Hamilton Lane® Research

WHAT'S TOP OF MIND FOR TODAY'S LP

By Mike Koenig, Chief Client Officer

With 2018 more than halfway over, the private markets continue their steady march onward, with a watchful eye on the broader markets and global economy. Media coverage is dominated by talk of geopolitics, international relations and the (very) occasional feel-good story such as the rescue of the Thai soccer team. In the world of private markets, investor conversations seem to be punctuated primarily by discussions around fundraising, purchase prices, performance and strategy expansion.

But beyond these omnipresent macro topics, we thought it would be interesting to pull back the curtain a bit more and review what other areas are occupying LPs' minds, and how they are spending their time. So, let's dig into what LPs in the private markets are really talking about. In typical Hamilton Lane fashion, we will overlay some statistics and metrics that support these areas and, naturally, weigh in with our own POVs.

People and Expertise

It is an oft-cited and generally accepted truth in our industry: Private markets investing is a "people" business. The relationships that exist between LPs and GPs, GPs and portfolio companies and even those amongst LPs and LPs themselves, are ultimately the tools used to find and source deals, execute due diligence, close deals and monitor the health of portfolios—all with the end goal of protecting, preserving and growing investors' capital.

The focus on people continues to increase as the asset class matures and evolves, and it currently has a few distinct facets that we've been hearing a lot about:

Value Creation

Complexity in the private markets has grown hand-in-hand with fundraising, fund managers, investors and strategies. Prices have been elevated for an extended period of time when compared with long-term averages (Chart 1), and the proliferation of funds continues, leaving investors with more choices and opportunities than ever before. This has compelled LPs to focus on the value-added capabilities of GP team members. Because of the current pricing dynamic, GPs can't just grow the top line of companies to drive value, but rather must fundamentally improve the operations of the companies in which they invest. This means that LPs are spending more time focused on GP return attribution, operating partner profiles and turnover statistics. They are diving deeply into value creation and understanding what specific capabilities a GP has in-house to best position their companies for success. This all means that LPs need better data sets, themselves (spoiler alert: we'll delve into this a bit more later), better tools at their disposal and more and different expertise.

