1. The Systems, The Credit: Biotech Issues You Need To Know

How do biotech companies’ real estate requirements differ from conventional tenants? And how much risk for a developer/owner is there in providing for them? Development asked someone who has had extensive experience in this specialized realm of the business for his insights.

Stan Wendzel is managing director and founder of BioRealty Inc., a real estate investment, development, and capital advisory firm focused exclusively on the biomedical and biofuels industries. With headquarters in Irvine, California, and offices in Washington, DC, and Kansas City, it is active throughout the U.S. and Canada, and primarily focuses on single-tenant transactions.

The key to working with biotech companies is understanding their credit profiles as much as the specific real estate requirements. Many of these companies are in their early stages and the transactions can be highly complex. Certainly construction costs can be steep because of specialized equipment and lab space. Wendzel noted that the construction costs could run as high as $600 to $700 per square foot. On the other hand, more generic labs with offices may not be substantially different from R&D space, in the low $200s per square foot.

“There absolutely are uncertainties,” Wendzel said. “It’s not for the faint of heart -- none of this is without risk. But we tend to get more comfortable with the risks than do our competitors.”

“We are viewed as much as a capital provider as we are a real estate developer by our tenant-clients,” he went on. “Our sweet spot is [working with] companies that have recently gone public or that are in the late rounds of private funding. From a project size perspective, we most often work with facilities of $5 to $30 million in scope, versus public REITs that typically focus on $30 million and up. We are also not afraid of highly specialized projects such as bioprocessing facilities.”

An example: CEL-SCI facility, which Wendzel described as “a bioprocessing facility for
a promising small cap biotech company.” This 73,025-square-foot facility located in Baltimore, Maryland, includes a biomanufacturing and fill/finish suite with supporting office, lab and warehouse space. It involves a major retrofit of an existing warehouse building and was structured as a acquisition, redevelopment and leaseback, which freed up $19 million in capital for CEL-SCI and provided a fair return for the institutional and private investors.

Wendzel observed that while the biotech industry has not changed radically over the last two to three years, several trends are emerging:

- More companies want to control their own manufacturing.
- More companies are looking at existing buildings with an eye on doing substantial retrofits. These could be simple warehouses that may not be much more than a shell, with high clear space and adequate parking.
- Speed to market is an important consideration, fueling interest in existing properties, which can often be retrofitted within 12 months or less.
- There is more interest in sustainable design.

Wendzel acknowledged that in an evolving industry, “our firm still has some learning to do. Problems tend to flush out after two years — that’s when you discover a tenant’s staying power. But so far, we haven’t had any unwelcome surprises on either the acquisition or construction side. We’ve also learned how important the tenant relationship is. These are complex deals and the requirements tend to morph and develop over time, so parties need to work collaboratively.” He went on to say, “So far our firm has been very blessed with some very open, honest, and motivated clients, and when that type of environment exists just about any deal is possible.”

One reason why the company is well positioned to cater to the biomedical industry is that its own corporate structure does not follow the traditional real estate development model. BioRealty attracts professionals from large biotech and pharmaceutical companies, who are consultants and project team members. BioRealty’s corporate management includes Wendzel and managing director Dough Kornich.

“We both tend to emphasize the finance side. We don’t need more guys who think like us,” Wendzel remarked. “You need to understand complex lab space and bioprocessing systems as well as the capital markets. Without those two perspectives, it doesn’t work.”

BioRealty has “fairly modest goals” for 2007, according to Wendzel, who expects the company to “comfortably achieve those goals by September.” He also expects that three years down the road, the biomedical industry will be “even healthier than it is now, with more capital flow and faster drug approval,” and Wendzel mused, “we just hope these young biomedical companies know there’s a real estate firm out there that can help them.”

For more information
BioRealty, Inc.: 
2. Owners From Mars, Tenants From Venus In Ranking Lease Negotiation Factors?

According to a recent Jones Lang LaSalle survey, property owners and tenants seem to have different priorities in gauging the top 10 important factors in negotiating leases. While 77 percent of the property owner respondents selected “rent” as the most important factor, 54 percent of the tenant respondents cited rent as the key ingredient. Tenants felt that building image, opportunity for expansion and build-out were next in importance. By contrast, property owners ranked lease term in years and months as second in importance.

3. Engaging in Early Dialogue to Avoid Pitfalls in Biotech Leasing

If the devil is in the details in conventional lease negotiations — with the inevitable push/pull between owner and tenant interests regarding control over property, flexibility and financial security — that is even more true with biotech companies.

