Hamilton Lane

OUR TOP THREE [PRIVATE MARKETS] PREDICTIONS FOR 2018

By Mario Giannini, CEO

New Year's resolutions and predictions; these irresistible guilty pleasures share some similarities: they are an oft-featured aspect of end-of-year discussions and writing and, by some time in the middle of the year, they lapse into silence – forlorn promises and prognostications that never came to pass. My New Year's resolution was to avoid making any predictions for the private markets in 2018. Fortunately, that resolution didn't even last through New Year's Day, because here I am sharing some such predictions.

These are a little different, however. Instead of making any outright bold and potentially silly predictions (you know what I mean because I've made them before), I'm going to offer my thoughts on a few surprising things that *could* happen in 2018. Not only does that allow for a natural hedge if I'm wrong (hey, I said could, not would), but it makes predicting more what it should be: a look into some trends that we should be anticipating or for which we should prepare.

#1: Revenge of the Techno-Nerds.

We spent a lot of 2017, particularly in the venture world, talking about the Softbank Vision Fund. A chunk of the discussion was around its outsized profile compared to any other fund in the market. Ironically, that turned out to be only one in a slew of interesting aspects of the Softbank Fund. More intriguing has been the fund's impact on venture investing and valuations. When a single fund boasts so much more capital than the rest of the industry combined, that will inevitably create consequences, both intended and unintended. Perhaps in 2018 we will begin talking about the – drum roll please – MEGA VENTURE FUND. Turn an ear to the investing world and you can already hear the rumblings:

- The world has changed and companies can't or don't or shouldn't go public. (Let's call them "Unicorns" to be original.)
- Unicorns need capital, either to continue to be category killers and achieve even greater profitless scale or to move into associated areas that promise red ink for generations. (Come on, it's worked for Amazon and, after all, these are all the Amazons-of-tomorrow.)

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- Unicorns also need capital to provide liquidity to various shareholders. With the public markets no longer functioning as a liquidity mechanism, private markets could fill that void.

- The scale and size of these Unicorns requires large amounts of capital. Traditional venture funds are too small to provide the requisite capital. Moreover, those funds can't make the outsized investments required in Unicorn rounds while continuing to invest in smaller, earlier stage rounds. The portfolio construction looks too odd. Finally, neither buyout nor growth funds can provide the capital because they don't have the expertise in this field.

- Softbank has proved that there is enormous demand for this kind of investment capital. If there wasn't, how could the Vision Fund be shelling out billions of dollars into Unicorn companies (including a recent multi-billion dollar investment into Uber) and be ready to come back to market so soon?

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Voilà, the need for massive funds designed to invest in Unicorns around the universe.

There are some strong reasons for this investment trend both to begin and to be successful. Some of the underlying dynamics are strong, secular trends and many Unicorns could develop into the Googles of the next 10 or 20 years. In the private markets, there exists a real gap between the venture world and the buyout/growth world in terms of skill set to invest in these opportunities. I'd argue, however, that the skill set is the more important missing item. Some of these funds, as they develop, will probably do well. I predict that most will not. If this trend picks up steam, we will hear the familiar refrain of "this time is different," that the public markets and private markets have changed forever, and that this kind of fund addresses a capital gap we've never seen before.

Here's an interesting perspective to keep in mind if this trend really does develop in any meaningful way. Mark Twain is quoted as saying, "History doesn't repeat itself, but it often rhymes." PE has seen two massive blow-ups: the late '90s blow-up with the venture world and the buyout world doing telecom deals, and the middle aughts with the buyout world doing giant public-to-private deals. Both periods were characterized by large funds (by historical standards) spending money very quickly in deals described as ones that PE had never seen before: It was perceived to be a new investment horizon where PE would stake out its place and generate great returns. I've wondered if we would see similar behavior marking the end of this current cycle, but there's been no evidence of that to date. Perhaps the rise of the huge venture funds, raised by VCs, growth capital funds and buyout funds, will mark that cycle's end. It will be the great blow-up, with echoes of both the late '90s and the 2007 buyout bomb. It's worth watching carefully. It will be challenging for LPs. Some genuinely compelling opportunities certainly exist, and some GPs stand to do quite well in this space, but there simply won't be as many as I predict will be advertised.

#2: "It's far worse than anything I was ever doing." Jordan Belfort (better known as the "Wolf of Wall Street" from the movie of the same name).

The year 2017 saw a good bit of time spent discussing Bitcoin and ICOs (Initial Coin Offerings). Mainstream media now regularly reports cryptocurrency ticker prices along with stock and index prices. ICOs raised huge amounts of capital that would normally have been provided either by the private or public markets. Much of the discussion has focused on how this development

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impacts venture capital investing, with some firms taking part in ICOs. I'll leave it for someone else to discuss whether that's what certain LPs are looking for in their VC investments. Instead, what I'll offer as a prediction is that fundraising in 2018 could begin to feature ICO-style funds rather than the traditional partnership fund model to which we are all so accustomed.

