LIFE SCIENCES UNVEILED

REITS AS THE LINK TO BIOTECH AND PHARMA INVESTMENTS

Specialized real estate investment trusts (REITs) have the potential to enhance returns and diversify portfolios via exposure to long-term growth trends. This article explores opportunities in the life science specialty sector, which stem from opportunities in the biotechnology ("biotech") and pharmaceutical ("pharma") industries. We also highlight publicly traded life science REITs through which investors can access these investment opportunities.

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INVESTMENTS

Understanding Life Science Real Estate

The tenants of the life science facilities encompass biotech and pharma companies, the most well-known of which include Moderna, Pfizer, Johnson & Johnson, and AstraZeneca. They use these facilities primarily for research and development ("R&D") purposes. These facilities typically consist of laboratories (50-75%) and often include some office space (25-50%) for supportive functions such as administration, accounting, and finance.

Life science facilities tend to thrive in regions where a synergy exists between hospitals, universities, and leading research institutions. Such regions also benefit from the presence of venture capital firms, along with established biotech and pharma companies that often recruit fresh graduates from the local universities to engage in specialized research fields. This combination forms the core of an ecosystem that fosters demand and opportunities for the success of life sciences real estate owners.

In the U.S., key clusters for life science innovation include Boston, San Francisco, and San Diego, while other notable locations include New York, Raleigh-Durham, Austin, suburban Maryland, and Philadelphia. Within these clusters, laboratory and R&D inventory has grown by 47% over the past five years to 181.7 million square feet ("SF") with a record 40.2 million SF of new construction currently underway.[1]

In the U.K., the British government has prioritized science as a top national focus, ensuring its global recognition as a key science hub, with over 6,500 life science businesses.[2] The U.K.'s key life science clusters are Cambridge, Oxford, and London, occupying 1.4 million SF as of 2022, the highest in the past five years.[3]

In Canada, the MarS Discovery District in Toronto is emerging as a promising location for the life science sector. Alexandria (ARE), a leading life science REIT, played a pivotal role in this expansion back in 2007 when they were involved in the growth of the MarS Discovery District. Their recent acquisition of a property at 720 Bay Street from Dream Office in 2023 is seen as a significant development, signaling a potential growing interest from global capital in Toronto as a life science hub.

Reliable Tenant Base

On the real estate side, the cost of interior build-outs in life science facilities is typically shared between tenants and landlords, with tenants also responsible for providing the associated equipment. Since tenants invest substantially in these facilities, they tend to remain in place for extended periods of time. Moreover, life science facilities require less ongoing maintenance compared to traditional office buildings. Despite this, the rents for life science facilities are often higher, making them a lucrative real estate asset.

Market Profile

The market cap for the U.S. life science REIT sector is roughly $17 billion (USD)[4] and the main publicly traded companies with life science facility exposure include the following:

Out of these companies in the U.S., the only purely life science REIT is ARE, while the others have degrees of life science exposure in addition to other asset classes.

With respect to the historical performance, Alexandria Real Estate Equities (ARE), as a proxy for the life science asset class, has comfortably outperformed the EPRA NAREIT United States Total Return Index since ARE's initial public offering (IPO) in May 1997. The annualized total return since IPO for ARE is 10.1%, relative to 7.8% for the EPRA NAREIT U.S. Total Return Index.[5]

We estimate that the U.S. life science REITs are currently trading at an 27% discount to their net asset value per share and at an average implied cap rate of 8%.[6]

In the U.K., there is one publicly traded life science company:

Life Science REIT plc., as a publicly traded asset class, has comfortably outperformed the EPRA UK REIT Index since its IPO at the end of 2021 by over 700 basis points per annum.[7]

We estimate that the U.K. life science REIT is currently trading at an 26% discount to its net asset value per share and at an average implied cap rate of over 6.4%.[6]

Recent Mergers

The world's largest real estate asset manager, Blackstone, has shown a strong interest in the life sciences sector through its acquisition of BioMed Realty ("BioMed"). Back in January 2016, Blackstone took BioMed private and subsequently transformed it into a leading player in the life science sector by focusing on high-growth markets. In October 2020, it sealed a $14.6 billion deal to sell BioMed to a group led by existing investors. The life science sector is also seeing consolidation and mergers among tenants, as large-cap pharma increasingly opts to acquire new drug pipelines instead of developing them internally.

Demand Drivers

Today, many diseases lack cures, leaving room for advancements, as seen for example in weight loss drugs provided by pharma companies Eli Lilly and Novo Nordisk. Life science real estate has witnessed consistent rent growth, primarily serving the biotech and pharma companies on triple-net leases. With increasing demand and institutional interest, these properties are poised for strong asset value growth over the long term.