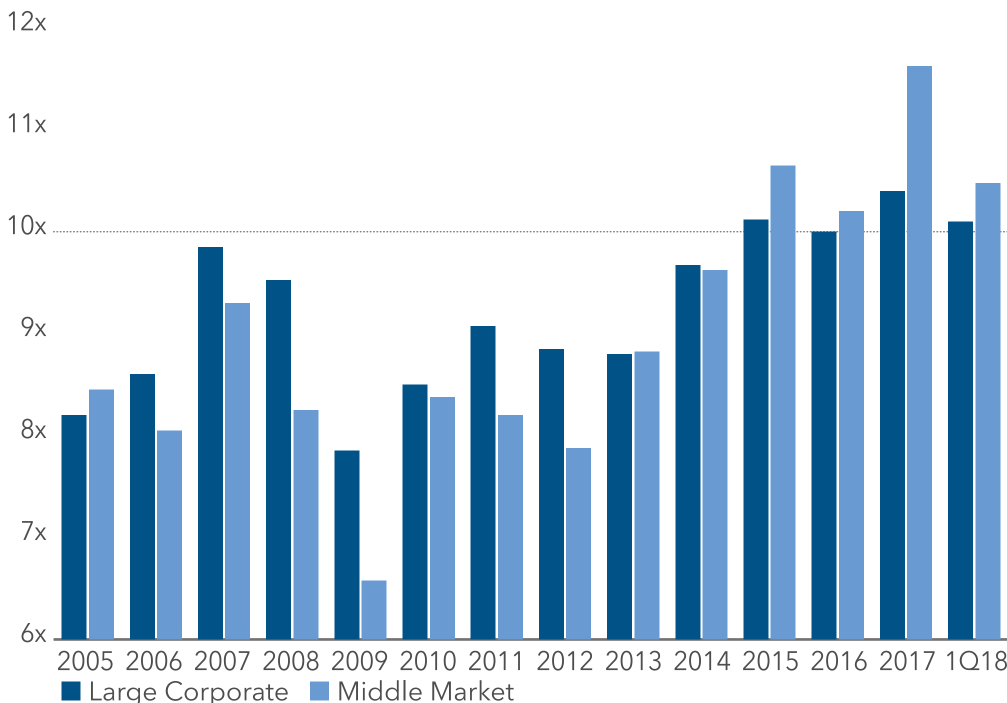
Operational Assessments

As LPs take stock of their GP relationships through a more analytical and data-driven lens, it makes sense that they have also turned that same spotlight on their own organizations. LPs of all sizes are focused on understanding what their teams do well and where they are best equipped, as well as finding new resources or external providers to supplement their current capabilities. The co-investing experience is a good example of this. U.S. plans searching for new professionals frequently include co-investing or direct investing as a preference or requirement, and that trend is even more prevalent globally. Although LPs are approaching co-investing in different ways—outsourcing, internalizing, becoming a direct player, etc.—most are doing *something* about it. The reduction in cost coupled with the allure of investing directly in companies is too hard to resist, and LPs are getting creative in identifying resources and ways to get in on the action.

Diversity and Inclusion

Finally, diversity and inclusion remains a major and appropriate topic amongst LPs. Virtually every LP we work with understands the benefit of diversity and shares the position that more diverse backgrounds and perspectives lead to better decision making. These LPs have begun to demand it of themselves and of their partners. As a result, many initiatives now exist to aid in developing a more diverse universe of investors today and in the future: Girls Who Invest, Toigo, SEO Alternative Investments and NASP are just a few examples (of which there are many more). Another practical example of activity in this area is one large LP that established requirements for GPs seeking re-up commitments to report specifically on how they have fostered diversity and changed their firm since their previous fundraise. This then becomes a component of the due diligence process to determine whether or not the LP participates in that next fund. At present, the consensus seems to be that, while there is much distance still to travel in creating a more inclusive industry, the mechanisms available for creating a more diverse workforce have grown and the path has become a little clearer.

Chart 1: U.S. Purchase Price Multiples



Source: LCD, an offering of S&P Global Market Intelligence (April 2018)

Portfolio Data and Information Flow

As the private markets have grown in sophistication and complexity, LPs also remain more focused than ever on using data and information to understand their private markets portfolios and make better decisions. It is no longer adequate to say that private investments are different and therefore excluded from the analysis. As an asset class, we're beyond that point.

As result, we're experiencing more and more LPs beginning to request in-depth risk and portfolio information; an appeal that had historically been more typical in the public markets. We've seen this merger of analytical approaches between the public and private markets play out in a variety of ways: LPs are doing things like implementing risk-based systems, calculating detailed performance attribution analyses and reviewing efficient investing frontiers specific to their private markets portfolios. They are analyzing historical deals and reviewing value bridges so that they can better assess which GPs and investment strategies are best suited to their goals. Five years ago, such practices were not widespread and were met with substantial information challenges.

The growing need for information and transparency is particularly evident in LPs' desire for more detailed, specific portfolio company data. It was not that long ago when private market values were completely cost-basis driven, and GPs offered only minimal transparency. Over the last decade, LPs have slowly demanded more granular data on their private investments. First it was mark-to-market, then came management fee and expense awareness, and today, we are in the middle of a major push for deeper portfolio company metrics. Many LPs who understand that the data they have available to make investment decisions is insufficient, are now striving to create those private data sets themselves.

The impetus for this shift? To aid in the information gathering and decision-making process for current investments, sure. But from a more macro, longer-term perspective, it's also to help enable a sharper and more holistic understanding of private investments in the aggregate. Increasingly, LPs are endeavoring to become better stewards of their capital by more fully understanding what makes the private markets run properly and efficiently. But, it's not just about getting clearer and sharper around the data. In many cases, integration with the broader plan portfolio is just as important. Risk teams want—and deserve—to understand what exposures they have and where they have them so that they can have a cross-portfolio view to monitor the entire subset of holdings at the portfolio company level.

"LPs are endeavoring to become better stewards of their capital by more fully understanding what makes the private markets run properly and efficiently."

Technology firms, reporting system providers and agents are building functionality to obtain and store portfolio company data, while industry groups and individual LPs are developing templated processes geared toward requesting and organizing portfolio company data at a granular level. One key challenge to all of this seems to be that these activities have not coalesced around a single "superset" of data. It is this superset concept that we believe has the best potential for success. It will provide GPs one leverage point to satisfy the many different data requirements of their LPs, and it can be managed in a repeatable and efficient way via technology. Despite and, in many cases, because of, the challenges around consistency and timeliness of data that still exist, we expect this push for more enhanced portfolio company data to continue.