Ok, so you're probably thinking I must have gone on hiatus at the end of the year and spent too much time in California lurking around the marijuana dispensaries, but hear me out. Why is the idea so far-fetched? An echo of what is to come has already occurred: The DAO fund ("Decentralized Autonomous Organization") raised what was then a record amount for what was essentially a revolutionary form of venture fund. The fund gave all the owners of the tokens a vote in the investments the fund would make. The DAO fund didn't collapse because of investment problems; it collapsed because it was hacked. It was a technology problem, not a problem of concept or investor interest. Given this, it seems likely to me that someone will work through a structure that offers potential investors a very simple set of ideas:

- The fund will invest in blockchain or cutting-edge companies.
- The fund will invest either using cryptocurrencies or mundane fiat currencies issued by banana republics like the U.S., China or Germany.

> "Why is the idea so far-fetched? An echo of what is to come has already occurred"

- "LPs" (they won't be called that in these structures) will be issued tokens (let's call them "HLCoin").
- And here's the real genius; investors aren't waiting around for the GP to send money back, nor are they paying a management fee (at least in my current theoretical construct). HLCoin is listed on the various exchanges and, particularly since values only go up for these things, investors can choose when to liquidate all or part of their holdings at a profit.
- The "GP" (also probably not called that in these structures) doesn't receive a management fee since it will have retained some amount of HLCoin and can use that, particularly as it appreciates in value, to fund operating expenses.
- "Carry" (again, probably not called that in these structures) comes in the form of appreciation on the HLCoin that the GP retains.

What's not to like? It's faster, more efficient and currently less regulated. It also opens up an entire new world of investors to the general partner community. I'd watch this area carefully as different forms of fundraising take shape. (I'd also take Mr. Belfort's warning somewhat seriously. He seems to have had some experience with money-raising schemes that leave investors with less capital than they started.)

#3: PE M&A (AKA, "How I finally saw the Loch Ness Monster").

It is hard to think of an industry anywhere in the world that hasn't seen waves of M&A activity as the enterprise expands and consolidates, grows and contracts; that is, with the notable exception of PE. Even amidst the depths of venture's woes in the early 2000s and buyout's troubles in the late 2000s, the industry refused to go through any kind of M&A activity. There are plenty of good reasons: huge egos, crazy fees locked in almost perpetuity, tons of capital sloshing around the market. So, you ask, is now any different? Probably not. But I'll argue there are a couple of things going on that might (and I say *might*) push for more M&A activity in the private markets area:

- GP investment funds, such as Dyal, Goldman or AlpInvest, are really a form of M&A in disguise. They

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are not bringing firms together, but, if you believe the stories, a fair amount of the capital is earmarked for expansion. It can be viewed as glimmers of M&A reaching the dusty corners of PE land. Expansion can be bought or built and some of these GP investment funds, even as passive as they are, might begin pushing for more aggressive expansion, including M&A.

- Many private markets platforms have already formed and their size is creating some real barriers to entry. Many firms don't care, as they make more than enough money with the assets they have, but some firms hunger to reach the top tier of the asset class. How do you do that organically in today's environment? It can certainly be done, but it takes a fair bit of time, and the larger firms continue to get larger very quickly. They say that breaking up is hard to do. Well, catching up at this point is even harder to do.

- If you are a GP that is either struggling or doing well, but either of a sub-size or getting to the end of your career, what do you do? The answer traditionally has been you hunker down and suck all the fees you can for as long as you can and either hope for a miracle or, when your fees run out, go sit on the beach and on various boards. (In some cases, you hand over the reins to your junior partners and blame them for the bad investments and fundraising issues.) I am not yet fully delusional; I suspect that will continue to be the case in the majority of end-of-fund-life scenarios, but it is becoming more difficult. LPs are savvier about cutting off fees sooner, and some GPs might figure out that the kind of M&A activity they routinely press their portfolio companies to do could help them not only survive, but prosper.

- Let's go back to the glimmers of M&A already taking place. It's not just the GP investment funds; many of the structured transactions taking place on the secondary side are disguised M&A. Yes, they are currently focused on a single GP, but is it hard to foresee an expansion of that to include more than one?

This one is admittedly more of a long shot than my prior two predictions. However, as more GPs and the investors and LPs around them see expansion as a necessary part of survival, it is only a matter of time before one GP engages in M&A. And what if it works? Then the tide turns.

There you have it: three topics with the potential to take up a great deal of conversation in 2018. I don't pretend to know with any real certainty whether they are good or bad developments for the industry. If the past is any guide, even if they are not favorable trends in 2018, they may improve the industry over the longer term. What we have learned over the past 20 years is that the private markets industry is incredibly adaptive. There is no reason to think 2018 will change that basic, core feature that has made it such a worthwhile, and interesting, area in which to invest.

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