Hamilton Lane

The Stressed-Out LP

January 2022 | Jeff Armbrister, Head of Direct Equity Investments

"Wish we could turn back time

To the good old days

When our momma sang us to sleep

But now we're stressed out"

- "Stressed Out," Twenty One Pilots

"Stressed out" is putting it mildly – and momma isn't around to lull us to sleep with her soothing melodies. There's been a lot for co-investors to process over the recent months. "Why so stressed?", you ask? Oh, let's see, how about inflation, rising interest rates, COVID-19 variants, supply chain issues, employee retention – all factors that impact not only our professional lives but also our personal ones. When it comes to working in today's private markets, it's probably time to turn on its head the question of "What are you stressed out about?" to "What *aren't* you stressed out about?"

It hasn't all been bad, though, right? Deal flow was at record levels in 2021, with plentiful liquidity events for investors to enjoy. While that's true, there's also been a different energy since the summer. Things have become more intense. Even positives like deal flow and the number of funds in market have left private markets investors feeling stretched to capacity. The optimism and expectations that our toughest days with COVID are over were miscalculated. Prior to September 2021, workers

in most countries around the world were either already returning to, or making plans to return to their offices. Ahhhh, you could almost hear the spirited conversations at the water cooler about Squid Game, Bitcoin and the billionaire space race. If only that was what happened. Omicron had different plans.

So, what are we supposed to do now? For most of us, the answer has been to just hunker down and get to work. And trust me, there's a lot for co-investors to evaluate. Some are general macro factors that impact all investors and others are unique to co-investors. Let's take stock of where we are and I'll attempt to help you wade through it.

Deal Flow

Just when you thought it couldn't happen, deal flow found another gear. How did it do that? I'm not sure. GP fundraising schedules also accelerated, with seemingly every manager back in market raising a new fund. What the heck happened? If you thought things were going to get back to *normal*, well, guess again.

This has put many co-investors in a tight spot, and the stakes are higher than ever. Many LPs have had to pass on deals or pass on funds because they are too busy or too capital-constrained to handle it all – or simply because things are just happening too fast. (After all, we're not all equipped to switch into Lonestar's hyperactive speed.) This is unfortunate for investors, and means that some relationships built over decades are at risk of being strained, and may even mean that certain LPs are at risk of missing out on future deal flow or being included in future funds. GPs are trying to lock up co-investors earlier to make sure they have capital for deals. Many are lamenting that their previously reliable LP partners are nowhere to be found.

When the numbers are finally tabulated, 2021 will set all kinds of records for deal flow. No matter how full we were, the deals kept coming – even Augustus Gloop would have to step away from this feast.

It shouldn't come as a surprise that transactions are happening. The environment is as good as it's ever been. Rates are low. Leverage is plentiful. Valuations are attractive for sellers, and concerns (valid or not) about tax changes from the Biden administration are stoking an already hot fire.

As 2022 gets underway we are still seeing an active market. Yes, maybe I'll hear of a deal here or there getting hung up because of inflation concerns or valuation (and we'll touch on these topics later), but honestly, the number of deals getting done is still so high that it's tough to notice. It wouldn't surprise me if at some point there is a more noticeable pullback, with investors focused on pursuing the best companies that are protected against inflation and positioned to stand up to a rising interest rate environment – unless, of course, there is a meaningful price concession.

