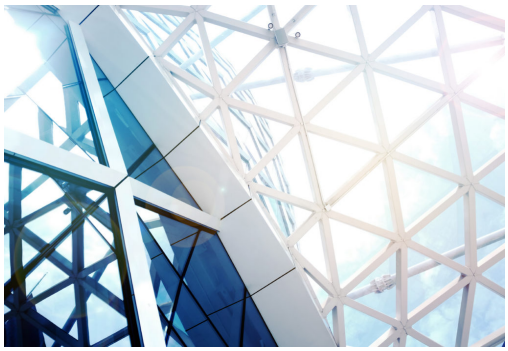
Underwriting Life Sciences Companies: What Owners and Developers of Real Estate Should Think About When Entering the Life Sciences Market



The process of underwriting tenants can be complex at the best of times, even more so when you add the particular requirements of early stage and/or fast growing life sciences companies and a global pandemic into the equation. With that in mind, we have summarized a few of the key landlord considerations when underwriting life sciences tenants.

Understanding the science (where possible)

It is important to try both to understand the viability of a tenant's business/financial model and, where possible, to make an assessment of the value of their science. This allows landlords 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 perspective into life sciences companies by sitting alongside venture capital investors.

Understanding the source of capital

Life sciences companies are typically only funded for the next stage or two of their development. 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 .

Protecting landlords from future financing difficulties

Landlords should keep in mind the fact 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. Whilst parent guarantees from venture firms are pretty much 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 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.

A key landlord consideration when reviewing large tenant improvement or specification 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. Consequently landlords are becoming much more involved in the planning, review and approval of design modifications to ensure that their property will remain attractive to a range of future tenants.

Three Key Leasing Models in Life Sciences

The real estate needs of life sciences companies can be fluid and complex, with early stage companies typically needing smaller flexible space and later stage companies typically requiring larger build-to-suit space. With an equally diverse group of life sciences landlords and business terms on the table, there are many variations of leasing models and terms to be negotiated between the parties.

However, perhaps as a result of a natural life cycle of a life sciences company, there are currently three major types of leases emerging in the U.S. for companies seeking space for research and development and laboratory uses:

Flexible License Model

Often used by early stage and pre-Series A companies, this model is often described as an "incubator," "accelerator" or the "WeWork" model of life sciences. Characteristics include functioning as a license, versus a full-fledged lease, and full-service amenities, including everything a company needs to immediately start performing their science.

Shorter-Term Lease Model

Sometimes referred to as "incubator-lite", this second model is often times attractive to companies seeking their Series A financing round that in its pre-clinical or discovery phase. The underlying agreement is generally in the form of a lease (versus a license), and is often for a two or three year period. Services can vary, but generally include those services that are capital intensive, such as conference facilities, common lab support areas and equipment.

Longer-Term Lease Model

The final model is more in line with other asset-classes and takes the form of a seven-ten+ year lease, largely with little to no landlord-provided services. Though for buildings with multiple tenants there can be shared services for things like a backup life safety generator and pH neutralization system, the landlord tends to take on very little responsibility for these shared systems. These long-term leases are often capital intensive for both the landlord and the tenant, with large improvement allowances, but the maximum flexibility for a user in terms of being able to program the space to best fit its needs. By the time a company gets to its Series B or C fundraising rounds and gets to a clinical phase of development, it has grown to the point where it needs to invest in its own space. Companies at this stage of life often need to weigh their financial situation, including their burn rates and pipelines, in order to ensure they are right-sizing their capital commitments for long term leases.

From the short-term license to the long-term lease, as life science companies move through their life cycle, their needs with respect to physical space will evolve along with the science. With many new owners and investors potentially pivoting towards this asset class alongside industry veterans, it seems like the sky is the limit as to innovation and growth both for and in partnership with life science companies.

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