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RPM Ep 9 Transcript

GS: What are StepStone current market views on inflation and interest rates? Welcome to RPM, the podcast that explores the world of private markets. I'm your host Graziella Scassillo and today, here with me to discuss this topic, Tom Keck, StepStone partner and head of research and portfolio management. Hi, Tom. Thank you for joining us today.

TK: Hi, Graziella. Great to see you.

GS: So, Tom, I would love to start this podcast by giving our listeners a StepStone view on inflation, particularly in the current environment.

TK: It's certainly very much on investors' minds. We've been thinking about inflation for over 10 years now, given the very expansionary monetary policies that central banks have been pursuing coming out of the global financial crisis. On top of that, you think about the fiscal policies that governments have put in place since Covid happened, and it really looks like inflation could take off pretty dramatically. And we've seen over the past few months some very high inflation numbers coming out that look pretty scary. I understand why investors are concerned about inflation, but again, this is something that we've been concerned about for years and we've been positioning our portfolios to handle. I think some of the readings that we're seeing come through on CPI are temporarily inflated and are really driven by the rebound coming out of Covid, as economies reopen. So, we think that these disruptions are going to be short-lived and that inflation is not something that you should dramatically change how you're building your portfolio today. And I think the bond market agrees with us. Certainly, if you look at the US 10 year over the just the past three weeks, it's come down 30 basis points from about 1.50 to about 1.20. So, you know, the bond market does not seem to be concerned about long term inflation at this point.

GS: And at this point, I would elaborate maybe a little bit on how is StepStone positioned and prepared for all of this.

TK: Yeah. So, as we thought about inflation coming into our portfolios and we obviously build private market portfolios across a variety of asset classes. So, we really focused on real estate, infrastructure and private debt as ways to position our portfolios for the potential for inflation. So, this is something we've been working on for a while. If you think about infrastructure, for example, many infrastructure revenue models have explicit inflation-linked features, so that revenues increase with the CPI, and that can provide a really nice hedge in a portfolio. Real estate rents work in a similar way, not as directly linked, but they tend to increase as inflation increases. And so having exposure to office and residential types of assets can provide some protection to a portfolio. And then on the private debt side, most of the instruments that we invest in on the private debt side have a floating rate feature. So as interest rates increase, the return on those assets increases. And so that features a nice hedge for a portfolio. On the equity side, we think about private equities. It's the same in the public markets. If you pick good companies that have pricing power, they're going to be able to pass through the cost of inflation and there's protection there. So, as we've built out our private equity portfolio, we've really tried to focus on businesses that have the ability to pass through any input increases that they might have. So, you know, as we thought about building out these portfolios, we focused on elements that are inherent in the types of assets that we're choosing, but also focusing on assets that are going to do better in an inflationary environment.

GS: Yeah. Now, Tom, we all know that with the economic recovery, there are always risks and opportunities. Would you please describe some of them? In other words, what should we expect next?

TK: Well, there's certainly going to be risks and opportunities. Inflation is obviously a risk to guard against, but there's going to be a lot of opportunities and across the different sectors that we invest in. Seeing the sectors that were hardest hit by Covid come back is an area of great interest for us. We have a lot of dry powder, so we have a lot of ability to deploy capital into areas where the relative value is higher. In the private equity space that could be investing into leisure-oriented businesses or travel-oriented businesses. On the real estate side, hotels were hit quite hard, and so that could be an area to find some value. Infrastructure, airports and toll roads got hit particularly hard. So, I think all those are areas where there could be pockets of value. Obviously, there's going to be some concern about how the economy recovers. So, office space in real estate, for example: I'm speaking to you today from my office, but we definitely don't have as many people here as we would normally have. And I think in many regions, we haven't seen whether this work-from-home trend that was forced on us by Covid will continue or if people come back to the office because they're tired of sitting at home in their pajamas. Same thing with restaurants. We've all gotten used to ordering food in and eating at home. So, are people going to go back to restaurants? Are they going to go back to the movie theaters? These are questions that we don't know the answer to yet. But in private markets, whether it's real estate, private equity, infrastructure, the big changes in these types of markets where assets need to be repositioned is an advantage for the private markets. And the reason is because it takes time to reposition these assets, it takes capital and it takes kind of active shareholding. And so whether it's private equity, whether it's private real estate, whether it's private infrastructure, the active shareholding element of the investors interacting, making sure you have the right management and having a vision for where those assets are going to go, it's much easier to pull all that together in a private context than in a public context. And so, in some of these hard-hit sectors where these assets need to be repositioned, where there's more complexity, I think that's an advantage for private markets. And so in addition to all of the businesses that made it through Covid with very little impact or perhaps even grew, those opportunities are still there. But I think there's a number of these sectors across the different private asset classes that are going to be quite interesting going forward.

