Hamilton Lane

cobalt for Limited Partners

The Private Markets Industry Has Evolved

How Investors and Managers Can Keep Up

Lindsey Gusenburg, Principal of Marketing at Bison, Inc., sat down with Hamilton Lane's Vice Chairman and Head of Strategic Initiatives, Erik Hirsch, to discuss how the private markets have evolved over time and how the industry's overall evolution has impacted the way Limited Partners build portfolios and the way General Partners attract investor capital.

LG:

Hamilton Lane is one of the largest allocators of capital in the private markets; how have you seen the industry landscape change over the past 25 years?

EH:

Our asset class, like a lot of asset classes, continues to mature and evolve. If you look back at the mid-90's, you had a little more than 100 GPs managing a few hundred funds. Fast-forward two decades and there are now thousands of GPs managing thousands of funds. That growth has brought both challenges and great opportunities. On the LP side, investors like choice, and the industry today has more choice than ever before. With it comes the pressure to have the resources and the know-how to work your way through all of those choices in the market. On the GP side, managers have benefited from the asset class' growth in both scale and popularity, but they've also had their own challenges, such as trying to distinguish themselves and stand out from this incredibly large crowd of GPs all clamoring to raise money each year.

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LG:

In what ways are the LPs responsible for driving some of this change in the industry?

EH:

What we are commonly hearing from the LP universe is, 'I like this asset. I want to do more in it, but I don't necessarily want to do more with more people.' I think what you see as a trend across our asset class and others is a shrinking and consolidating of relationships. Investors want to have their dollars be more important and relevant and so they put more dollars in the hands of fewer managers. That creates more pressure on the GPs. Today it takes more than simply walking into an LP's conference room and proudly announcing that 'I am top quartile.' Great. That puts you among the top few hundred fund managers. That simply isn't enough to make the case. Instead, what we're seeing among the really great GPs is that their story has become more thoughtful; beyond that, the tools at their disposal to help tell that story have become a lot more rigorous, and also more thoughtful. Today managers walk into a conference room and explain why they are going to be a good fit in that particular LP's portfolio, where they are adding value, how they're a different risk proposition, why they bring diversification benefits - having real value-add discussions rather than being chosen by gut decisions. Now the conversations are about how GPs can be used as building blocks for LPs as they go about trying to build thoughtful, well-constructed portfolios.

LG:

How have these changing dynamics impacted the way you think about and approach due diligence and the evaluation of managers?

EH:

I think if you go back to this notion of GPs wanting to stand out and LPs wanting to assemble really thoughtful portfolios, it's really going back to this notion of 'we have more and different choices than ever before.' We essentially have more flavors that we get to choose from. So our approach on due diligence has gotten much more sophisticated.

We have access today to data and tools that we believe are better than ever. At the same time, our ability to use those tools to make better, more informed decisions has also increased. Historically, if you go back 20 or 30 years, most diligence lacked in any quantitative rigor. Today, that's not true. At Hamilton Lane, our diligence process takes weeks, if not months; it involves an incredibly deep dive into all of a GP's cash flows and underlying portfolio companies; trying to uncover the real value proposition. We have the benefit of having an awful lot of data and tools at our disposal to perform that due diligence.

That's the trend I see across the LP universe - people want to make good, smart, informed decisions. The irony here is that for the last 30 years, our asset class has really looked and behaved at lot differently than most others. We've been, arguably, the least quantitatively rigorous asset class out there. Part of that was simply that LPs were more focused on the relationships than the numbers. The other part is that there was a real void of data. Both of those factors have changed – and that has really upped the game. What we're seeing today is our asset class becoming increasingly more quantitatively rigorous - much more akin to what we see across the other asset classes.

LG:

From your perspective, this changing landscape is affecting the way LPs approach things, but have you seen the GPs markedly shift their approach as well? Have they adjusted to this change?

EH:

So the simple answer is some have and some have not. I go back to this notion of it's a huge industry with thousands of participants. So, like most industries, there are some examples of GPs who are real thought leaders, GPs who are advanced and who are constantly looking at how to evolve, how to make sure they are adhering to best practices, and how to focus on making sure their firm and their funds are truly best in class.

And then you have the other side of the spectrum, which is GPs doing business the same way they have for the last 10, 20, 30, 40 years. From an LP perspective, you see a real marked difference across that universe. So, from my experience, the fund managers who are engaging in best practices are also the GPs who are investing in the infrastructure of their organization; Those that are recognizing that they need to embrace technology; those that are recognizing that investing in things like investor relations professionals becomes really important; those who are building out larger finance teams internally in order to be more responsive to LPs; and those who are using tools and technology to accomplish all of that.

It's funny that when you look at GPs' management of their portfolio companies, they are ruthlessly efficient and effective at trying to elevate the game of those companies, looking to make them smarter, faster, more efficient and profitable. But yet, I find that a number of GPs don't employ that same lens or same tool box on their own businesses.

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They are not as focused on making their own organization as smart or as efficient or as profitable, let alone as scalable or as responsive to their clients as what they would expect from their portfolio companies. So I think today, not surprisingly, you see a real range around how managers are each handling this. There are certainly those who are top quartile of running their firms in a great way – and there are firms that are in the bottom quartile when it comes to running their franchise. And I think it's up to the LPs to figure out who falls into what bucket and to invest accordingly.