Pension plans dally with biotech

Plans for a $75-million fund specializing in biotech private equity—the IB Australian Biosciences Fund—was announced by the Australian arm of international advisory and funds management group Intersuisse and London-based boutique investment firm Bioscience Managers on March 21, 2006. The money is to be raised over the next six months and funded by pensions. Pension managers have been reluctant to invest huge sums of money in biotech private equity, but may be warming up to the idea that the high rewards that come from investing in mid-stage biotech companies may justify the high risk these investments typically entail. That change in attitude could become a boon for early-stage biotech companies that don't have other sources of financing—especially in countries like Australia or Canada.

In September 2005, the state of Victoria, one of the regional biotech capitals in Australia, scuttled proposals that would have earmarked up to 0.5% of state pension contributions towards investment in biotech. However, even in the absence of this state support, the higher-than-average returns on investment, combined with a strategy to control risk, could be a new carrot that compels pension managers to invest in private equity in the biotech sector.

In Australia, returns on traditional investments like the Australian stock exchange are generally smaller than in the US, for example. The IB fund managers offer a unique approach, not tried before in Australia. According to its promoters, the new fund takes some of the risk out of investing in biotech by investing only in mid-stage biotech firms "at or near clinical development" where the risk of failure has already been greatly discounted through R&D, thus addressing the biggest objection by pension managers to investing in biotech private equity.

The Australian fund is a follow-up to the BML Maple Leaf Fund, which was funded by the Ontario Teacher's Pension Fund last year. The Bioscience Managers Maple Leaf Fund uses the same investment approach as the Australian fund. It acts as a lead investor in syndicated investment rounds of ~$20–$30 million. Its sole investor is Teachers' Private Capital, one of the largest private equity investors in Canada, with $6 billion in private equity assets.

In Australia and Canada it is much harder to find funding for private equity than it is in the US, even for companies that have had some successes. Consequently, the ability of pension funds to invest in venture capital has an added attraction in those countries. In the US, though, the attraction of private equity is purely return driven for pension managers. This is especially true as US pension managers deal with underfunded pension plans that need higher returns to stay solvent.

S. Daniel Marsula/Pittsburgh Post-Gazette/NewsCom

Pension plan managers are still reluctant to invest in biotech

In late April the US Congress continued to wrangle over the details of a bill that would force companies to better keep promises to fund private pension plan obligations. The House estimates that these plans may be underfunded by as much as $450 billion. A whole host of companies, including General Motors and IBM have announced that they are freezing or phasing out participation in defined benefit pension plans in favor of voluntary contribution plans known as 401ks. The problem is not just localized in the US either. In April, the UK's British Broadcasting Corporation also announced that it was closing its pension plan to new entrants while raising retirement age.

According to Shashi Mehrotra, chief investment officer for Legend Group in Boca Raton, Florida, manager of a pension plan with $2 billion in assets, the unusually high general market returns in the 1990s caused pension and benefit managers to promise inflated benefits thinking that the higher returns would go on forever. In addition, demographic trends mean fewer workers contributing to pension plans that will have to support a great number of retirees. Consequently pension managers are turning to alternatives to the stock market including hedge funds and venture capital to boost returns.

"This issue of investing in biotech venture capital is driven by defined benefit plans not having enough money to pay out what they have promised," Mehrotra stated while adding that his company does invest in public biotech companies and eschews venture capital of all types. Greenwich Associates, in the cover note of a report studying pension plans for 2005 that was released in April, was more upbeat: "[P]ension plan sponsors are taking several ambitious steps to improve their funding situations, including shifting assets into…alternative asset classes including…private equity." That means that pension managers will probably make more money available to biotech companies looking for private equity investors.

"Historically, 25% or more of all funds in the venture capital area come from private pension funds," explains Tracy Lefteroff, Global Managing Partner for Life Sciences at PricewaterhouseCooper, in San Jose, California. He believes, however, that the amount of money going into biotech venture capital from pension funds is now decreasing. Rising stock market prices in the overall market could be behind the slowdown.

Mehrotra, however, believes that any amount of money invested in biotech venture capital is too much. "I wouldn't invest someone's life savings in something that had that much risk. It's the wrong use of other people's money," he says. Matt McNamara, general manager of the IB Australia Fund disagrees, saying that IB's management system can take much of the risk out of investing in biotech companies by only investing in mid-stage biotech companies. "When you invest in companies in clinical or near clinical development, you've taken much of the risk out of the equation," IB's general manager concludes. In either case, Lefteroff says that private equity still makes up <5% of pension plans' overall holdings in the US.

With the strong regional affiliations of many pension plans, especially state-sponsored plans, and with many states already offering incentives to help incubate bioclusters, it may not be long before pension plans, politicians and venture companies hook up with the promise of regional economic growth to make this type of investing acceptable.

For regional governments, like those in Australia, where funding for private equity is scarce, it offers the ability to pare down the amount of tax money thrown to bioclusters and replaces it with private, although often state-sponsored, pension investment dollars and promises a return on investment. However, for those biotech companies thinking that pension plans offer an Aladdin's lamp solution to their funding problems, the reality is that the biotech industry is still a tough sell to pension managers who must always account for risk first.

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