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RPM Ep 7 Transcript

GS: You’re listening to RPM, the podcast that explores the world of private markets. I’m your host Graziella Scassillo and it is my pleasure to have here with me today, Bhavika Vyàs, Managing Director and member of the Responsible Investing Team at StepStone. Before joining StepStone in 2020, Bhavika worked at such esteemed investment shops including Goldman Sachs (which included some time in Imprint Capital Advisors Team), Bain Capital, Siguler Guff, East Rock, and Acumen Fund and Velocitas where she had Impact Investing roles. She will discuss with us Impact Investing, one of the hottest trends in financial services today. We are going to delve a bit deeper into this trend to understand the drivers and where we are seeing the most interesting investment opportunities. Bhavika, welcome to RPM.

BV: Thank you for having me, Graziella. It's great to speak with you.

GS: So Bhavika, Impact Investing, along with ESG is one of those terms that gets thrown around a lot, and that many people take to be synonymous with Corporate Social Responsibility, ESG, Responsible Investment. So, briefly, could you please define Impact Investing as we as a Firm use it?

BV: As Suzanne Tavill spoke about on the last podcast, our Responsible Investing work at Stepstone encompasses both ESG integration and Impact Investing. For us we believe very strongly that proper evaluation of ESG factors, both positive and negative, is vital to making sound investment decisions, and so now it's integrated into everything we do across the Firm. On the impact side, we've been working with a number of clients who want to build more focused portfolios targeting specific social or environmental impacts that could include, for example, climate change or improving health outcomes or diversity. In order to better clarify and define our clients’ focus areas, we've created internally here, at Stepstone, an *impact taxonomy*, and we use that to map what we consider to be the most investable themes today. So, we've mapped hundreds of funds actually across five themes that we think are really achieving both really strong environmental or social impact, but also strong financial returns. And for us, those include energy transition, natural capital, health, sustainable communities and empowerment. Within each of these, we also further define specific areas where we see the greatest potential for these simultaneous return and impact outcomes. And so, this taxonomy that we've developed really enables us to better target and come up with perspective pipelines for client portfolios that are looking to have specific types of impact.

GS: Really interesting. I have read that in 2020 according to Morningstar, public ESG funds ballooned, amassing more than 50 billion dollars in 2020, double what they raised in 2019. While public ESG funds certainly capture headlines, the private impact market has grown and diversified substantially over the last 10 - 15 years to north of 400 billion dollars in assets under management today.

BV: One of the things that's really interesting about the private investment market, particularly in impact, is that investors have the unique ability to influence both financial and non-financial impact outcomes, partly because they're more concentrated, in terms of their positions in the companies and investments, and because they're very active investors. And so, we think it's a really unique situation for private investors when they're looking to have strong impact. It's part of the reason that both we at Stepstone and our clients are really intrigued by the opportunity set across all the private asset classes that we work in.

GS: It would be great to talk a bit about how we are seeing investor appetite changing and why. In recent times we have seen a shift in perspective, overall among younger people. I'm thinking about Millennials for example…

BV: Yes, we agree. We're definitely observing that generational shift. I think we saw a lot of that last year with the level of activism in the US, particularly around social injustice in the Black Lives Matter movement. And I think that's just one example of exactly that sentiment among Millennials that you're describing. It is a big factor in what's driving the interest and impact as well. Right now, there's a 30 trillion dollar intergenerational wealth transfer happening to Millennials, and that's definitely part of what's driving this change. As you said, Millennials are very focused on how to align their values with where they put their capital. We've also seen Millennials consider this in their own consumer and employment decisions. You know, we see them trying to make a difference both with their dollars, whether it's investment dollars or spending dollars, but also in where they spend their time and where they work.

GS: So Bhavika, speaking about investors, how has their critical thinking changed about their fiduciary responsibility and their ability to contribute to global solution? In other words, as a Managing Director at StepStone, what reactions have you seen to the evolution of Impact Investing?

