

## ***BIOREALTY REPORT #7***

### ***5 Common Mistakes When Developing & Financing a Biopharma Facility***

By Stan Wendzel

February 2009

After years of serving in the capital advisor or development role for biotechnology and pharmaceutical clients and their life science facilities you begin to see certain events repeat themselves. When you witness some events – like the process to move from design through construction and commissioning – you gain comfort that the project is moving forward as expected, but other repeating events are a bit less comforting. The recurring events that are not particularly enjoyable to witness are the seemingly common mistakes that are made when developing or securing the financing for a biopharma facility.

This report is intended to outline the five most common mistakes we have seen when a biotechnology or pharmaceutical firm is developing or financing one of its facilities. These are not complex issues; in fact, most of these issues are rather straightforward. The only thing that makes these mistakes particularly noteworthy is the frequency in which they occur. Based on our involvement with dozens of facilities over two decades we have seen many of the same mistakes made multiple times – on occasion by the same firm. Learning in this fashion - by making mistakes – is always costly, time consuming, and can often have a significant adverse impact to a biopharmaceutical product's success. With so much time and money required to take a biopharmaceutical product to the market and keep it successfully in production, the “learn from mistakes” approach makes little sense. It is our hope that by sharing our observations about the “5 most common mistakes when developing and financing a biopharma facility” the reader has a better understanding of their adverse impact and has a greater chance to avoid them.

#### **1. Not obtaining an accurate read on the current capital market environment**

Capital markets ebb and flow like the tide. Today's credit crisis is a prime example. Unless you plan to own a project financed with all cash, the impacts of the credit crisis to your biopharma project are numerous. Senior loans terms are far less attractive than they were even one year ago – loan amounts are reduced, amortization is shorter, interest rates are higher, and underwriting assumptions are far more conservative. Perhaps most challenging is the fact that few lenders today want to lend long term, which means you may end up with a mismatch in terms of a long term asset being financed with short term debt.

Lease rates for new biopharma projects have also become more expensive. Despite the weakening overall economy, the cost to develop a project is equal or higher than it was two to three years ago; meanwhile, landlords are faced with the same challenging debt markets faced by all borrowers, and these inferior debt terms translate directly into higher lease rates.

In short, the current capital markets are as unfavorable as at any other time over the past decade. Consequently, if you financed or leased a project over the past few years you cannot expect to replicate those terms today. To do so is to be unrealistic. However, as we said earlier capital markets do indeed ebb and flow, so in twelve to twenty four months these markets could improve just as quickly as they deteriorated. The point is to make sure to obtain an accurate read on the current market whether that be through contacting a professional who works in the market on a daily basis or that means doing your own market due diligence. The upfront homework will help establish reasonable expectations for the financing for your project and very likely save you significant time later on.

## **2. Not having a “reuse strategy” for the facility**

Pharmaceutical and biotech companies are known for requiring highly specialized facilities that have a very specific purpose and must be fit-for-purpose. These firms often employ highly trained, engineering professionals to insure that the facility is designed and built to perform exactly as intended. Many of these facilities are owned, so the view of an outside investor is often not a consideration, but are there any drawbacks to this approach?

The primary drawback may be that unique and specialized facilities will likely have poor reuse alternatives, which means that current lenders will provide inferior loan terms and, should the facility ever be shut down, the value to future tenants or building purchasers will most likely be significantly reduced. After seeing dozens of facilities shut down due to product failure, merger, acquisition, or lack of financing, you realize how critically important are reuse considerations. We have all heard the story of the biopharma executive saying his firm will be in its facility for the next 25 years and then just a few years later you find it moving out due to one of the reasons cited above. In a world with M&A activity on the rise, frequent product failures, limited access to capital, and an unpredictable clinical trials process it is more important than ever that your facility have a plan for reuse.