SMID

Small and mid-market (SMID) investing is a buzzword for LPs around the world. From large pensions in the U.S. and Europe to endowments, foundations and family offices, the quest for sourcing the best SMID managers is all the rage. To level set for the purposes of this piece, let's first define SMID as small and mid-market funds with fewer than $3 billion in total commitments.

Some more level-setting: The focus on SMID is not a new trend. In fact, if we look back at our last annual Private Markets Survey, when LPs were asked to what sector they planned to increase allocations the most, 31% named other buyout, which includes SMID. On the flip side, 32% of LPs said they plan to reduce their allocation to large buyout over the next two years. LPs want it, and so GPs are offering it; in our current "funds coming to market" pipeline, nearly 70% of all buyout funds projected to be raised in the next 12 months are SMID.

With that as the backdrop, here are our three key reasons LPs have interest in SMID:

1. Performance - There seems to be consensus amongst LPs that SMID performance is superior to all other strategies. The reality? The consensus stands: Our data does prove out that SMID is clearly a best-performing strategy. In fact, a review of strategies by vintage shows that in 12 of the last 15 vintage years, SMID outperforms the composite of all private markets strategies (Chart 2). (We'll take a beat here to let that last sentence sink in.) However, what also is apparent is that SMID funds are not uniquely the top performer across vintages—other sectors also offer strong performance. A defined and diversified commitment strategy is crucial, while the approach of "let's just commit to SMID funds" is unlikely to yield the desired results.

Chart 2: Pooled IRR by Vintage Year

1999	2000	2001	2002	2003	2004	2005	2006
EU Buyout 14.4%	Real Estate 24.2%	EU Buyout 32.8%	EU Buyout 33.2%	EU Buyout 20.8%	Nat. Resources 26.7%	Growth Equity 19.4%	Distressed Debt 9.6%
Real Estate 13.7%	EU Buyout 20.0%	Distressed Debt 21.4%	Real Estate 24.2%	U.S. SMID 17.9%	EU Buyout 23.1%	U.S. SMID 9.6%	Growth Equity 9.2%
ROW 12.7%	U.S. Mega/Large 16.6%	Real Estate 20.8%	Distressed Debt 22.1%	All PM 16.5%	Real Estate 17.6%	U.S. Mega/Large 9.2%	U.S. SMID 7.9%
Mezzanine 9.8%	Growth Equity 10.5%	All PM 17.9%	All PM 20.7%	Distressed Debt 15.2%	U.S. Mega/Large 12.7%	All PM 8.9%	Mezzanine 7.6%
U.S. SMID 8.3%	Mezzanine 10.4%	Growth Equity 17.7%	U.S. SMID 18.4%	ROW 14.4%	All PM 12.5%	EU Buyout 8.7%	Multi-Stage VC 7.2%
U.S. Mega/Large 6.9%	U.S. SMID 10.0%	U.S. SMID 17.5%	Late Stage VC 17.2%	Mezzanine 9.9%	ROW 11.2%	Distressed Debt 8.2%	EU Buyout 6.8%
All PM 5.3%	All PM 9.3%	Mezzanine 16.1%	Mezzanine 13.9%	Real Estate 8.8%	U.S. SMID 10.4%	ROW 8.0%	U.S. Mega/Large 6.8%
Late Stage VC -0.2%	ROW 3.3%	ROW 15.6%	Multi-Stage VC 6.3%	Multi-Stage VC 2.7%	Seed/Early VC 9.9%	Infrastructure 7.9%	All PM 6.5%
Multi-Stage VC -4.3%	Multi-Stage VC 2.6%	U.S. Mega/Large 12.8%	Seed/Early VC -2.4%	Seed/Early VC 0.7%	Mezzanine 8.7%	Mezzanine 6.9%	Seed/Early VC 6.0%
Seed/Early VC -6.9%	Late Stage VC 0.9%	Multi-Stage VC 2.8%			Multi-Stage VC 7.9%	Multi-Stage VC 6.7%	ROW 4.6%
	Seed/Early VC -2.8%	Seed/Early VC 1.4%			Distressed Debt 3.8%	Seed/Early VC 6.3%	Infrastructure 2.4%
		Late Stage VC -3.1%				Real Estate 0.0%	Real Estate 0.8%
							Nat. Resources -1.7%