Valuations

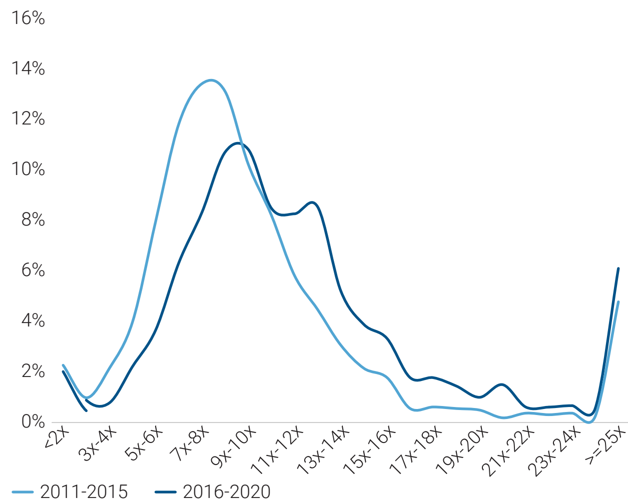
Due to the favorable deal environment and strong operating performance, valuations continued to march upward in 2021, and as we enter 2022 with growing concerns about rising interest rates, investors are still left in the unenviable position of determining how high is too high and surmising about when valuation levels may fall off a cliff...

Sticker shock is all too common these days, but as ever, it's important that investors avoid trying to time the market. Investment practitioners are working extra hard to find mispricing in this setting – which does still exist. For our part, we are looking for complexity, dislocation and disruption; we're partnering with sector experts who can find

opportunities earlier, get control of processes, minimize price with speed and certainty, and then turn on their value creation engines once they own the company.

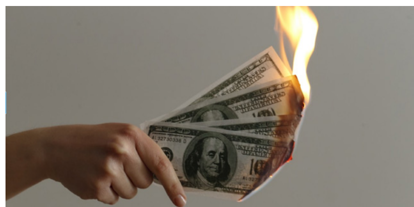
Distribution of Buyout Deal Purchase Price Multiples

EV/EBITDA, % of Deals by Count



Source: Hamilton Lane Data (January 2022)

Inflation



What about inflation, you ask? There's a lot to discuss here and it deserves its own paper. Thankfully, my colleagues have written some great analysis on this subject, so I direct you to those articles.

It's a fast-moving situation. In a short period of time, we went from no impact, to transitory, to maybe the Fed stops its asset purchase program, to one rate hike this year, to now maybe four or five?

This environment requires co-investors to try and understand what's transitory (and when those pressures may subside), and what's more permanent, but it's hard to know. It's even befuddled some of the smartest people in finance with access to the best economic data. In the United States, the Fed has said that QE will end in the spring and to expect three rate increases in 2022. An abrupt, hawkish change from six to nine months ago. Central bankers will have to find a delicate balance of implementing rate increases without threatening an economic recovery that is still fragile in the COVID environment. Examination of the impact of this topic prompts such questions as: Is this a labor story? A supply-side story? A demand-side story? What policies need to be enacted? Will they be rolled out effectively?

These are all the right questions, but let's take a deep breath and check one of the best voting machines on inflation, the bond market. The 10-year treasury yield is just shy of 1.8%. This is only a small uptick from yields of 1.3%-1.4%, which is where they were at the start of the fall when the inflation story started to gain more traction. Is this really indicating concerns about runaway inflation and crisis level issues requiring sky-high interest rates? This is not to call a top on interest rates rising. Certainly, some upward movement in rates and downward pressure on valuations is expected as central banks around the world start rolling back accommodations that have benefited asset prices and liquidity. The health picture will play a big part in determining how high rates go, but, even as some of these factors and uncertainty are being priced into treasury yields now, we are still near historic low levels of interest rates. As supply chain issues subside, so will some of the pressure on prices. Gaining control of the virus should also help reduce inflationary pressures and allow rates to stabilize at an appropriate level – but as I've said previously, it's tough to predict when this will occur.

As we debate over future impacts, what is for certain is that all of the GPs we work with are dealing with some form of inflation now, no matter the cause. They are seeing it in their portfolio companies. They are seeing it in their acquisition targets' financial results. It's out there. This and the labor shortage are two things we hear about from our portfolio companies most. Some companies are positioned to handle it better than others, and investors are obviously trying to find and invest in these

companies. Although there may be some near-term pain caused by anticipated reality versus actual long-term results, we expect this will help generate some attractive buying opportunities in the future.