Our firm employs a three-pronged approach to “reuse”. First there should be a plan for a complete change of the facility’s use (“Alternative Use”). For example, we have developed projects with a plan to convert the warehouse portion of a lab/office/warehouse facility to additional R&D labs in order to strike a more appropriate 60/40 or 50/50 lab to office ratio. We have had projects where a specialized fill/finish suite was configured to facilitate its conversion to biology or chemistry labs in the future. We have also had cases where lab/office buildings were configured so that the use could be downgraded to generic industrial R&D space. This may sound crazy but it addressed a market need, which is the key. The reuse strategy should be consistent with the unmet needs of the tenants in the market. Lenders, financial partners, and developers are all fearful of the biopharma project that goes vacant and sits that way for years. An Alternative Use that is consistent with the needs of a deep tenant base will usually assure investors and lenders that this multi-year vacant scenario won’t occur. In addition, this is just good business sense even if you own your facility financed with all cash. If a facility is shut down due to a product failure, merger, acquisition, or lack

of financing, the owner who factored reuse considerations into a project's design will usually be significantly rewarded in the form of higher value upon sale or higher rates upon re-lease.

The second prong to our approach to facility reuse is making sure the facility can accommodate multi-tenancy with minimal modifications ("Multi-Tenant Capability"). Insuring that a facility has Multi-Tenant Capability is perhaps the hardest concept to convince a large, stable biopharma firm to consider. Most firms believe they will never move from their facility and therefore see little use of factoring in the needs of multiple, possible, future building occupants. However, making a building multi-tenant capable often entails very little other than some extra thought during the design stage. A few key questions can often help steer the design in this direction. For example, do we have the R&D lab space configured based on a generic lab module? Can we utilize more open lab versus closed? Do we have clear lab versus support versus office zones? Can we incorporate mobile instead of fixed casework? Are the air-handling units of a type, size, and configuration that could be used to service the needs of a much larger area of lab and office space in the future? If certain engineering systems are deficient for a multi-tenant configuration, what is the cost to build engineering systems with additional capacity? Is the configuration of our utility systems congruent with utilities for separately metered spaces in the future? If the building is multi-story, can we place most of the fume hoods on the upper floors and can we add extra vertical risers? These are just some of the questions you might wish to consider during the design phase to enhance the Multi-Tenant Capability of your facility.

