LIFTS Secretariat
Business Growth Directorate
Department for Business and Trade
1 Victoria Street
London SW1H 0ET

By email: LIFTS@beis.gov.uk

28 April 2023

Re: Long-term Investment for Technology and Science (LIFTS) initiative – Request for feedback

The BVCA is the industry body and public policy advocate for the private equity and venture capital (PE/VC) industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based PE/VC firms, as well as their professional advisers and investors. Between 2016 and 2020, BVCA members invested over £47bn into around 3,500 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by PE/VC currently employ 1.9 million people in the UK and 90% of the businesses our members invest in are small and medium-sized businesses.

Venture capital and growth equity funds have historically provided diversification and strong returns for various UK and international institutional investors, as an example, the successes of Canadian and Australian schemes investing in alternative asset classes is well known. When comparing the investment performance of the UK private capital industry with public markets, the five-year and ten-year annual returns were 21.1% and 13.9% respectively, compared to the FTSE All-Share, which returned 5.1% and 5.6% to investors over the same respective periods.[1] So, there is a powerful potential for DC pension schemes to improve the retirement outcomes for scheme members through greater allocations to VC & growth capital funds. As well as delivering positive, long-term, investment outcomes for investors, UK-managed VC funds also play a vital role in the growth of the economy.[2]

The BVCA welcomes the engagement on LIFTS and we believe the government has a central role in showing leadership and driving the changes required. We see LIFTS as part of a wider discussion about how to unlock greater institutional investment into UK alternative assets. Consolidation of DC pension funds and other approaches must be taken in the medium term to unlock the capital necessary to transform the outlook for UK funds and the companies they invest in. A key aspect of this, is developing the skills and understanding so UK pension funds and other institutional investors have tools to invest in this asset class.

The UK has one of the strongest ecosystems for early stage investment and companies are supported by a wide range of investors. Angel investors and tax advantaged schemes such as EIS and VCTs play a central role of supporting the start-up ecosystem, and the UK has one of the strongest venture capital markets from early stage to series A. There are areas where the UK can still improve, especially how to increase levels of investment in the regions and nations of the UK, but overall this area is well served and companies can receive the majority of their capital from domestic investors.

It is at the scale-up stage that the financing of these companies transitions to syndicates led by US, Asian and European investment groups. This highlights the gap in UK scale-up investment capital and investment capability. The UK market disfunction at the Series A stage, identified a decade ago, has been pushed back to the scale-up stage. BVCA analysis of Beauhurst data from 2020-21 reveals that over half of 52 Series B growth rounds in UK science and technology companies (ranging from £35m to over £400m) were led by US VCs, while only seven were led by UK investors. Comparable deals in America are 80%-led by US investors.

[1] Performance and Public Market Equivalent Report 2020
[2] Measuring the contribution of PE/VC to the UK economy 2021

Overseas investment is welcome and validates the quality of UK companies and the investment opportunities being created in the UK knowledge-intensive sector. However, it is a concern that the UK lacks a domestic scale-up investment capability in these knowledge-intensive sectors. To realise the government's Science Superpower vision, the UK needs to become world-class at both creating knowledge-intensive companies and scaling them up. Relying on foreign investment to scale up UK companies exposes the UK to geopolitical risk and fluctuations in global capital allocations. It also prevents the UK from growing a generation of investment managers experienced in scaling knowledge-intensive businesses.

What we propose as part of LIFTs is twofold. Firstly, we argue that there must be a programme to help UK pension schemes (principally DC but also potentially DB) better understand this asset class and give them the confidence to invest in the near future (which complements ongoing government and industry discussions around "value for money" in the DC sector). The second is the creation of a government-supported fund of funds, which will use the £250m set aside by the government to help catalyse investment in this area. We believe that a fund of funds structure will help DC schemes to invest by allowing them to partner with expertise in illiquid fund management and VC manager selection and delivering greater diversification and realisation of returns faster in the fund cycle. The fund of funds should have an ambitious fundraising target, starting at £2.5bn, that can invest in VC and growth funds of sufficient scale, which will also provide the most support to UK science and technology companies.

