Hamilton Lane

Direct Equity Dashboard: 10 Things on My Mind

By Jeff Armbrister, Managing Director | **21 October 2020**

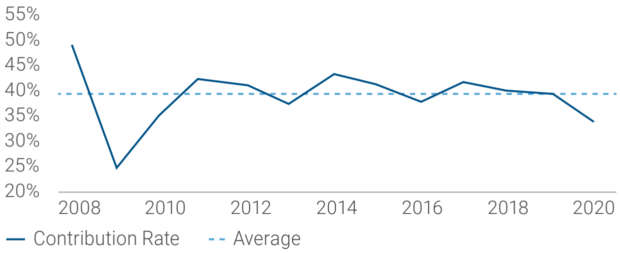
F 2020. You read that right. I'm not a big fan of the song of the same title by Avenue Beat, but I agree with the sentiment.

Everyone's lives have been upended by this invisible monster, COVID-19. Like at the snap of Thanos' fingers, jobs, financial stability, health and safety, contact with family and friends, bicycles and people's sanity disappeared in an instant. And, COVID-19 isn't even the only problem: We have wildfires, civil unrest, social inequity — the sobering, troubling list goes on. The toll of the events over the last several months on some level is difficult even to quantify, never mind absorb.

But in the corner of the world in which we operate, we have endeavored to get a handle on the events that have transpired and the resulting shifts and impacts on the private markets – and on direct co-investments, specifically. Here's a deeper look at where we stand today.

Given how turbulent the environment is, you'd expect not much to be happening in the private markets realm. That's not necessarily the case. After a lull in March and April, deal flow has picked up, but volumes are still below last year. According to Pitchbook, private equity transactions fell nearly 20% in deal value in the first six months of 2020 from the same period a year before, and dropped 30% to 40% compared to Q2 2019.[1] Looking at it from a different angle, our gauge of LP contribution activity shows that contributions have dropped off a bit, though not as precipitously as you might think. The average contribution rate (contributions/unfunded capital) has hovered around 40% over the last few years, and through Q3, we were on pace for 34%. Some of this could have been lines of credit being paid down, since we know new deal activity slowed during this period.

Contribution Rate



Source: Hamilton Lane Data via Cobalt (October 2020)

What started in the late-March/early-April period as defensive follow-on investments to address portfolio company liquidity needs and some opportunistic investments here and there, have now moved to platform deals or offensive follow-ons for add-on acquisitions. GPs have worked around logistical diligence issues by concentrating on companies they know well, and are now doing more in-person diligence.

We have still not seen many valuations come down as a whole, but private markets investors are busy. To date, the deal pipeline has been filled with the best-performing companies. GPs have been pursuing companies and management teams that are well known and were probably diligenced on some level pre-COVID. We are probably closer to the end of the pipeline of well-known, high-performing companies than the beginning. We are seeing the new post-COVID processes starting to be launched, with GPs becoming more active with diligencing. Starting in July and August, many began conducting more in-person meetings either by their deal teams or through third-party advisors. This was more prevalent in Asia and Europe than in North America, but there were examples everywhere – a lot more growth-oriented deals in the mix vis-à-vis buyout, but very little distress.

Activity has been high for direct co-investments as well. Some LPs have slowed their aggressive pre-COVID pace, leaving more allocation and opportunities for scale investors. The importance of strategic relationships between LPs and GPs has grown, and with valuations of strong-performing companies still at pre-COVID levels, the need for capital to complete deals is high. Plus, co-investors are being asked to put up their fair share to support struggling portfolio companies.

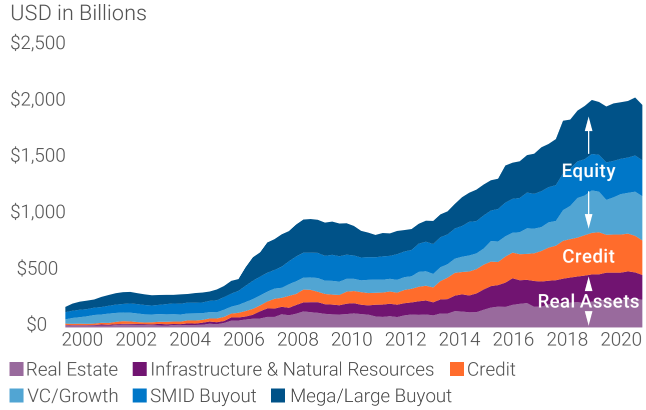
So, what's next? Here are the 10 questions I'm pondering...

1. **Another COVID Resurgence?** This fall will be a little more interesting with COVID-19 *and* the flu. We are seeing cases tick back up, which can be partly attributed to more testing, but the rise in case levels in many areas around the world (and the announcement of more restrictive measures in the UK, continental Europe, Israel and elsewhere) has heightened concern. Thankfully, the medical community has learned a lot about treating patients with COVID-19, which is helpful in leading to better outcomes.