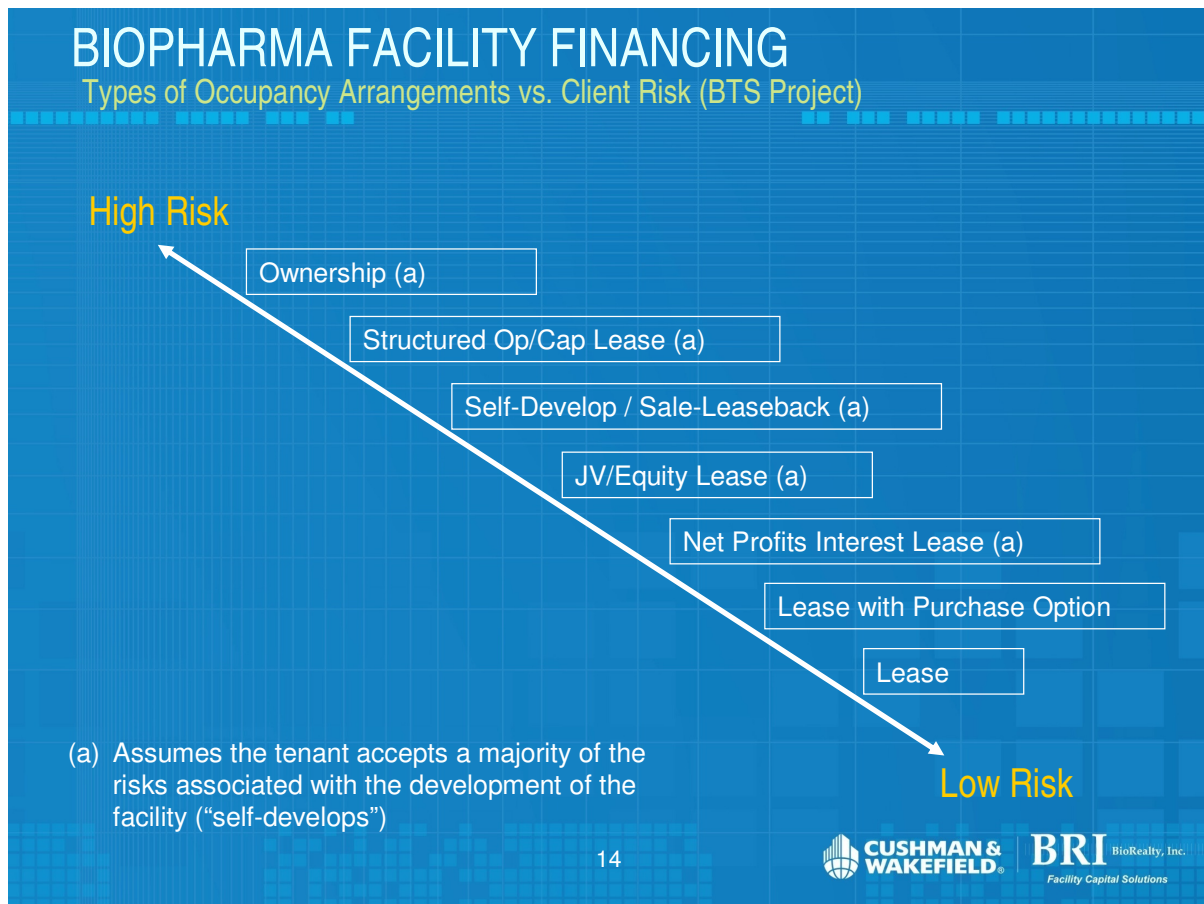
The third prong to our reuse strategy applies primarily to facilities with space dedicated to manufacturing or fill/finish suites. Key questions you may wish to consider - Do these spaces have the capability to produce or fill for more than one product ("Multi-Product Capability") in the future? Can these spaces be reconfigured to produce products other than the product for which this facility was designed? What minor changes could we make to enhance the appeal of this facility to another biopharma firm or contract manufacturing organization ("CMO")?

Earlier we mentioned "product failures" and "lack of financing". If either of those events occurs the last thing one wants is a beautiful facility that has only the capability to produce a product that is no longer being produced. Often times a facility can be designed to accommodate the development of other products with only minor changes in choice of processing equipment or a slightly more robust mechanical systems or other modest changes. These simple considerations could pay big dividends in the future. Should you be fortunate enough to configure a facility that is uniquely attractive to other biopharma firms and CMOs you might even find the facility can become its own unique profit center during times when it is not needed to produce your firm's products.

### **3. Not addressing the ownership vs. lease question**

Have you truly evaluated whether it is better for your firm to own its facility or to lease? Have you evaluated the pros and cons of the various available occupancy arrangements - owning, owning with debt, a traditional lease, a structured capital or operating lease, a leveraged lease and a tax exempt

financed lease? If you are considering a traditional lease, have you considered an option to purchase, a net profits interest lease, or a JV/equity lease? Each of these types of occupancy arrangements – and the underlying financing associated with them – has positive and negative features, involve varying degrees of risk, and ideally, should be evaluated in the context of the firm’s goals for each project. At a minimum we recommend that you thoroughly discuss the issue of ownership versus lease within your organization and have sound reasoning for selection of one option.



We all know to compare the financial cost of different occupancy arrangements using discounted cash flows, but understanding the benefits and constraints of different occupancy arrangements can often time be more important. We have seen several instances where a company elected to own its facility without having evaluated the different ownership and lease alternatives only to find out later that there was an arrangement that provided an equal degree of long term asset control and to which it was better suited. For example, some occupancy arrangements have low cost but adverse balance sheet impacts. Others have low cost but provide little to no flexibility. Other arrangements are significantly more costly just because they provided for flexibility that is really not needed by that firm. Some occupancy arrangements entail significant risk (e.g. ownership). Some arrangements provide complete long term control over the asset (ownership or long term lease with options) while others do not. Meanwhile certain lease arrangements can be structured to maximize

specific shareholder considerations. For example, some structured lease arrangements maximize net income (i.e. increase EPS) while others maximize operating income at the cost of reducing net income.

