

## UNDERSTANDING LIFE SCIENCES LEASING

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Life sciences leases are at the vanguard of the new real estate economy. The highly specific and costly requirements of life sciences leases set them apart from other commercial leases. Therefore, an enhanced understanding of the tenant's needs and the landlord's capabilities is critical to a successful life sciences lease.

This piece highlights the fundamental differences between life sciences leases and commercial leases of other asset classes. In particular, this piece describes the heightened underwriting considerations and fit-out requirements, as well as the operational aspects incumbent to life sciences leases.

### I. UNDERWRITING

Evaluating a potential life sciences tenant requires sophisticated analysis. Many life sciences tenants are start-ups or newly created ventures with little or no track record. Therefore, underwriting a life sciences tenant can prove challenging. While many factors are important, the bona fides of the science and the strength and commitment of the tenant's backers are among the most critical considerations.

**A. The Science.** A landlord will want to know:

- Whether the science is proven
- Whether the science is innovative
- Whether the science is needed

Competition in the life sciences space is fierce. Under the best circumstances, many companies will fail. If the science is not proven, innovative, and needed, even if the venture is well funded, it will likely fail. Think Theranos.

**B. The Funding.** Life sciences companies require a lot of capital. As a result, important underwriting considerations for the landlord include:

- The level of existing funding
- The anticipated runway, or burn-off rate, of such funding
- Whether future capital has been committed and on what terms

Early-stage funding typically affords a runway of 12-18 months. Since most life sciences companies fail to generate any profit in the early stage, future capital is going to be a necessity. If the source of future capital remains a variable, the landlord's risk is considerably higher.

**C. The Operations.** Even a well-funded life sciences tenant that is generating proven, innovative, and needed science will not succeed if its execution is not spot-on. Therefore, it is important for the landlord to evaluate the experience and capabilities of the tenant's senior management team, as well as the tenant's business plan, when underwriting the tenant.

Of course, the tenant will want to underwrite the landlord as well. Given their highly specific design and operational requirements, the tenant will want to make sure the landlord has the capital, commitment, and sophistication to accommodate the considerable needs of a life sciences tenant. A landlord who typically operates in the office space, but does not have experience with life sciences leasing, may not appreciate the significant differences between the needs of a life sciences tenant as compared to those of a typical office tenant.

## **II. LEASING**

**A. Fit-Out Requirements.** As mentioned above, life sciences tenants tend to have very specific and sophisticated design requirements. Many will require fully operational laboratories and some will need highly specialized manufacturing facilities. Others may require a combination of the two or even something entirely different. When it comes to life sciences tenants, there is no "one-size-fits-all" formula. Admittedly, some life sciences tenants will be able to operate in generically designed laboratories or facilities, but most will not.

Typical fit-out requirements of a life sciences tenant include some or all of the following:

- Enhanced air handling and filtration
- Sophisticated temperature controls
- Specialized lighting
- Increased floor load capacities and vibration dampening
- Enhanced power supply
- Fourteen plus foot ceiling heights
- Advanced water processing capabilities
- Enhanced hazardous waste handling

Due to the specialized design requirements, retrofitting an existing office or industrial building may not be cost effective, necessitating new construction.

**B. Improvement Costs.** Designing and constructing a modern life sciences facility is an expensive endeavor. This is especially true when the particular project is highly specialized. Recent labor shortages and supply chain problems have resulted in unprecedented construction cost increases, particularly where specialty labor and materials are involved. This confluence of factors is making life sciences projects especially costly and even more challenging than usual. As a result of the foregoing, whether a retrofit or ground-up construction, the improvement costs for a life sciences lease can easily exceed \$1,200 per square foot.

**C. Operating Expenses.** The utility and service requirements of laboratory and specialty manufacturing facilities tend to be very high. Laboratories and specialty manufacturing facilities frequently operate well beyond ordinary office hours. They also tend to require higher levels of energy and significantly more water than other types of facilities. A life sciences tenant's need for additional utilities and services must therefore be weighed against the needs of the other occupants of a multi-tenanted building or facility housing a life sciences tenant. Whether as a result of the need to provide enhanced utility facilities, to acquire additional energy, or to provide additional services, the landlord's operating costs will certainly increase when leasing to a life sciences tenant and must therefore be factored into lease pricing considerations.

**D. Landlord Concessions.** As touched on above, the fit-out or fit-up requirements of life sciences tenants are often very particularized and costly, and landlords are often asked to make a sizable up-front investment in the tenant.

Typical landlord concessions in life sciences leases include:

- Significant leasehold improvements
- Substantial tenant improvement allowances
- Considerable free rent

The significance of the landlord's upfront investment in a life sciences lease speaks to the landlord's need to engage in thoughtful and critical tenant underwriting at the start.

**E. Lease Security.** To mitigate the risks inherent in life sciences leasing, a sizable security is often required. Due to the significance of the landlord's up-front investment in the tenant, security deposits often equal as much as 18-24 months' base rent. Since this amount is so high, to ease the tenant's burden, the landlord will often adopt a burn-down structure tied to key financial benchmarks. This arrangement tends to work well for both parties as the tenant usually has more cash on hand at the outset, while the leasing risks to the landlord lessen over

time.

### **III. CONCLUSION.**

Life sciences companies are increasingly important to humanity. The products they develop allow us to envision a bold new society free from the ravages of disease, disability, and food insecurity. Landlords that are sufficiently capitalized, sophisticated, knowledgeable, and motivated can, and will, help these companies fulfill their destinies. With a better understanding of their tenants' needs, landlords will do it right, and both sides will get what they need.

### **PROFESSIONALS**

Jonathan Grosser

### **CAPABILITIES**

Real Estate