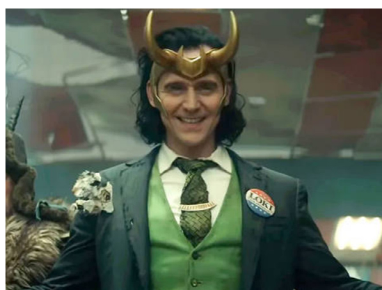
Deals These Days (Secondaries, Mid-Life, Warehousing – Oh my!)

Why are we talking about this in a piece that's ostensibly about the co-investment landscape? It's all about creative solutions and morphing deals that are creating opportunities for LPs throughout the private markets – including within co-investments.

Some naysayers ponder whether co-investing is experiencing an existential crisis from being caught in the tsunami of single-asset deals/continuation fund deals/late-stage primaries, etc.

Ha! No way (at least if you ask us), but it makes for good conversation over wine!

Lines are blurring, friend. More than ever, private markets activities are becoming interrelated, which is ultimately good. Change, evolution, creativity – these are all meant to be embraced and it's happening all around us. It's like a mashup of your favorite song with some other song. At first you want to hate it, then you reluctantly start tapping your feet and humming the melody and then before you know it, your eyes are closed, and you are left wondering how this version of the song didn't exist before.



Nowhere is this more evident than in the secondary market. Because making co-investments is what I get paid to do, I don't say this lightly, but here goes: The shape-shifting secondary market is everywhere and can seemingly do anything. It's encroaching on everyone's turf, but again, there are many positives here and it is a two-way street. My colleague Dennis Scharf has written, in my opinion, one of the best pieces I've ever read on the secondary asset class and has provided some visibility to an opaque corner of the private markets. In his write-up, Dennis details what is happening in the secondary market and how it has evolved from buying LP portfolios to now include things like single-asset deals, continuation funds, etc. This terminology barely existed a few years ago. It is really becoming an avenue for GPs and LPs to seek liquidity solutions in any type of structure.

So why again am I mentioning it here? Because it's impacting everything transaction-related. This is the existential crisis I flippantly mentioned previously. Ok, again, that was an overreaction, but CI professionals are often left to consider whether some of these new deals are co-investments in disguise or if there really is an opportunity that was unintentionally miscategorized – which does happen. The truth is that even as this market provides new offerings and continues to grow, so too does the co-investment market, which had a record year in 2021. With Hamilton Lane's extensive platform and scale, we are involved in many proprietary deals that start off as one type of transaction, but eventually end up being a co-investment opportunity. Additionally, this new cadre of deals allows us to benefit from new options for liquidity events that didn't exist a few years ago. The upshot is that there are more deals coming. They may look different. They may not be traditional co-investments. But they are deals that co-investors should potentially consider. Why? They are change-of-control-oriented or ultimately bridging to a change-of-control transaction. They are solutions-based, they strengthen relationships with GPs, and they are good deals. Never be afraid of a good deal.

Continuing our discussion of topics that may not appear to be CI-related but nonetheless complicate matters, let's briefly talk about all the funds coming to market. When GPs raise capital, co-investment activity usually increases, which, as I've mentioned above, has clearly happened. But again, there's an opportunity for co-investors to take advantage of this. For instance, we have seen high-quality GPs seeking bridge capital to complete deals while they

are in the middle of lining up a close for their funds. This is a great opportunity for co-investors to work with GPs to solve a discrete problem, get access to proprietary deal flow and strengthen relationships with the best GPs. We've worked on a number of these opportunities. I'll say it again: Never be afraid of a good deal.

Conclusion

Although it's therapeutic to write about this, I don't expect there to be any rest for the weary anytime soon. There will be challenges and volatility, but that's okay. Opportunities are born in these types of environments. The good news is that a large diverse platform like ours continues to be well-positioned in a dynamic and evolving market. The deal volume may fluctuate year to year, but creativity will continue and offer new investment and exit opportunities for LPs, which, at least in my opinion, makes it worth the stress.

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