April 2023

Long-term Investment For Technology and Science (LIFTS) initiative: request for feedback

A submission from the UK Government's Life Sciences Investment Envoy

Introduction

I was appointed as the UK Government's Life Sciences Investment Envoy to support the Government's ambition: to establish a globally competitive life sciences investment ecosystem.

Delivering this ambition is essential to addressing the severe lack of domestic scale-up capital, which acutely affects life science companies, where capital requirements are much greater than other R&D intensive sectors. Success here will not only benefit the UK economy, by giving companies the choice to scale-up in the UK rather than move overseas in search of capital, but also help overcome challenges faced by the NHS and, ultimately, benefit millions of patients. The priorities I have identified for achieving this are inter-dependent:

- **Unlocking UK institutional investment**
  Helping to unlock capital held in the UK's pension funds and directing it towards UK life sciences, removing barriers preventing UK institutional investors (pension funds and insurance companies) from investing in private companies, including through venture capital.
- **Rebuilding the UK life science financing ecosystem**
  Creating a sustainable financing continuum (from seed to public markets) to support companies from proof of concept to clinical development, to market approval and beyond.
- **Offering end-to-end support for UK scale-ups**
  Doing all we can to remove barriers and friction for scale-ups navigating the Life Sciences ecosystem, making their growth trajectory much easier.

Of these three priorities, unlocking capital held in the UK's pension funds and directing it towards UK life sciences is the most pressing, and so I warmly welcome the LIFTS initiative. This initiative has the potential to 'unlock' the financial firepower of the City of London and allow us to create deeper pools of capital for our scaling companies. Without this deeper capital pool, promising UK companies will continue to look overseas when raising scale-up capital, with the risk that they relocate operations and build manufacturing infrastructure outside of the UK.

A significant cultural shift is also needed. After decades of investing in liquid and fixed income assets, many of our institutional investors are less experienced in allocating capital to illiquid investments, and Trustees are wary of the fees associated with investing in this high risk/reward asset class. We need to provide institutions with a "handrail" that guides trustees, advisors and their consultants towards venture capital and appropriate fund structures.

Executive summary

In advance of responding to the LIFTS proposals, I have – along with the UK BioIndustry Association (BIA), which I Chair – prioritised engagement with investors to ensure whichever form LIFTS takes it is attractive to the life sciences and venture capital community and boosts long-term investment in UK life sciences.

As part of this effort, I recently convened a roundtable discussion with specialist life science investors and UK pension/insurance funds, complementing those being convened by the Office for Investment, HM Treasury and Department for Business and Trade, to inform this submission.

In this submission I detail the need for action to unlock pension funds to enable the scale-up of life science companies here in the UK and recommend what course of action would be most effective in the short to medium term to achieve this. While I have developed this submission from a life science perspective, I believe the solution I am proposing would also be beneficial for other venture capital-dependent sectors. I also believe it is complementary and not mutually exclusive with proposals I am aware of being made by financial institutions in the pensions industry and the Lord Mayor of London. In fact, more than one of these initiatives should get Government support.

In summary, I am proposing the LIFTS initiative:

1. Use the majority (c£200m) of capital allocated by Government to seed a privately-run fund of funds that will invest into life sciences and technology venture funds focused on growth/scale up.
2. Seek to build this fund of funds to the scale of £10+ billion with additional capital Local Government Pension Schemes (LGPS) and other financial institutions. Speed is key here, both in building the fund and deploying the capital, as there is immediate need for it in the UK ecosystem, which I estimate to be approximately 120 growth-stage UK life science companies each seeking £100 million or more within the next three years.
3. Use the remaining LIFTS capital to conduct an information and awareness campaign to drive cultural change towards a focus on returns rather than fees within the pensions industry, its advisers and customers (including individual scheme members).
4. Use the fund of funds and British Patient Capital as a proof of concept to demonstrate the viability and prudence of investing in UK-based venture capital funds.
5. <u>Does not</u> seek to subsidise fees or cap returns for government, as this is not politically or financially sustainable nor will it provide a long-term solution to this market failure.

