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● THROUGH THE LOOKING GLASS

Capital and innovation: This time is different

Roles of technological innovation and capital are changing—the 2020s will be a very different landscape compared to the 2010s

THE DECADE OF the 2010s has been bookended by the Covid-19 pandemic. If one takes a longer expanse, the tech boom that spawned in the 2010s changed the world and indeed, unwittingly, made it much better prepared to handle the pandemic. From e-commerce to ride-hailing, from delivery to streaming, from e-gaming to social media, tech innovations permeated into our daily lives and thereby commanded high valuations in public and private markets.

The investment acronym that defined the 2010s was FAANG (Facebook, Amazon, Apple, Netflix and Google). Even so, it missed out on so many other life-changing innovations and market-cap creators. This is also very US-centric: Many unicorns and decacorns were created in Asia and Europe—these companies effectively solved unique local challenges using technology. Not all these companies started in the 2010s—many

started in the decade prior, but blossomed in the last decade.

Technological innovation was honed close to the market where entrepreneurs would identify a niche or a need, and address it enabled by technology. The companies thrived as innovation was broadly encouraged. Regulators allowed innovations to prosper before drawing the lines—indeed, in many cases, regulatory sandboxes were created to nurture innovation. Regulators of various types (tax, competition, content, distribution, privacy, security, etc) are now beginning to put in place frameworks to better govern these innovations from a societal perspective. It is a reasonable assertion that regulations followed innovations in the tech boom.

The business model of identifying and backing innovation settled down in the 2010s—accelerators right out of engineering or business college campuses, angel investors, early-stage venture capitalists (VCs), late-stage VCs, pri-

vate equity, pre-IPO and finally the public market. Every innovation went through multiple stages of scrutiny and refinement—both within their target markets and with the providers of capital. Successful firms could cross these hurdles quickly, others would spend time refining their business models at various stages, and some others would fall off.

Capital would chase successful technologies. The institutions managing large pools of wealth—sovereign wealth funds (SWFs), pension funds, private equity funds, VCs, public market asset management companies, etc—did not have a set vision of what tech innovation should lead to. As new technologies matured and became ready for their next round of funding or listing, the investors would come in.

...and now things are changing

Fund managers are now increasingly aware of their enhanced responsibilities. Many of the large investors have a thriving environment, sustainability and governance (ESG) philosophy and practice. Their principles are laid out in various international declarations which fund managers have adopted. The power of finance to 'nudge' for change is now a key mantra. Let us specifically look at this in the context of environmental and climate concerns.

Politicians and statesmen are now voicing the shared concern of climate change that humanity is faced with. Countries and societies are finding their stand on the topic. Discussions on climate change are now central to the agenda of many statesmen: The US President is hosting leaders from 40 countries on the Earth Day and the UK will be hosting the COP26 summit in a few months.

As the concerns from societies increase and political consultations and compromises begin, the regulators are getting into the act. Companies are now seeing increased disclosure requirements of climate risks, lenders are now more conscious of the climate exposure, and investors are asking tough questions to their investee companies on ESG. Accounting institutes and credit rating agencies are coming up with the maturity models of rating companies.

'Climate equity' could create substantial fund transfers from currently developed nations to others with the explicit intention of investments into climate-

related projects. Capital directed by governments across the world will play an important role in fostering new technologies and helping bring down the green premium in various sectors.

All this means that capital is being nudged in a particular direction. For long-term investors, who are investing with multi-decadal horizons, climate change is an issue that they explicitly need to consider: how the world changes because of the changing climate could dramatically change their liabilities and payouts. SWFs and pension fund investors are hence bringing this to bear on their investee fund managers who onwards are nudging their investee companies. Companies with large carbon footprints are thinking of ways to reduce their impact. Also, a completely new set of technologies and industries that will work towards meeting the climate targets is taking shape.

Unlike capital chasing technological innovations in the 2010s, now technological innovations are being driven by the availability of capital.

This is a marked shift and hence it will have material implications on various stakeholders. Earlier, large pools of capital could wait for various Darwinian mechanisms to ensure that they invested in those companies that survived the rough and tumble of the markets.

Now, large investors must

take a call on the technological innovations that will materially impact climate trajectory. Since many of these technologies are nascent, this increases the risk that investors may back those which may ultimately turn out to not being successful.

The dominant strategy for investors would hence be to learn from each other to see which technologies are finding the greatest number of backers—and this could make such technologies winners via a self-fulfilling prophecy. Some technologies could see crowding in of investments and others may not find many backers. In each of the four key segments (energy, transport, food and materials), there are likely binaries that may emerge. For example, coal and fossil fuels for energy and transport are globally seeing significant push-back, while renewables and electric vehicles are seen as the right sectors for investments.

These binaries will create interesting opportunities for those investors willing to take some risk beyond the obvious.

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