GS: Well, taking a closer look now to the supply and particularly to the raw materials prices increase, how is this going to affect private market assets over the short and long run? And how StepStone is facing it?

TK: Yeah. So, this goes back to some extent to what we were talking about earlier. Some businesses have the ability to pass through raw material prices, through price increases to their end users. Businesses with pricing power are going to be able to maintain their margins. Those are the types of businesses that we have been focused on. There are businesses that are exposed to commodity prices. Generally speaking, when we make those investments, we try to ensure that there is at least some short-term ability to hedge those prices, either through explicit hedges or through linkages built into the contracts that allow for some sort of surcharge for increased commodity prices. So, in the short term, you try to protect yourself with some of these structural features within how these businesses interact with their customers. Over the long run, you look for businesses that are in segments of the economy that have this pricing power and are going to be able to maintain margins by passing through the cost of inputs. And so that's basically how we've been thinking about it across the different sectors that we invest in.

GS: Lastly, moving now to monetary policy. In the event central banks raise rates, how will private markets be affected?

TK: So, I would expect that eventually central banks will need to raise rates. As a global economy, negative real rates is not a healthy place for the economy to be. For some types of businesses, increasing real rates can be a positive. So, interest rate sensitive financials, for example, that could be a positive. But generally speaking, across not just private markets, but public markets as well, valuations have become extremely high because of the low interest rates that we're seeing. And so, you would expect that as interest rates start to increase, those businesses that have these high valuations, the multiples are going to come down. On the real estate side, typically if interest rates go up by one percentage point, the cap rates will typically go up by 60 basis points or so. So, you do see cap rate expansion both on the real estate side and on the infrastructure side. So, with those multiples coming down, it will be important, first of all, for the capital structure of the businesses that we've invested in to be sustainable through that expansion. So, they need to be able to service the debt as the interest rates increase because interest expense will go up and they need to be able to maintain cash flow to amortize the debt. The good news is that as multiples have been going up across the private markets and this is true for private equity as well as real estate and infrastructure, even though we're seeing multiples that are at an all-time high, those high multiples are really driven by expanding equity in the capital structure. 15 years ago, preceding the global financial crisis, we were seeing buyouts done with 30% of the capital structure being in equity. That means two thirds was in debt. And then when you had that multiple contraction, the equity piece got very thin. Today, the deals that are getting done typically have 50 to 60 percent equity in the capital structure. So almost twice as much equity as what we saw leading up to the global financial crisis. What that means is that those capital structures are much more survivable in the event of multiple contraction. They're more survivable in the event of higher debt service costs. So, we think that the capital structures that have been employed over the last 10 years are much more sustainable than what we saw going into the GFC. So, if there are increases in interest rates, and there will be, the businesses that we've invested in across these different asset classes are much more sustainable. Now on the private debt side, as we talked about before, because most of what we've invested in is floating rate, as central banks increase their interest rates, the income on that portfolio will rise in lockstep. And as new debt gets placed into the portfolio, we will be focused on the credit spreads, making sure that we replace the maturing debt with equally attractive assets.

GS: Thank you, Tom, for your insights. It was really a pleasure having you with us today.

TK: Well, thank you. This is obviously an area that we spend a lot of time thinking about. And I think the bottom line is there will be higher inflation, but if you position your portfolio in expectation of that, everything should be fine.

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