These actions must be complemented by a redoubling of effort to address the structural issues that are impeding the allocation to venture capital by pension schemes, both defined contribution (DC) and defined benefit (DB), including the fiduciary responsibility of Trustees, the prudent person rules, and the myopic focus on achieving low fees at the expense of long-term returns.

The workstream that has been set up by Sir Jonathan Symonds, working with the Treasury, is reviewing many of these issues and should produce its conclusions for the Autumn Statement. The intended consequence of this work is to release capital from different types of institutional investors so that it can flow to innovative companies in the UK that need it for growth. Releasing capital from institutions is the first step. How that capital is deployed is a separate issue that requires a targeted government kickstart but over time is likely to be solved by market forces.

Using LIFTS to create a fund of funds will ensure that there is at least one viable and diversified vehicle already in place and ready to deploy when pension schemes look at the value creation opportunities available to them in the UK's world-leading life sciences and technology industries. LIFTS alone will not unlock the £4.6 trillion[1] currently held in pensions and insurance assets overnight, and other initiatives will be necessary, but it will be a critical first step on this important collective journey.

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[1] https://www.theglobalcity.uk/PositiveWebsite/media/Research-reports/Powerful-Pensions.pdf

The immediate need to unlock pensions to increase the availability of scale-up capital

The UK's R&D-intensive life sciences sector is universally recognised as world-leading, and it delivers great benefits to the economy, the health of the nation, and it is key to the Government's net-zero agenda. From improving patients' lives through new treatments and digital healthcare, to the development of environmentally sustainable technologies – including fossil fuel substitutes, biodegradable bioplastics and the cleaning of polluted waters – our deep understanding of biology is helping to address humankind's greatest challenges.

As the UK life sciences sector matures, access to scale-up capital is critical but there are few sources of this type of capital in the UK, and this is holding back growth and global expansion of UK businesses. Despite record sums being raised by the sector through venture capital and public markets in recent years (although there has been a downturn since mid-2022)[2], the investment is largely coming from overseas investors, which is a vulnerability for our domestic sector and means value is not being captured in the UK. Companies are increasingly looking to the US public markets for capital or being sold to larger business before establishing "sticky" roots in the UK, adding a further pull to move operations across the Atlantic, to the detriment of the UK science base and our economy. We clearly have life sciences companies that can compete for capital on a global stage, but significant domestic investment is notable by its absence, which does not make for a resilient financing ecosystem in the UK.

UK pension schemes, especially those operating in the defined contributions (DC) market, are not investing in these companies. Pension savers should have the opportunity to gain exposure to sectors that will benefit their own and others' health *and* deliver real asset value growth for their savings to provide a comfortable income in retirement. There is an added injustice here, as taxpayers are funding the academic science base on which these innovative industries are being built, but not being given the opportunity to benefit from the financial upside through their state-mandated DC pension. As a result, much of the wealth created by UK companies is being accumulated by overseas investors.

Through my conversations with specialist life science investors, I estimate there to be at least 100 unlisted growth-stage life science companies in the UK that will each need to raise £100 million or more over the next three years. Many of them are in or approaching the clinical phase of product development (the most expensive stage for a life science company's development is when it is investing in human clinical trials) and privately owned. The vast majority of these companies have their entire R&D footprint in the UK and there would be great economic benefit from scaling them in the UK.

There is, therefore, a significant need for the LIFTS initiative and an urgent need for a fund of significant scale to meet immediate demand (c£10 billion to accommodate life sciences and technology opportunities together). We cannot afford to dither, we are in a globally competitive situation and our neighbours are already racing ahead; France is about to launch the second iteration of its Tibi Scheme, the first of which unlocked €6 billion of venture capital for life sciences and technology companies.[3]

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[2] https://biotechfinance.org/

[3] https://www.tresor.economie.gouv.fr/banque-assurance-finance/financing-the-fourth-industrial-revolution

Using LIFTS to create a fund of funds that will finance a diversity of growth capital

Given the immediate need for scale-up capital, I propose the creation of a fund of funds using approximately £200 million of allocated LIFTS funding to seed it thereby enabling the deployment of capital in 2024. This fund of funds would then leverage in further private capital to reach the scale of £10+ billion, within three years, which would have a meaningful impact on the UK financing ecosystem for life sciences and technology companies.