Within the U.S., as of 2023, the life sciences sector remains steady, driven by substantial R&D spending, ongoing National Institute of Health funding, and total cash reserves held by large-cap pharma companies of approximately $200 billion for growth and mergers. Over the past five years, R&D expenditure has surged by 40%, reaching nearly $154 billion in 2022, surpassing venture capital investment.[1] Government economic incentives are further boosting growth by alleviating operating expenses and capital investments. The life sciences sector also plays a pivotal role in reducing healthcare costs, enhancing quality of life, and fortifying defenses against potential future pandemics.[8]

The U.K. stands as a global leader in scientific research and development within Europe. It is backed by renowned academic institutions, such as the University of Cambridge and the University of Oxford. The U.K. also excels globally as a leader for venture capital funding per capita, with Cambridge taking the top spot, followed by London and Oxford securing positions within the top five.[2] Laboratory vacancies in the U.K. are also at an all time low (0.2% in Cambridge and 2.6% in Oxford)[1] and there is currently a deficit of 21 million SF of new space projected for the coming decade.[3]

The U.K. government has put science high on the national agenda with initiatives such as the largest ever R&D budget of €20 billion by 2025 (+30%), an increase in R&D investment to 2.4% of GDP by 2027, the launch of a €119 million fund for overseas research collaborations, and the launch of a €37 million science and technology framework to boost investment in innovation. The U.K. government is also offering tax relief for companies that

spend more than 40% of total expenditures on R&D and has put forth a proposal to establish an expedited approval procedure for the latest and most advanced pharma and devices.[9]

Despite the favourable long-term outlook, over the next two to three years we anticipate a moderating in tenant demand for life science facilities, driven by rising interest rates and the overhang from the collapse of Silicon Valley Bank earlier this year. This slowdown on the tenant demand side is coming as the supply pipeline for life science facilities remains at record highs, the bulk of which is expected to deliver between now and 2025. As we get closer to 2025, the volume of new supply is expected to drop significantly as the current costs and availability of debt capital remain constrained, while demand is likely to rebound, leading to a positive longer-term outlook for the market.

Where are the risks associated with the sector?

1. Near-Term Supply Risks: The strong fundamentals of the life science sector over the past few years have driven a surge in interest from institutional investors, which has led to a rapid expansion in the under-construction pipeline in major gateway markets. This pipeline is expected to continue delivering through 2025, which will have a near-term impact on market vacancies, rental rates, and rent growth.

2. Potential Slowdown in Funding: Because early-stage life science companies are generally in clinical trials without established revenue streams, they are reliant on external fundraising to make it to key milestones. While fundraising has been plentiful in the past, the collapse of Silicon Valley Bank earlier this year, which was a key player in the West Coast venture capital ecosystem, has pressured new fundraising initiatives. Further pressures have come from the rapid increase in interest rates, which have made safer investments like cash and bonds more attractive than they have been for many years, giving investors a higher hurdle rate to justify committing to riskier venture capital funds. This increase in hurdle rate is translating to lower valuations, a process that takes time to play out. While we ultimately expect venture capital volumes to rebound, we believe the adjustment process will take some time and lead to a near-term slowdown in funding growth, which hampers the ability for earlier-stage life science companies to expand their real estate footprint.

3. Renewed scrutiny on U.S. drug policies: One of the headwinds facing the life science sector includes renewed scrutiny on drug pricing policies in the U.S., with President Biden adopting a relatively hands-off stance. A substantial portion of life science company income is derived from drug sales. Consequently, if there are changes in legislation or a stricter regulatory approach towards drug pricing, it could significantly impede these companies' revenues. This, in turn, poses challenges to their ability to meet critical financial obligations, including rent payments.[10]

4. Regulatory uncertainties: The increasing regulatory uncertainties and complex approval processes in the U.S., particularly delays resulting from more stringent regulations that could potentially impact life science companies, are a growing concern as well. When the U.S. Food and Drug Administration faces challenges in swiftly and effectively approving new drugs, it leads to a backlog in the industry. Prolonged approval timelines not only create logistical difficulties, but also reduce the attractiveness of the life science sector as a real estate investment opportunity.

Conclusion

Investing in life science REITs can be an attractive proposition for investors looking to diversify their real estate portfolio and enhance returns. Despite their associated risks, the life science sector continues to have a robust long-term outlook, with demand driven by the growing need for cutting-edge research facilities to develop new drugs to improve human health. Accordingly, we believe that the current slowdown in market fundamentals has made life science REITs an attractive investment opportunity, offering investors the potential for steady cash flow and long-term growth.

Sources:

1. Bidwells Q4 2022 Research.
2. UK Government Q4 2022 Research.
3. Savills Q4 Research.
4. Data sourced from Bloomberg as of 09/30/2023.
5. Alexandria Real Estate Equities compared to the EPRA NAREIT U.S. Total Return Index; Data sourced from Bloomberg 05/28/1997 – 09/30/2023.
6. Data sourced from Internal Valuations as computed by Hazelview Securities Inc. as of 09/30/2023.
7. U.K. Life Science REIT compared to the EPRA UK REIT Index; Data sourced from Bloomberg as of 12/31/2021 – 09/30/2023.
8. CBRE Research 2023.
9. Cushman & Wakefield Q4 2022 Research.
10. RBC Capital Markets, Equity Research, 04/30/2021.