Deborah Howitt Easton, is counsel to the Boston-based law firm Sherin and Lodgen LLP and a member of the firm’s real estate department. Peter A. Spellios, is a partner in the firm’s real estate department and chair of the firm’s land use, permitting and development practice. Both have had extensive experience negotiating biotech leases on behalf of owners and tenants. In offering their insights about key issues, both stressed the importance of early, ongoing dialogue to hammer out details satisfactory to both parties in order to avoid future difficulties.

Lease terms generally are designed to deal with any number of “what if?” scenarios. For a biotech tenant, the biggest “what if?” revolves around the company’s path of growth — or its opposite. So issues of security deposits, rights of first refusal, expansion, contraction and assignability of leases are critical for both owners and biotech tenants.

“Thousands of smaller biotech tenants don’t know what the future holds,” said Spellios. “They may be swallowed by bigger fish. They need flexibility — an escape route. They want to be able to grow and transform the business as it needs to be transformed. A lab could turn into a pilot manufacturing facility; it changes the use of the premises. Tenants can be lost to other properties if a landlord fails to consider the growth needs of a successful biotech company.

“You can’t be blind to corporate realities,” he went on. “There is not a high prospect of a biotech company being around in five years.” Therefore, an exit strategy in a lease —
allowing for mergers and takeovers with minimal consent by landlords, as well as sublease rights — is critical.

Easton said that landlords often agree with minimum consent to a tenant’s merger with a higher net worth company and will also devise a list of criteria for assignees or sublessees.

What might be the biggest nightmare in leasing to a biotech tenant? Spellios said that “Some people think it would be an environmental issue, but there is comprehensive environmental insurance available.” But, he said, what if a biotech tenant goes belly-up, rent has just begun and it has used up the lion’s share of tenant improvement dollars? “You have limited recapture rights under bankruptcy laws,” he said.

Moreover, an owner doesn’t want “Tenant A doing something that adversely affects Tenants B through Z. You can’t take care of everything with one lease. All your leases have to work together so you don’t create a house of cards.”

Spellios noted that “you have sophisticated and nonsophisticated parties on both sides. Larger tenants view real estate as an asset of the business. They know what the model is. The young biotech tenant signs a generic agreement and then it becomes a battle on each item with the landlord.”

In representing tenants, Spellios addresses the issue of default, in part because biotech companies are so dependent on venture capital funding. “We want to make sure that the landlord can’t push us off because this month’s financial statement isn’t as good as last month’s.”

Easton pointed out that landlords don’t want to be hurt because of a tenant’s default or because of environmental issues. “It’s important to have a baseline with the space to be rented,” she said. “We get a decommissioning report from NRC or a report from a certified industrial hygienist that the space is being delivered free of radioactive material and chemicals and that the new tenant is not responsible for pre-existing conditions and will comply with laws governing its industry.”

Spellios explained that biotech tenants need to protect proprietary information. “While the landlord wants to know what’s going on, being ultimately responsible for what goes on in the building, there needs to be a balance — and a need to be cognizant of other tenants. Different landlords have different comfort levels with what they want to know.”

Some leases have an exhibit that lists quantities of materials that can be used, for example, although Easton said that compiling such a list can often delay the leasing process. As an alternative in representing landlords, she said, “we’ll have the right to make a request at any time.”

One of the main differences between biotech versus conventional tenants, as Easton pointed out, is the extent and cost of tenant improvements, due to use of base systems,
the need for additional venting and HVAC systems and handling of hazardous materials. Spellios said that in the Cambridge area, tenant improvement allowances could easily be $100 per square foot, for example.

From the tenant’s perspective, said Spellios, there may be a need for separate systems and/or the need to use additional building space, such as the rooftop. There are issues of how to install and handle wastewater purification and where to house hazardous materials. Determining what constitutes a tenant’s portion of the demised premises dictates its percentage of operating expenses. A building’s base systems are likely to be significantly below what a biotech tenant would need, Spellios remarked.

Not surprisingly, either, it can take longer for build-outs for biotech tenants. Easton said this raises the issue of what may be considered delay on the tenant’s part, assuming rent starts with the delivery of space. Moreover, alteration provisions are more heavily negotiated with extensive build-outs. Landlords will want full consent rights if alterations affect building systems.

With tenant improvements, she added, it is not easy to convert space when a biotech tenant moves out, so the security deposit is typically fairly substantial. With a start-up company, the landlord will want a high deposit as protection as well as letters of credit. “We’ll sometimes allow for a reduction in the letter of credit as time goes by if the tenant shows stability,” she said.

One way to offset high tenant improvement costs is to negotiate a long lease term. But as Spellios pointed out, “younger companies want three to five years, not 10 to 15.” Easton said that most tenants with shorter terms negotiate expansion rights.

By Ron Derven, co-editor of Development magazine