The fund of funds should preferably be evergreen, privately run and able to make decisions quickly without the strict audit requirements placed on other Government investments. However, Government's investment and an appropriate corporate governance structure would provide reassurance that pension trustees are acting prudently when investing in it. The investments made by the new fund of funds vehicle would be predominantly into funds or investment companies that provide growth capital to companies in innovative sectors such as life sciences and technology.

While there was a question related to qualifying investments, if the goal is to leverage in private capital, then strict criteria related to the UK domicile of underlying investments may act as a deterrent to external investment. A better option would be to ensure this capital is allocated to fund managers regulated by the Financial Conduct Authority (FCA) and UK domiciled funds. Not only would this ensure strong regulatory oversight and compliance but also attract talent and expand the investment expertise in the UK. We already have companies that are globally competitive in attracting capital, we should be confident that a growing domestic growth capital ecosystem would look to the opportunities already on its doorstep.

In terms of sources of private funding, this fund of funds vehicle could be a solution for private wealth managers and individuals via investment platforms (including Self-Invested Private Pensions), DC pensions schemes as well as DB pensions schemes. Notwithstanding that the latter two may face issues related to fees, which I address below.

While outside the remit of the LIFTS initiative, if the UK Government wants to have an immediate and significant impact, then the creation of such a fund of funds could be co-ordinated with a decision to mandate LGPS to invest 5% of their assets into UK innovative growth companies. This would unlock a meaningful proportion of the £364 billion[4] held by LGPS to drive business growth across the UK. While some LGPS may have the capabilities to select individual funds (or even companies) themselves, the proposed fund of funds would be a viable and diversified investment option that would meet the criterion of deploying into UK growth sectors.

Nonetheless, the key logic behind the recommendation for a fund of funds to be quickly set up with the LIFTS funding is that there needs to be something in place to meet immediate demand for scale-up capital that is open for business as and when pension funds of different types look to allocate capital as a result of the wider reforms to regulation and culture for the industry.

The fund of funds is not intended to be the only vehicle through which pension funds should or could invest in venture capital; a diversity of approaches, including market-generated ones, will be essential to the creation of a sustainable investment ecosystem in the UK driven by unlocked pension capital. Over time, and based on observations of the evolution of the pension funds industry globally, I would expect pension funds to build internal expertise to select funds themselves and potentially invest in growth companies directly. This would lead to a more market-based solution and reduce the need for the Government to intervene, if at all. However, a

[4] https://www.gov.uk/government/publications/spring-budget-2023

Government-backed catalyst is needed now to address the current market failure and allow time for market-driven forces to work.

Increasing information and awareness of the opportunities for pension savers in venture capital

There is a widely acknowledged cultural problem within the pensions industry (including trustees, advisors and employers) of risk-aversion and an excessive focus on low fees to the detriment of seeking long-term returns from investment in real assets. With inflation now a major problem, there is a growing risk that this culture will result in insufficient retirement incomes for millions of UK citizens. Furthermore, the awareness and expertise required to allocate to venture capital has been eroded from the UK pensions industry due to the length of time it has been withdrawn from this type of investment activity.

Another element of the LIFTS initiative should therefore be to increase the information available to and awareness of asset allocators to “nudge” them towards the long-term benefits of venture capital investment. The British Business Bank has already shown the benefit for a 22-year-old new entrant to a default DC scheme with a 5% allocation to growth equity, who could achieve a 7-12% increase in total retirement savings[5]; and its subsidiary British Patient Capital is leading the way in showing the performance of its own venture capital investments[6].

LIFTS should commission more studies to demonstrate the benefits of investing in venture capital and communication campaigns to deliver these messages to the different decision makers in the pensions supply chain. The fund of funds should itself publish its investments and performance to illustrate the opportunity to other institutional investors.

