

## Navigating the New Normal

# Life Sciences Real Estate is Going Viral — What Lenders Need to Know

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While traditional office and retail properties have come under pressure from work-from-home and social distancing measures imposed during the COVID-19 pandemic, life sciences real estate has thrived. Moreover, given an aging population and a growing need for medical innovations, investors' demand for life sciences real estate should continue unabated for the foreseeable future.

As a result, lenders have taken notice and are actively seeking to lend in this space. Financing life sciences real estate can be more challenging than lending on other asset classes, however. Life sciences real estate is not simply repurposed office space, and lenders must understand myriad unique issues that are not present in a typical real estate loan.

### **Location and Sponsorship**

Location and sponsorship, essential factors in analyzing all real estate loans, are even more critical in the context of underwriting a life sciences real estate loan.

Perhaps no industry benefits from collaboration and physical connectivity more than life sciences. The clustering of organizations proximate to universities and research institutions is a phenomenon that has proved integral in life sciences companies developing drugs and treatments. Beginning in Boston, San Francisco and San Diego, life sciences clusters now extend to New York, New Jersey, Austin, Philadelphia and Washington, D.C., to name a few. By focusing on established life sciences clusters, lenders increase the likelihood of a successful investment.

Partnering with the right sponsorship is also crucial. Unlike a conventional office building, a life sciences property typically contains multiple uses and is occupied by companies with varied areas of focus and specific space requirements. Lending to sponsorship with the requisite experience and know-how to develop and operate the type of buildings and space life sciences companies require is vital — and the stakes are high.

For example, life sciences companies typically require specialized air handling systems to conduct their business. If sponsorship develops a property with a flawed system, such a mistake would be catastrophic. Not only would life sciences tenants eschew leasing space in the building, but ownership also would be unable to salvage the project by pivoting to conventional office space. This is because the lower rents typically paid by office tenants would be insufficient to offset the higher construction costs of a life sciences development.

Given the importance of sponsorship, the lender must be confident the operator will remain in place during the loan term. Accordingly, it is key for the lender to carefully review the joint venture documentation, together with the relevant loan documents, and confirm it has consent rights over any change in ownership or control of the operator and any transfer of the operator's equity in the venture. Alternatively, the parties may agree to a list of pre-approved transferees.

## Redevelopment Versus New Construction

Whether redevelopment or new construction, developing a life sciences property is more complex, expensive and time-consuming than an average real estate project.

Redevelopment of an existing property is riskier than new construction. The lender must be sure the structure is suitable for conversion, given the unique space requirements of life sciences companies. Factors to consider include:

- Does the building have sufficient floor-to-floor clearance?
- Structurally, can the facility support heavy loads, including rooftop mechanical equipment, and prevent vibrations?
- Does the structure have high ceilings to provide enhanced ventilation?
- Is there space for electrical systems to support increased power and utility demands, including redundancy, and accommodate the strict requirements likely to be imposed for hazardous uses at the property?

Ground-up construction is also tricky. From an underwriting perspective, it may take years to complete the delivery and lease-up of the premises. Essentially, the lender is betting on the landlord's ability to collect premium rents to offset the property's high basis. However, with demand for life sciences space currently outpacing supply and many tenants willing to pay premium rents for immediate occupancy, this concern is lessened. Considering these factors, lenders willing to lend on speculative development have a leg up on the competition.

A lender's underwriting of life sciences real estate (whether redevelopment or new construction) should also account for the high failure rate of life sciences companies. The lender's financial analysis must factor in the likelihood that the original tenant will burn through its cash and no longer pay rent. As a result, the lender will need to underwrite the

cost and time it will take to retrofit such space and re-tenant the premises, including setting aside appropriate reserves. One mitigant to such potential cost and time is incorporating maximum flexibility into the original building design, allowing future tenants to move in quickly and at relatively little cost.

## Regulation

Not surprisingly, federal, state and local authorities impose many unique requirements on the development and operation of life sciences facilities. Life sciences real estate development requires a significant capital outlay, and the lender must be confident the finished project complies with all applicable laws, including zoning, building code and environmental, to avoid any costly surprises at the end.

Questions unique to a life sciences property include:

- Does the zoning code allow for laboratory or manufacturing use or the handling of hazardous materials?
- Does the structure comply with building height requirements, taking into account rooftop equipment unique to a life sciences building?
- Has the environmental impact of the structure been thoroughly vetted?
- Does the building comply with air emission requirements? Noise ordinances?

## Leasing

Paramount to underwriting a life sciences real estate debt transaction is the lender's ability to project the property's income stream with a reasonable degree of certainty. Therefore, the lender must know the asset's tenant profile, the needs of each tenant and the risks inherent in the leasing model best suited for each tenant.

Life sciences leasing models come in three formats:

- License;
- Short-term lease; and
- Long-term lease.

Licenses terminable upon 30 days' notice and requiring minimal capital outlay are ideal for start-ups needing flexibility, a collaborative environment and instant access to a full suite of amenities. Tenants typically pay a premium for this type of occupancy, and the lender must be satisfied that this is a sufficient mitigant to offset the lack of long-term, predictable income and the ad-hoc nature of such an arrangement.

The second type of leasing model, the short-term lease, is usually two to three years in length. This arrangement is best suited for companies in the pre-clinical phase that continue to require capital-intensive services.

The final type of occupancy arrangement is the long-term lease, commonly seven to ten or more years in length with multiple extension options. This model is best for more mature companies that require their own space and no longer need to pay a premium for the flexibility and services described above. In this scenario, both tenant and landlord make significant capital outlays, including substantial tenant improvement allowances. While this leasing model, with its long-term rent payments and escalations, appeals to lenders, it raises many issues.

More so than with a tenant under a license agreement or short-term lease, the lender must be comfortable with the ability of a tenant under a long-term lease to pay its share of improvement costs and perform its obligations under the lease. The lender must understand the tenant's business and prospects for success, and it should consider specific credit enhancements, including:

- An escrow for construction costs;
- Completion and lease guarantees;
- An assignment of security deposit or letter of credit; and
- A security interest in any valuable fixtures and equipment at the premises.

In addition, the lender should ensure the following:

- The lender's prior written consent is required for assignment/subletting under the loan documents;
- The loan documents are consistent with the lease provisions, including the mechanics for payment of contractors and disbursement of escrows; and
- The lease has standard mortgagee protection provisions, including notice and cure rights.

The lender also needs to tailor the loan documents to include the following concepts for all life sciences loans, irrespective of the tenant mix:

- The documents should address the likely presence of hazardous substances and biomedical waste, the transporting of animals, if applicable, and the need for adequate insurance coverage; and

- The casualty restoration provisions should realistically reflect complications likely to arise due to the presence of hazardous materials and waste, and the unique space requirements of the building and tenant spaces.

### Tax Benefits

Many state and local governments offer real estate developers a range of tax benefits. In New York, for example, the NYCIDA Life Sciences Program provides owners with various tax incentives, including real estate tax abatements, a reduction in mortgage recording tax related to the project's financing, and potential exemption from sales tax related to materials used to develop life sciences buildings. The lender must understand the status of these benefits following a mortgage foreclosure and structure the loan accordingly.

### Conclusion

With life sciences real estate financing on the upswing, lenders need to understand a complex business. They must learn to strike a delicate balance between offering a competitive debt package and loan documents tailored to the realities of the life sciences business and the unique characteristics of the property, and at the same time, incorporating sufficient structure to mitigate the many potential pitfalls presented by this type of real estate.

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