2007	2008	2009	2010	2011	2012	2013	2014
Growth Equity 15.1%	Seed/Early VC 19.0%	U.S. SMID 21.7%	Seed/Early VC 24.4%	Multi-Stage VC 25.1%	Infrastructure 19.1%	Multi-Stage VC 24.0%	Multi-Stage VC 22.9%
U.S. SMID 11.9%	Growth Equity 17.4%	Multi-Stage VC 16.9%	Multi-Stage VC 16.9%	Seed/Early VC 22.9%	U.S. Mega/Large 18.8%	Seed/Early VC 21.2%	EU Buyout 19.1%
Multi-Stage VC 10.7%	U.S. Mega/Large 14.8%	Growth Equity 13.0%	U.S. SMID 13.6%	Real Estate 17.1%	Seed/Early VC 18.5%	U.S. Mega/Large 18.7%	U.S. Mega/Large 17.8%
U.S. Mega/Large 10.2%	U.S. SMID 14.2%	Seed/Early VC 12.5%	Real Estate 12.0%	Growth Equity 16.7%	U.S. SMID 18.5%	ROW 15.9%	ROW 17.3%
Seed/Early VC 9.6%	Multi-Stage VC 13.9%	All PM 12.1%	Mezzanine 10.4%	U.S. SMID 16.7%	Multi-Stage VC 16.6%	U.S. SMID 14.5%	U.S. SMID 15.5%
Distressed Debt 9.4%	EU Buyout 12.1%	EU Buyout 11.8%	All PM 8.8%	U.S. Mega/Large 16.4%	EU Buyout 15.9%	EU Buyout 13.1%	All PM 15.1%
All PM 8.6%	All PM 11.5%	Real Estate 11.0%	Distressed Debt 8.5%	EU Buyout 14.4%	Growth Equity 15.8%	Real Estate 12.5%	Distressed Debt 13.7%
Mezzanine 6.5%	Mezzanine 10.8%	Distressed Debt 9.6%	EU Buyout 8.2%	All PM 13.0%	ROW 14.8%	Growth Equity 12.3%	Nat. Resources 11.5%
Infrastructure 6.2%	Distressed Debt 10.7%	Infrastructure 8.4%	ROW 6.8%	ROW 10.6%	All PM 14.4%	All PM 10.9%	Growth Equity 10.6%
ROW 6.1%	Late Stage VC 9.5%	ROW 7.9%	Nat. Resources -8.3%	Mezzanine 9.6%	Mezzanine 10.1%	Mezzanine 10.0%	Seed/Early VC 10.6%
EU Buyout 4.3%	Infrastructure 9.3%	Nat. Resources -1.7%		Distressed Debt 8.8%	Real Estate 10.1%	Infrastructure 8.4%	Mezzanine 10.0%
Nat. Resources 3.8%	Real Estate 8.4%			Infrastructure 4.9%	Late Stage VC 9.4%	Distressed Debt 4.5%	Real Estate 9.6%
Real Estate 1.7%	ROW 6.0%			Nat. Resources 4.2%	Distressed Debt 8.1%	Nat. Resources 3.0%	Infrastructure 9.3%
	Nat. Resources 2.4%				Nat. Resources 5.2%		Late Stage VC 6.5%

Source: Hamilton Lane Data (May 2018)

2. Control - LPs cite that smaller companies offer the potential for a greater control premium to the GPs invested in them. Also, the perception is that fundamental improvement is easier to achieve in these smaller companies. There are many examples of exactly this tactic being used by SMID managers, but similar to the performance point above, other sectors can certainly also offer opportunities to exert control and grow companies. Moreover, this fundamental advantage is starting to cost more, as middle-market deals have transacted at higher multiples than large buyout deals for the last three years (Chart 1).

3. Leverage - SMID deals have less leverage than larger deals, and less debt means that those deals are safer by comparison. Year-end 2017 statistics do indicate that middle-market deals are less levered than larger deals, with an average adjusted debt-to-EBITDA ratio of 5.5x compared to 5.8x for larger deals. Less leverage is one thing, but there are numerous other factors that contribute to the riskiness of a deal—and no single statistic can be the predictor of return or risk.

Just as in fashion, trends come and go in the private markets (SMID is the new black, anyone?). Here, we've attempted to highlight just a few of the current movements receiving attention from LPs around the globe. There are others out there for sure, and these will change over time. But they're all a reflection of LPs' strong desire for enhanced capabilities as the market cycle continues, and a recognition that in order to be successful, they need to focus on many different facets of the investment management process.

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As of July 31, 2018