Companies: What Owners and Developers of Real Estate Should Think About when Entering the Life Sciences Market

The process of underwriting tenants can involve a range of important – and sometimes competing – considerations at the best of times. In the propsci space, this is further complicated by the particular requirements of early stage and/or fast-growing life sciences companies, which can create a unique and challenging set of factors for a landlord to consider. This is especially true for owners and developers that are new entrants to this rapidly-growing sub-sector of the real estate industry. The pressures of a global pandemic only serve to increase the importance of properly and thoughtfully underwriting tenants prior to entering into new leases.

In this latest article in our *Envisioning the New Normal: Real Estate + Life Sciences* series, we explore some of the key considerations for a landlord when underwriting new life sciences tenants and offer some thoughts regarding the differing approaches that we have seen in the U.S. and UK markets.

Understanding the Science (Where Possible)

When assessing a potential life sciences company as a tenant, it is important to try and understand the viability of its business/financial model and, where possible, to make an assessment of the value of its science. In the U.S., some of the most sophisticated and established life sciences owners, developers and operators either employ specialist advisors or have in-house capabilities to assess the science-related information provided to them by prospective life sciences tenants. This allows them to better understand the background of a life sciences tenant and to seek to weed out – on their assessment of the strength or otherwise of their science –those which they consider may not have a sustainable business plan.

Knowledge obtained from this exercise can also afford landlords the opportunity to capitalize on gains to be made in early investment into life sciences companies by sitting alongside venture capital investors. Similarly, there are also some examples of landlords which are part of venture firms that look to form relationships with tenants so that they can participate in future financing rounds of such tenants. While this has an obvious advantage in terms of access to opportunities for future investment, the key aim for landlords in understanding the science behind prospective life sciences tenants is to prevent a company with doubtful prospects of success from signing on to a very expensive lease.

Despite some notable examples of landlords that are able to meaningfully perform diligence and assess the science, the vast majority of real estate firms and investors recognize that they will not be able to understand the science in any meaningful way and so do not currently attempt to do so. That said, many are conscious that even a basic understanding of the science carried out by a prospective tenant will be beneficial to landlords, and therefore we expect this capability to become an increasingly common trend among those real estate firms that focus on the growing propsci market.

Understanding the Source of Capital

Companies in the life sciences sector require significant cash to fund their activities. Most early stage, and many later stage, life sciences companies are likely to be totally reliant on external financing. They will typically be heavily loss-making and a number of years away from the point where they will generate any revenues from their operations. Life sciences companies are typically only funded for the next stage or two of their development activities, and so their cash runway is often only 12-18 months, at which point they will need to seek a further cash injection from their current investors or raise capital from new investors.

Any cash that life sciences companies do have will be carefully budgeted and earmarked for the clinical development of their drug or device. With this in mind, landlords will need to undertake careful due diligence to enable them to understand how a prospective tenant is financed: is it venture backed? Does it get its capital from a foreign parent? Does it rely entirely on the strength of its science or its reputation for its pipeline of fundraising? Or is it financed in some other way? The source of capital and the security or availability of future financial support can make a significant difference from a financial underwriting and risk perspective.

A landlord's analysis can be made simpler where one or more major venture firm is involved in the backing of a life sciences company. Such venture firms are constantly developing a pipeline of new portfolio companies and, if one of their portfolio companies were to fail, some landlords take comfort from the fact that there will likely be another company to plug into the vacant space from the same portfolio without too much disruption or renegotiation of the relevant lease.

If the life sciences company relies on foreign capital, there can be concerns regarding enforcing and collecting on guarantees from foreign parent/ sister companies. This can make for complicated legal negotiations to ensure someone of worth is backstopping these obligations and that such obligations can be enforced in a meaningful and cost-efficient manner.

If a life sciences company's ability to fundraise is in doubt, this can lead to a very different discussion with landlords regarding the terms of rent amounts/structure, security deposits and tenant improvement packages, and so landlords should be prepared to show flexibility and imagination when approaching these discussions.

Notwithstanding availability of capital, life sciences companies operate in a world where at any time their development program could simply fail. If that happens and the company does not have a back-up or alternative program, in most cases investor capital will be withdrawn and the company will simply be wound-up.

Protecting Landlords from Future Financing Difficulties

Security deposits from life sciences companies are generally large (when compared to other sub-sectors of the real estate industry) and in the form of letters of credit/bank guarantees. It is not abnormal to design creative burndown structures for 12+ month security deposits which are based not just on time but also on growth milestones. Examples of burndown milestones include: (i) future fundraising events, such as raising an agreed level of follow-on financing by a certain date; and (ii) the achievement of certain clinical or commercial milestones in the drug development (although accurately defining those milestones can often be a difficult drafting exercise where input from specialist life sciences lawyers is essential).

Landlords should also keep in mind that most life sciences companies will run out of money only a few years (or even sooner) into a 7–10+ year lease term and so security deposits and future sources of capital are essential. While parent guarantees from venture firms are generally unheard of, to the extent that there is another source of capital available, landlords should seek out upper-tier entity guarantees wherever possible.

Design Considerations

Life sciences companies often have very specific requirements for the space they occupy and may require a landlord to facilitate these specific requirements. Life sciences companies can have complex requirements in terms of the fit-out of their space. Some will need a bespoke, fully operational laboratory and given the innovative nature of their work they will often demand a very high specification in terms of the security of their premises. Other tenants will have particular requirements in terms of utilities and building services and a need to store, use and/or dispose of hazardous materials. Tenants will also want to ensure that there is space for them to expand as their development program and headcount increases.

A key landlord consideration when reviewing large tenant improvement packages is to make sure that the design of the space is going to be useful for second-generation tenants. As noted above, life sciences companies can run out of funding before termination of their lease and so a space which can be easily re-purposed will be leased again more quickly and will require less investment in terms of future specification.

Given the above, landlords are becoming much more involved in the planning, review and approval of design modifications. We are aware of specific examples where tenants with off-market requirements, like very large vivariums or bespoke laboratory equipment, can only use a certain percentage of their landlord capex allowances to build those modifications and must meet a minimum standard for the rest of their laboratory space. This allows landlords to facilitate their tenant's requirements, while minimizing expenditure on bespoke fit-out items (where the return on such items is uncertain) and ensuring that their property will remain attractive to a range of future tenants.

Part 5 Preview

The next article in the *Envisioning the New Normal: Real Estate + Life Sciences* series will explore the impact of technology in the growth of the life sciences industry. This new spotlight on life sciences companies comes amid a historic surge in investment in biotech, pharmaceutical and medical device start-ups focused on the search for innovative approaches to, among other things, health issues facing an aging population. In order to keep research, development and production on pace, life sciences companies old and new, as well as owners and operators of life sciences lab and office space, are accelerating the use of existing and new technologies.

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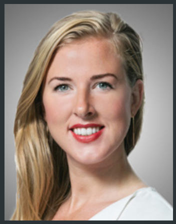

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