2. **Forced Selling?** Beyond the most troubled sectors, there has not been much forced selling, and therefore, very few bargains. Unlike during the GFC, there was no liquidity freeze and most companies had access to capital through credit facilities or follow-on investments from current stakeholders. The longer we go without a vaccine, the larger the universe of companies that can potentially become vulnerable to underperformance and subsequent liquidity issues. If forced sellers become more prevalent, buyers are armed and ready with large amounts of committed capital at their disposal. According to our records, total dry powder has been hovering right around $2 trillion since 2018, with buyout dry powder comprising around $800 billion, and VC/Growth dry powder slowing its upward trend at about $387 billion. Credit and natural resources are two places where dry powder is declining.[2]

Private Markets Unfunded Capital

USD in Billions



Source: Hamilton Lane Data via Cobalt (October 2020)

3. **Valuations…?** This is a situation related to forced sellers. Given that only the companies that have not been impacted by the virus are transacting, valuations of consummated deals are largely at pre-COVID levels. Many companies that would like to sell – but are not operating in the industries du jour or have shown some temporary softness in their financial performance – are left on the sidelines because they do not want to accept lower prices, and thus a logjam is developing. Will this continue? Will they be patient enough to wait until their prices are met?

4. **Will LPs keep up the pace?** LPs, like all investors, have learned lessons from past down cycles. They've learned that consistent investment pacing is important, and that dislocations often present good buying opportunities. We've seen more of a commitment to maintaining investment pacing for primary investments versus co-investments, which benefits large-scale CI players as more allocation is available.

5. **Growth. Do all trees grow to the sky?** I realize this is my second mention of a tree-related theme and no, I do not have an infatuation with trees. Growth has dominated the headlines and investment performance for the past 13 years pre-COVID, and that theme has not abated these last several months. Many companies with business models poised for growth in any economic environment are doing well now, and the lack of leverage gives more operational flexibility during difficult times. Value has all but been forgotten. Things cycle, but when?

6. **Accelerate adoption – but will it last?** COVID-19 has forced adoption of certain technologies and practices in order to facilitate business operations in a remote work environment, by helping employees adhere to social distancing and continue operations with a reduced staff, or maintain critical practices. Collaboration software, TMT, online shopping, automation, telehealth, etc. are all having a moment. As we look at different investment opportunities, we're focused on understanding which trends will persist and which may only be benefiting from a temporary COVID bump.

7. **Is the U.S. Presidential Election over yet?**
   - Hot Mess
   - Dumpster Fire
   - Train Wreck
   - Sh*t Show

No, these aren't names to describe your [ex-boss/lousy neighbors/former significant other]. These were actual descriptions of the first presidential debate that took place at the end of September. If people weren't paying attention before, it would be hard to believe they aren't tuned in now. In addition to worries about specific policies for either candidate, there is a growing concern about instability – which is typically unwelcome and disruptive to the markets. Over the long haul, though, investors have been able to digest different parties, and policy changes (for better or for worse), and move on, but it could be a little rocky in the interim. With the cancelling of the second debate, though, we will be spared of a repeat performance. We were, however, treated to competing town halls, on two different networks, aired at the same time, that could not have been more different in tone. I'm trying to reduce my usage of the word "unprecedented," otherwise I would use it here – I guess I just did.

Hamilton Lane

8. **Who are the winners and losers? Is a "changing of the guard" occurring?** There's been tremendous bifurcation during this pandemic. In many ways it has exacerbated the inequities that already existed and created a larger gap between the haves and have-nots across many aspects of daily life. Focusing on private markets specifically, our Fund Investment Team does a tremendous job of staying on top of what's going on at more than 1,000 GPs across the private markets, and they are noticing strong performance from some upstarts versus some of the more established and well-known firms. Is this a real changing of the guard? Many of the upstarts are experienced from the GFC, but are not chained to old school playbooks. Will their outperformance continue, or is this a temporary blip?

9. **What will this mash-up of fiscal policy, monetary policy, interest rates and inflation create?** Everyone, including the Fed, is hoping for a strong fiscal stimulus package to help those in need, but that appears unlikely before the election. What else can the Fed do to instill confidence in the markets? Looks like they are willing to keep rates low for as long as possible. When will we see more broad-based inflation?

10. **Will I ever be able to keep the days of the week straight again?** I hope so. If time is an illusion, then days and weeks and so on are just a social construct – so I guess it may not matter, anyway.

Conclusion

So what's the purpose of all this? It's important to maintain a list of what could potentially impact your investment activities and portfolio. Right now there's a lot going on and a lot of volatility. So much has happened in the short few weeks of writing this white paper: The Dow Jones dropped by 5% and then increased by 6%; the President and a number of his aids, staffers and fellow party members contracted COVID-19, causing concern and reminding everyone how transmissible this virus is; the second Presidential debate, after much back and forth between the parties, was canceled; and fears continue to rise about a COVID resurgence. Should I keep going?