Another element of the information and awareness campaign could enlist the Canadian and other long-term endowment funds (such as the Wellcome Trust and Novo Holdings) that have already proven the success of investing in venture capital. They should be presented as exemplars to the trustees, advisors and customers of UK pensions, and potentially as mentors for the asset allocators of the pension schemes themselves.

Addressing the fee problem through LIFTS alone may prove difficult

Fund management fees continue to be a barrier to the allocation of pension funds to venture capital. While the Government has made welcome changes to the charge cap related to performance fees, this is still a serious problem that must be addressed. In consultation with investors and industry, I have considered whether LIFTS could be used to cover the management fees for pension funds investing in venture capital.

Given the amount of Government money offered in the LIFTS consultation, I do not believe paying fees for the pensions industry would be politically or financially sustainable or provide a long-term solution to this market failure. A £250 million Government subsidy for management fees would run out, potentially quite quickly, and the pensions industry would maintain its expectation for low fees, which could mean that the flow of capital is quickly curtailed once the subsidy expires.

A similar argument applies to the idea of capped returns for Government. This is simply another subsidy to induce pensions funds to invest in venture capital that does not seem to be required by

[5] https://www.british-business-bank.co.uk/research/the-future-of-dc-pensions-enabling-access-to-venture-capital-and-growth-equity/
[6] https://www.britishpatientcapital.co.uk/annual-reports-and-accounts/

pension fund allocators in other parts of the world (some of whom already invest directly or indirectly into UK-based life sciences and technology companies).

The above-mentioned information campaign should instead seek to address head-on the issue of fees, arguing, as Government has stated[7], that low fees do not necessarily equal good value. It should also seek to demonstrate how investment in venture capital can be done as cost-effectively as possible while still ensuring scheme members can access the best returns possible. Again, this may beyond the remit of LIFTS, but I believe that Government needs to revisit both the fiduciary duty of Trustees and the prudent person rules.

LIFTS needs to co-ordinate with a broader set of initiatives

While I welcome the LIFTS initiative and have made some proposals for how it could be implemented, it is important to ensure that the final LIFTS strategy coordinates with proposals from Government and other interested parties.

For example, the Government is right to encourage consolidation in pension funds. Lessons from Canada and Australia tell us that a level of scale is needed to ensure that allocations to venture capital are economically viable. However, scale can have some drawbacks and it is important to maintain diversity within a financing ecosystem. For example, promoting a single superfund or one large growth fund that invests in companies directly may appear attractive, but such concentration can create a "too big to fail" risk for the ecosystem combined with a lack of resiliency.

Moreover, some of the more sophisticated LGPS already invest in smaller local venture capital funds that are crucial for supporting early-stage businesses. The UK life sciences sector needs a continuum of funding, from seed to public market. We must be careful not to pull the plug on one part of the ecosystem to solve a problem in another. Ensuring small early-stage venture funds continue to operate in the UK is vital. A regional venture funds programme could be part of the fund of funds structure to address this, satisfying the regional interests of the member schemes and the Government's levelling up agenda.

Any policy to persuade institutional investors (pension funds and insurance companies) to allocate capital to UK life sciences companies needs to acknowledge their different investment time frames, risk/reward profiles and regulatory challenges. There is unlikely to be a single solution or policy recommendation that will unlock capital from everyone. That said, LIFTS could play a critical role in catalysing capital from some institutional participants and, as importantly, providing information about the opportunity and benefits of backing the fastest growing companies within the UK life sciences sector.

I am keen to work closely with the Chancellor, Kemi Badenoch, George Freeman and other Ministers and Departments to help the Government's aim to deliver a transformative package of policies, one that will unlock billions for scaling science & tech companies in the coming years to cement the UK's leadership as a science superpower.

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[7] https://www.gov.uk/Government/consultations/value-for-money-a-framework-on-metrics-standards-and-disclosures/value-for-money-a-framework-on-metrics-standards-and-disclosures