BV: Yeah, it's been really gratifying to see. As you note, we've seen institutional investors moving in this direction, also. It's driven by a lot of different factors. So, their stakeholders care about these issues, whether it be their Millennials stakeholders or if they're representing a union or a pension. There are a number of groups that could care about all of these global issues. And the investment opportunity set within impact is now deeper and broader than it's ever been before. You know, as one example, in cleantech, the movement of green technologies down the cost curve, whether it's solar panels or batteries, is really driving a lot of business models that maybe weren't financially sustainable before to be financially sustainable and viable businesses. Similarly, we've seen consumer demand also shift. We talked a little bit about Millennials and how they're shifting, but in general, buyers are incorporating some of these considerations much more into their buying decisions, whether it's things like environmental impact of the products they're buying, whether it's the supply chain and issues like modern slavery or how sustainable a supply chain is or issues like health and well-being. And so, this is partly driven by the fact that information is much more available to consumers. Companies have been increasingly providing disclosure on these issues publicly and really using it as a way to distinguish themselves in the market and in their marketing. An example of this, that we've been spending some time on and that we observe, is the alternative meats or plant-based food sector. We've all heard of companies like Beyond Meat, and there's another company that I'm a personal consumer of, Oatly, which is a dairy substitute, which is slated to IPO soon. And the interest in that is driven both by health consciousness but also environmental consciousness by consumers. And so, we're seeing this broader shift across the market as well. All of this is increasing not just the interest in the impact base, but also the opportunity set. It proves that there is an exit environment or an exit opportunity set for these types of businesses. And it means that investors, institutional investors as well, realize that there doesn't need to be a trade-off between your fiduciary responsibility and having both social and environmental impact. The other factor that I would just mention is there's been a lot written about the data and the studies around the investment benefits of integrating ESG factors into your investment considerations in the public markets. We've certainly seen that play out and I think folks are much more comfortable in acknowledging that that is the case. But on the private side as well, there's an increasing body of evidence that there are private impact investments that can achieve both market returns as well as simultaneous impact. And a number of things are in the works right now: everything from increasing regulation to increasing disclosure requirements to investors signing up for the same standards and frameworks.

And all of these trends are sort of supporting and increasing the consistency of impact investing products, increasing the transparency and making the asset class much more investable than it's been before. And I think that is driving institutional investors as well as to think about this is a real opportunity set.

GS: So, Bhavika I know we at Stepstone have a due diligence process in place for aligning our approach with the main frameworks of Impact Investing, right?

BV: Yes. Yes, we do. I think what I mentioned in your last question around. The biggest focus today across the Impact Investment community is really around coalescing around standards and frameworks. And it's similar to, frankly, what we saw happened in the traditional investment community in the early 20th century where people were coming together around financial reporting. Similarly, the Impact Investing community is coming around, and is sort of coalescing around a few different standards and frameworks that we are also adopting because we want to make sure we're consistent in being aligned with the best practices out there. Within that group, some of the leading groups include the UN Principles for Responsible Investing, which is a group of investors of different types, including direct investors like our GPs and groups like us, who are signatories to really express a commitment to increasingly integrating responsible investing to what they do. We signed on to become a signatory in 2013 and so since then have been increasingly driving our work on the ESG integration side. In addition to this, the Impact Management Project and the IFC [International Finance Corporation] has come out with a newly issued set of operating principles which focus even more in depth about around how you integrate impact evaluation into your investment decision making and your management of assets after you've invested. And so, we've sought to be aligned in our processes and to evaluate the managers we work with in a way that's consistent with those as well. And the other factor that I mentioned in terms of Impact Investing, that is very important and maybe a little bit somewhat unique to Impact: it's very important, in addition to measuring and tracking your financial performance, to also measure and track your impact performance. And that's an area where, you know, investors are continuing to develop and get up to speed and develop consistency around. And so, on the metrics side of the work that's being done in the space, the Global Impact Investing Network has created, it's been in development for some time, a metrics catalogue that's called IRIS (or IRIS+ today), and it's really a database enabling investors to think about the best metrics to track, based on the theme you might be investing in. So whether it's education or health care, you might track different metrics in terms of, say, student served or patients impacted. And then even further to that, there's an initiative going on across that is coming out of Harvard, but also supported by a number of other institutions called the Impact Weighted Accounts Initiative. And it's an initiative to really integrate into single metrics, both positive and negative impacts. It's an initiative that's in process, but it's very interesting. It's really to trying to create a single metric that gives investors a sense of the net positive or negative impact of your investment. So, we're trying to stay abreast of all of these new frameworks that are coming up and we've tried to align our own, as you said, tools and processes to these main frameworks, so that we can be ahead of the curve as things continue to evolve in the space.