We believe that the best way to invest and scale UK science & technology companies is to create larger VC funds who can support companies in the later stages of their growth journeys. The need for investment in the strategic sectors that the government has identified, such as life sciences, clean tech, deeptech and others, is great, and the overall quantum of capital required is far greater than what LIFTS can ultimately provide. The type of fund vehicle that we propose in this document is just part of the solution and should be seen as a catalyst that will allow more funds to be deployed in this space. We also note that there remain challenges around fees and liquidity that need to be considered further in discussion with DC trustees and their advisers. The government should consult on further measures that will allow the quantum of capital required to truly make a difference to allow UK companies to access the funds they need to create truly global businesses.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Chris Elphick and Tom Taylor).

Yours sincerely,

Michael

Michael Moore

Director-General, BVCA

BVCA responses to specific questions

Q1: In your view, will the options for delivery be effective in achieving the LIFTS objectives? Please outline any adjustments to these options that you believe would increase their effectiveness.

As identified by the Productive Finance Working Group, the barriers that UK DC schemes in particular face when considering whether and how to invest in venture and growth capital include risk, cost, lack of skills and networks, liquidity, and lack of scale. The proposals from the BVCA will help address these areas and provide value for money to the taxpayer. The BVCA proposal outlined below is intended to allow DC pensions to get a foothold in this asset class with government support and then gain the expertise and returns so that they can continue to invest in private capital without government support.

The first two options outlined in the request for feedback, investment collaboration and information exchange & pari passu co-investment, would not create the quantum of capital required with the £250m provided by the government to make a substantial difference in funds that invest at the scale-up phase. It is our understanding that the capped returns outlined in option 3 are less appealing to pension funds who are more concerned with the initial costs and fees involved with investment in VC and growth funds.

The fee offset mechanism described in option 4 could play a role in the LIFTS scheme, but would require careful consideration. There is a risk that this could create a system where further funds are required to support such a scheme which in the medium-long term would be undesirable. Our preferred outcome is for a fund that would not require such an offset mechanism, as the money would be put to better use by investing it directly in the new vehicle to crowd in additional investment from institutional investors, which would also seek to generate returns for the taxpayer, rather than being a sunk cost.

Q2: Which option, or combination of options, would your organisation be most interested in if you were to put forward or support a proposal in due course?

(i) Support DC pension schemes and upskill CIOs to understand VC and growth capital market

One of the most important immediate needs is to support DC & DB pension schemes to better understand venture and growth capital and vice versa, so the government needs to help develop the understanding and networks required to begin a program of private capital fund investing (initially via a fund of funds structure as described below). After decades of investing in liquid and fixed income assets, many UK 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. Unlocking capital from this sector will require knowledge, networks and an appropriate risk appetite to the growth and scaleup economy.

We believe that the government can play in important role in developing these, for example by bringing together sophisticated pension funds who already successfully deploy money in this sector, and supporting pension funds to develop in house expertise The aim would also be to equip them better for more sophisticated upstream communications with employers and beneficiaries about the need to consider fees in the broader context of potential returns/value. As part of the LIFTS framework, a national programme to help implement this could be carried out before the end of 2023. We understand that several DC pension funds are looking to develop their understanding and hire teams, but would not be ready for a number of years. A development programme led by the government would help bring this forward and allow them to invest much earlier. A parallel programme to help VC and growth funds understand the requirements of DC pension funds could also be considered.

(ii) New fund of funds vehicle for knowledge-intensive scale-ups

Funds of funds have historically been seen by various types of institutional investor around the world as a potential route in to the asset class. Their participation in such structures can be a sensible place to start building a program of private capital fund investments because it reduces risk through greater diversification, whilst helping the investor to start building expertise and relationships required eventually to "go it alone" by investing directly into private capital funds. They can also help to provide access to the best VC funds that inexperienced investors may not be able to access.