This will continue, but so will progress in how we treat this disease (which has improved a great deal already), and so will advancement toward a vaccine, and so will people finding ways to adapt their everyday lives and business activities until we come out of this. The private markets will continue to progress forward as well, and that's a good thing. As we review opportunities, we must assess the short- and long-term risks and weigh them against the potential rewards – so while the variables may have shifted greatly, our goals have not.

Hamilton Lane

[1] Pitchbook

[2] Hamilton Lane Data

This presentation has been prepared solely for informational purposes and contains confidential and proprietary information, the disclosure of which could be harmful to Hamilton Lane. Accordingly, the recipients of this presentation are requested to maintain the confidentiality of the information contained herein. This presentation may not be copied or distributed, in whole or in part, without the prior written consent of Hamilton Lane.

The information contained in this presentation may include forward-looking statements regarding returns, performance, opinions, the fund presented or its portfolio companies, or other events contained herein. Forward-looking statements include a number of risks, uncertainties and other factors beyond our control, or the control of the fund or the portfolio companies, which may result in material differences in actual results, performance or other expectations. The opinions, estimates and analyses reflect our current judgment, which may change in the future.

All opinions, estimates and forecasts of future performance or other events contained herein are based on information available to Hamilton Lane as of the date of this presentation and are subject to change. Past performance of the investments described herein is not indicative of future results. In addition, nothing contained herein shall be deemed to be a prediction of future performance. The information included in this presentation has not been reviewed or audited by independent public accountants. Certain information included herein has been obtained from sources that Hamilton Lane believes to be reliable, but the accuracy of such information cannot be guaranteed.

This presentation is not an offer to sell, or a solicitation of any offer to buy, any security or to enter into any agreement with Hamilton Lane or any of its affiliates. Any such offering will be made only at your request. We do not intend that any public offering will be made by us at any time with respect to any potential transaction discussed in this presentation. Any offering or potential transaction will be made pursuant to separate documentation negotiated between us, which will supersede entirely the information contained herein.

Certain of the performance results included herein do not reflect the deduction of any applicable advisory or management fees, since it is not possible to allocate such fees accurately in a vintage year presentation or in a composite measured at different points in time. A client's rate of return will be reduced by any applicable advisory or management fees, carried interest and any expenses incurred. Hamilton Lane's fees are described in Part 2 of our Form ADV, a copy of which is available upon request.

The following hypothetical example illustrates the effect of fees on earned returns for both separate accounts and fund-of-funds investment vehicles. The example is solely for illustration purposes and is not intended as a guarantee or prediction of the actual returns that would be earned by similar investment vehicles having comparable features. The example is as follows:

The hypothetical separate account or fund-of-funds consisted of $100 million in commitments with a fee structure of 1.0% on committed capital during the first four years of the term of the investment and then declining by 10% per year thereafter for the 12-year life of the account. The commitments were made during the first three years in relatively equal increments and the assumption of returns was based on cash flow assumptions derived from a historical database of actual private equity cash flows. Hamilton Lane modeled the impact of fees on four different return streams over a 12-year time period. In these examples, the effect of the fees reduced returns by approximately 2%. This does not include performance fees, since the performance of the account would determine the effect such fees would have on returns. Expenses also vary based on the particular investment vehicle and, therefore, were not included in this hypothetical example. Both performance fees and expenses would further decrease the return.

Hamilton Lane (UK) Limited is a wholly-owned subsidiary of Hamilton Lane Advisors, L.L.C. Hamilton Lane (UK) Limited is authorized and regulated by the Financial Conducts Authority. In the UK this communication is directed solely at persons who would be classified as a professional client or eligible counterparty under the FCA Handbook of Rules and Guidance. Its contents are not directed at, may not be suitable for and should not be relied upon by retail clients.

Hamilton Lane Advisors, L.L.C. is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 in respect of the financial services by operation of ASIC Class Order 03/1100: U.S. SEC regulated financial service providers. Hamilton Lane Advisors, L.L.C. is regulated by the SEC under U.S. laws, which differ from Australian laws.

Any tables, graphs or charts relating to past performance included in this presentation are intended only to illustrate the performance of the indices, composites, specific accounts or funds referred to for the historical periods shown. Such tables, graphs and charts are not intended to predict future performance and should not be used as the basis for an investment decision.

The information herein is not intended to provide, and should not be relied upon for, accounting, legal or tax advice, or investment recommendations. You should consult your accounting, legal, tax or other advisors about the matters discussed herein.

The calculations contained in this document are made by Hamilton Lane based on information provided by the general partner (e.g. cash flows and valuations), and have not been prepared, reviewed or approved by the general partners.

As of October 20, 2020