GS: That's great. Moving now particularly to the Venture and Growth Market, so, you've mentioned before green tech…personally, I'm really fascinated by breakthrough technologies and big steps for humanity. Recently I've read about Bill Gates investing again in cleantech…it is actually very unusual to hear about climate tech and the fact that they're not only helping just the environment, but they're also moving down the cost curve. So, Bhavika what are your thoughts about this?

BV: As you note, the technology evolution and then also regulatory frameworks that are supporting this evolution towards a more green economy have led many to reconsider the opportunity set today in climate tech, which folks distinguish from cleantech partly because of what happened in kind of the cleantech 1.0 timeframe. I think as we look back thinking to what happened then, Venture and Growth managers took, back then, substantial technology risk. Climate tech today is really fundamentally different, it spans the risk spectrum. It includes a range of enabling technologies that support that inevitable transition that we touched on to a greener economy, globally. And there's some really potentially game changing emerging technologies like green hydrogen or carbon capture that I think can really change the game and offer really interesting, unique opportunities for venture investors. And then, as you mentioned, you know, there are groups like Gates and others who are supporting even the development of those technologies. I would also note that this evolution of climate tech also includes asset light businesses, which seek to improve the emission profiles of sectors that are already the biggest emissions contributors. Climate tech venture grew at nearly five times the rate of the overall global and venture market between 2013 and 2019. And then we've also seen, as we've observed, the rise in SPAC activity generally in the private markets. We've seen a large number of the SPACs actually dedicated to clean energy or new energy themes. And so, I say that to say that there's support both from a regulatory standpoint, both from a fundamental technology standpoint, but also the exit markets seem to be really ripe and interested and the public markets seem to be really ripe and interested in this theme. But I would also note that we see interest in this area across all of our asset classes, actually. When I say this area, I mean, the energy transition theme broadly. The renewables projects comprise the majority of new power construction going forward. And so, infrastructure opportunities are continuing in renewable development's energy storage, grid management. The lower battery costs, that have actually been driven by the growth in consumer electronics, have made things like electronic vehicles more cost competitive. And then, on the other side, we're also seeing real estate investors seeing the benefits of owning green or LEED certified assets both from the actual cost savings in their operations, but also at exit with increased valuations. And so, for us, the climate change theme, as we talk to clients about it, actually spans multiple asset classes, and it's making the opportunity set even more interesting for our client base because they can tailor and really create portfolios that fit their own risk return objectives.

GS: Bhavika, I imagine there are also challenges presented by Impact Investing though. If any, which are the solutions that Stepstone suggests?

BV: Yes, for sure Graziella, there are a number of challenges that private impact investors have to navigate. Many of them are actually not unique to Impact Investing, but just unique to any asset class that is more emerging. One of them being is that there's a bit of a bifurcation in the market today. There's a large number of smaller, more specialized investment firms that have grown over time in the Impact Investing market. Many of them have really deep experience in the themes or sectors that they're focused on, but they've tended to be below 500 million, often below 300 million in terms of fund size and often have developing but more unrealized track records. And for these firms, we tend to have a much more tailored approach to diligence and evaluating peer group comparisons. It's something we've done a lot of at Stepstone in terms of evaluating emerging managers, and so, we adapt our diligence to be appropriate for those types of groups. At the other end of the spectrum, over the last five to seven years, we've seen a number of traditional private asset managers move into the space, including groups like TPG, KKR, Bain Capital, Apollo, Carlyle. It's really a testament to the fact that they're seeing both the financial and impact opportunity set emerging and growing, and here we spend a lot of time evaluating the team's impact credentials, their authenticity. And then in any situation where we're looking at a new strategy on a broader platform, we look at issues of governance, alignment, commitment to the impact business.

Generally, investors categorize these issues or potentially these issues as impact washing or green washing. And it's something we're very focused on as we evaluate some of these newer but larger experienced groups that are moving into impact. So, we seek to tailor our diligence, we also, as I mentioned earlier, use our impact taxonomy to define for clients where the pipeline fits within the impact goals they're looking to have. It's a pretty developed taxonomy that we use to track all of our managers across the board, across asset classes. We are tracking now today north of 600 funds using the taxonomy. And so, it's a great tool for defining the impact universe and enables us to really build pipelines that are tailored for a client's impact and risk return goals.