There are a lot of options and impacts to consider but the bottom line is that you don't necessarily need to evaluate all the different possible occupancy arrangements in this level of detail – but that might not be a bad idea. You should at least do both a quantitative (DCF analysis) as well as a qualitative analysis (basic pros versus cons) before making the own versus lease decision. Whether you do this on your own or bring in an advisor to assist you, as the economics of the alternatives are being modeled, we strongly suggest a separate analysis be done that compares the pros and cons of different occupancy formats. Oftentimes, this simple exercise provides a sense of clarity of choice that merely “running the numbers” cannot.

#### **4. Not exploring all available facility financing options**

Once you've selected your preferred form of occupancy we recommend you also evaluate all the underlying types of available financing. For example, if you wish to own but obtain a senior loan to finance a portion of the acquisition or development, you may want to at least think about which type of loan is best and which financial institutions are likely to offer terms closest to your liking. This means that for a construction project requiring a senior loan you should have clear reasons for selecting between a construction loan, permanent loan, construction to mini-perm, etc. You might also want to have a general understanding of the likely available loan terms from the various public and private lending sources, including local and regional banks, thrifts, S&Ls, money center banks, credit companies, regional and national life companies, credit unions, mortgage conduits – although not currently very active due to the credit crisis, REIT lenders, and pension funds. You then might ask, “In today's lending environment, which of this group of lenders is most likely to offer the loan terms we seek?” Some projects will be more appropriate for a local or regional bank loan while others better matched with a life company loan and vice versa.

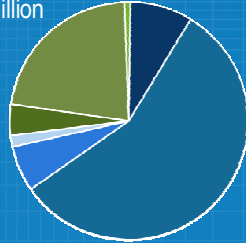
This thought process ties into the concept we mentioned earlier – “#1 obtain an accurate read on the current capital market environment.” For example, if you did your evaluation of the current capital markets for senior debt you would discover that certain types of lenders are now providing a substantially larger percentage of new loans than in years past. If you followed our advice and asked, “which group of lenders is most likely to offer the loan terms we seek” - you might be able to quickly conclude whether or not your senior loan financing expectations are reasonable given today's debt market. This thought process is a very simple exercise - but many don't do it. Understanding the type of loan you want and which lenders to approach can at minimum save you significant time and will most likely dramatically improve the loan terms you end up with.

# CAPITAL MARKETS UPDATE

Real Estate Capital Investment 2007-2008

## U.S. Real Estate Debt Investment 2007

\$3,290.3 Billion



### Private Debt

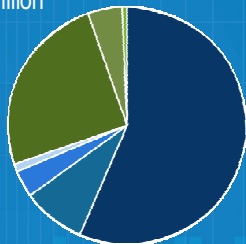
Banks, S&L's, Mutual Savings Banks	\$1,871.2 Billion
Life Insurance Companies	\$289.0 Billion
REIT Unsecured Debt	\$205.7 Billion
Pension Funds	\$43.4 Billion

### Public Debt

Commercial Mortgage Securities	\$741.0 Billion
Government Credit Agencies	\$113.9 Billion
Mortgage REITs	\$26.0 Billion
Public Untraded Funds	\$0.1 Billion

## U.S. Real Estate Debt Investment 2008

\$3,598.7 Billion



### Private Debt

Banks, S&L's, Mutual Savings Banks	\$1,991.2 Billion
Life Insurance Companies	\$314.5 Billion
REIT Unsecured Debt	\$142.5 Billion
Pension Funds	\$10.9 Billion

### Public Debt

Commercial Mortgage Securities	\$921.2 Billion
Government Credit Agencies	\$189.5 Billion
Mortgage REITs	\$18.7 Billion
Public Untraded Funds	\$0.1 Billion



In a perfect world a firm would actually “test the market” and obtain indicative quotes from each type of lending source as they are likely to offer differing terms and financial benefits; moreover, the appetite of individual lenders tends to ebb and flow based on market conditions, lender appetite, and lending volumes achieved that year, so there is no replacement for going out and confirming what the market has to offer. You may be surprised what you find.