The creation of a targeted fund of fund to stimulate the growth of scale-up investment capabilities in knowledge-intensive sectors would be the easiest way to allow DC pension funds to quickly bridge any gaps in knowledge/expertise. This fund of fund would draw in LP commitments from UK DC and potentially DB pension funds to create a £2.5bn plus fund of funds that will invest in funds managed by existing venture and growth firms active in knowledge-intensive sectors that are raising scale-up investments funds (growth funds, opportunity funds etc.) as well as providing secondary fund opportunities. It would generally look to target investment in larger VC and growth capital funds of £300m and upwards. The fund should also be open to DB schemes (e.g. LGPS), who do not face the same liquidity and regulatory hurdles faced by DC schemes and could help the fund of funds reach scale. LGPS funds may also be more likely to seek funds that invest locally as part of their remit.

There are a number of ways the £250m put forward by the government could be used to help set up a fund of funds and catalyse investment by DC/DB pension funds, and the optimal solution may be a combination of several of these options:

1. Use as seed capital to allow the fund, which could be evergreen, to acquire an initial portfolio of more mature venture capital fund interests via secondary transactions. This could generate early returns (initially for the taxpayer), resolve concerns around the "J-curve" and quickly demonstrate proof of concept to DC schemes prior to them investing alongside the government.

2. Provide 'cornerstone' capital (e.g. 10% of the overall fund) that would encourage DC schemes to join the fund as investors alongside the taxpayer, potentially on different terms. For example, the government could shoulder a greater portion of the costs in order to assuage concerns about fee loads for pension schemes.

3. For a fixed period the funds could be used as part of a fee offset mechanism to allow more DC pension funds to invest.

4. Cover the costs of creating the fund and offset the management fee for a fixed period until returns are generated early in the fund life cycle in the secondary fund market.

An "evergreen" fund of funds structure should be considered for this vehicle, which would not have a fixed year term that would necessitate the assets being liquidated by this end point, and distributions can be reinvested thereby growing the pot of capital to invest in the VC space indefinitely. It also aligns with the long-term nature of venture capital investment.

The manager to run this fund-of-funds would be considered as part of the call for proposals and with adequate support could potentially deploy in early 2024. The government should bear in mind a range of options and identify which will unlock the most capital from DC and DB pension funds. VC and growth funds that receive backing through the fund of funds would agree to the criteria outlined below. Managers would also commit to prioritising the recruitment and development of UK-based, scale-up investment teams, consistent with the diversity goals of British Business Bank.

Q3: Do you agree that a requirement to invest at least 50% of the proposed fund or structure into qualifying investments would be a suitable minimum threshold for proposals? If not, what alternative threshold would you propose that would achieve sufficient focus on UK science and technology companies?

We believe that the definition of qualifying investments including R&D intensive companies is too restrictive. It would also be very challenging to track the % of assets that meet the criteria across a highly diversified pool of assets. The requirements for R&D spending, intellectual property and research requirements are too narrow and would be difficult for VC and growth funds to agree to these restrictions at the time of investing capital with them, in particular given the need to secure capital commitments from other LP investors without such requirements. Ideally the definition would be significantly relaxed. We note the experience of the EU's ELTIF vehicle in this regard, which was established with too restrictive investment criteria that the EU has recently widened to counter a relative lack of adoption.

A principles-based solution for UK based fund managers would be preferable to a defined target based approach, and we have made suggestions on this in our answer to Q4 below

Q4: Do you agree with the proposed definition of qualifying investments? If not, what alternative definition would you propose that would achieve sufficient focus on UK science and technology companies?

Again, these definitions should be made less onerous as VC and growth funds would not be able to introduce contractual restrictions that limit the types of investments the funds they manage can make, whilst also acting in the best interests of their broader investor base. Again, we would argue for a principles based approach and suggest any fund of funds vehicle established under the LIFTS program should aim to agree the following criteria with the underlying VC and growth fund managers in whose funds it invests:

"The fund must employ reasonable efforts to invest predominantly in companies that: (i) are incorporated in the UK with significant UK operations; (ii) invest in R&D spending and are developing defensible intellectual property in the UK; and (iii) carry out research and hire employees in roles that require a relevant master's degree or higher."

Q5: How likely is your organisation to put forward a proposal in due course, either individually or in collaboration with others? If relevant, please summarise any changes that would make your participation more likely.

We understand that BVCA members will be making proposals and the BVCA is happy to support this process.