GS: Now Bhavika, I'm pretty sure you've had numerous discussions with our impact clients. Would you share with us what sorts of areas they are the most interested in and is there any evidence to suggest that they're more geared towards things that will fall under “planet” category, let’s say?

BV: We've observed two areas of greatest interest among the clients that we've been talking to recently. The first, as you mentioned, is climate change. And clients do define it in different ways. As I mentioned, some clients may be looking to stay entirely away from dirty industries. Others may look at those industries as an opportunity, if they can invest in technologies that help to reduce their emissions profile. So, we work with clients to really tailor, define, what they're looking at in climate. The other area that we're seeing a great deal of interest in, and I think partly this is driven by a lot of what we saw happening around the world, around social injustice, and bringing that back into focus is diversity. And it's an area that we've tried to define pretty clearly what we mean. I think this is a topic in which we work very actively with clients to ensure that we're defining and clearly allocating based on what they mean by diversity. But it's become a much more, it's become a very big area of interest for our clients, and I think partly that's also supported by the fact that there is more data also showing that the performance of diverse managers or investment in businesses that are managed by diverse management teams actually have strong performance, and I think that that fact is being appreciated by investors, and so that combined with a lot of what we saw happening in 2019, 2020, is leading a number of investors to think more about building portfolios focused on diversity.

GS: And so finally, Bhavika, we often like to end these episodes asking its guests to share a bit about themselves and how they wound up the way they are today. So, what are some of your experiences that led you down the path of Impact Investing?

BV: So happy to talk about that. My journey has really been about merging two areas that I've been personally very interested in. My family is originally from India. I was born there, so growing up, I've been very aware of the challenges that, you know, the bottom of the pyramid faces and that particularly emerging economies face. I started on this path actually when I was in college, and I got involved in a few volunteer initiatives to help fund both critical infrastructure and education projects in India and then in Pakistan. And it was very, very gratifying work, but many of them weren't reaching the scale or sustainability, where they could continue to operate without financial support, and so it was it was great to be providing grand capital at that time to these initiatives. You could see the impact they were having, but I was constantly wrestling with this idea that they weren't financially sustainable and how to actually see if we could find models that would be. At the same time, I had a real interest in private investing and so soon, and I soon realized as I continued to work in private equity that there was an opportunity to bring these two interests together. In the mid 2000s, I actually spent several years working at one of the more pioneering GP's in the space that's focused on funding financially sustainable water and sanitation projects.

At the time, the organization, which is expanded significantly now, was focused in East Africa, South Africa and Southeast Asia and really focused on projects that provide goods and services to individuals making less than two dollars a day. And what really drew me to this organization was that everything that we did was built on the belief that there was an underserved market of real consumers. And if you could deliver the right products and services to them, you could create a real business that was serving that consumer base. And so, we were making traditional debt and equity investments and really working with those investors to put them on a path to financial sustainability. And so, the work was not meant to be charitable or concessionary, but we did also provide a high level of engagement and technical support to the businesses we were investing in, to ensure that they could achieve the level of financial sustainability that they needed for our investment to be a traditional investment. I've continued over time to develop these two interests of mine in parallel. So, you know, in my career, which has been quite actively on the private equity side, and then various parts of my career and in my personal time in the development space. And so, I'm honestly very excited to see where Impact Investing has come to today, both in terms of depth and breadth. I think, as we've talked about, there's a wider acceptance by investors that you can have both impact and financial goals that are aligned and achieve simultaneously, something I believed for a long time. So, I'm happy to see others come around to that. And we're seeing a greater than ever number of investment options. And so, for me, it's it feels like there's an interesting tipping point for impact. And so, I'm very excited to be part of it at this moment.

GS: That's great. Thank you Bhavika for being with us today.

BV: Thank you. Great to speak with you.

GS That does it for this episode of RPM. Stay tuned for new episodes every few weeks, and please be sure to follow us on Apple Podcasts, Spotify, Stitcher, or wherever you get your podcasts. If you enjoyed this episode, head to www.stepstonegroup.com where you can find all our research on ESG, Responsible and Impact Investing.