By the way, this entire discussion on “facility financing options” has centered on the example of obtaining a senior loan, but the same thought process applies to other occupancy arrangements such as leasing. For example, we recommend you evaluate which type of lease is best and which financial institutions (i.e. developer/investors) are likely to offer terms closest to your liking.

This may all sound like a lot of work – and it is – but unless you do a full exploration of your facility financing options you won’t know if you have achieved the best mix of low occupancy cost, flexibility, asset control, balance sheet and earnings benefits, tax benefits, economic participation, etc. – based upon your project specific objectives.

## 5. For development deals – hiring the developer to perform services and roles that are not needed.

Here is a mistake that we see occur in a majority of biopharma development projects involving a 3<sup>rd</sup> party developer. Usually the tenant/client engages the developer to perform a litany of roles without thinking about which roles are needed and which ones are not. Most developers are happy to provide services or serve in roles for which they are compensated whether or not that service or role is actually necessary. We have encountered this issue ourselves but have come to the conclusion that to preserve long term relationships and repeat customers it makes zero sense to sell services or play a role that the client does not need.

Now you are probably wondering exactly what services and roles to which I am referring. It's often said that a picture is worth a thousand words. With that idea in mind perhaps a picture can best explain this.

## BTS DEVELOPER ROLE (Overview)



1. Own the Project (usually via an spe)
2. Accept Risk
  - During Construction:
    - Completion
    - Cost
    - Schedule
    - Insurance
    - Contracting
    - Financing
  - After Completion:
    - Ownership
    - Re-leasing
    - Obsolescence
3. Invest Equity Capital
4. Arrange Debt Capital
5. Manage the development process

*If 1 or more of 1<sup>st</sup> three true = "at risk"*

*If none of 1<sup>st</sup> three true = "fee developer"*

**CONCLUSION:**  
The role of the developer should be based on client specific goals for each project.

Valuable services but not "at risk"

In most development projects the developer is asked to provide one or more of the five basic roles of a developer. These five roles are: 1) own the project, 2) accept various risks, 3) invest equity capital, 4) arrange debt capital and 5) manage the development process. Now these five roles are often broken down into more specific roles, which may or may not be appropriate for your project, but the bottom line is that the roles a developer will perform will fall into one of these five categories. Once this basic concept is accepted it leads to another interesting observation - roles 1

through 3 are areas where the developer is accepting risk, while roles 4 and 5 involve the providing of a service but entail no risk.

With this understanding it leads one to consider some additional questions. Should you compensate a fee developer the same as a developer that is accepting risk? - of course not. Should you compensate a developer that accepts all possible forms or risk the same as one that merely establishes a single-purpose-entity to serve in an ownership role? – of course not. Should you decide which specific risks you want your developer to accept? – sounds like a good idea. And, should you compensate the developer based on the specific risks it accepts and roles it performs? – again, sounds like a good idea.

The developer should indeed be paid only for the risks accepted and roles actually performed. For development projects owned by a biopharma firm the developer role is usually limited. Even with biopharma development projects that are leased, the tenant usually accepts some of these risks and self performs a portion of these roles. We think it is a disservice to clients to charge for a role or service that is being performed by the tenant/client. This is another very simple idea that is often not considered by biopharma firms when financing their facility, but it is a wise thought process that can save a company substantial sums in development fees. And by the way, if your developer does not follow this philosophy – pay only for risks accepted and roles performed - perhaps it is time you consider a different developer.

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## BIOPHARMA FACILITY FINANCING

### Five Common Mistakes

1. Not obtaining an accurate read on the current capital market environment
2. Not having a “reuse strategy” for the facility
  - Alternative Use
  - Multi-Tenant Capability
  - Multi-Product Capability
3. Not addressing the ownership vs. lease question
4. Not exploring all available facility financing options
5. For development deals - hiring the developer to perform services and roles that are not needed.