Hamilton Lane®

The Truth Revealed, **Fact 4:**

Governance structures in private equity may contribute to the asset class' outperformance

What you should know

- A key reason private equity tends to perform better than public equity may be due to more robust governance structures.
- In the private equity world, key stakeholders are laser-focused on seeing the portfolio company do well – rather than focusing more narrowly on stock price.
- Data shows that the private capital markets are comprised of a high volume and variety of companies which generally have strong growth, governance models and use of leverage.

Once considered speculative, private markets continue to evolve, especially as the structural hurdles for high-net-worth (HNW) investors have come down. Still, no matter the level of expertise or market environment, investors and advisors who understand this segment of the market are well-positioned to make informed and comprehensive decisions about their portfolios.

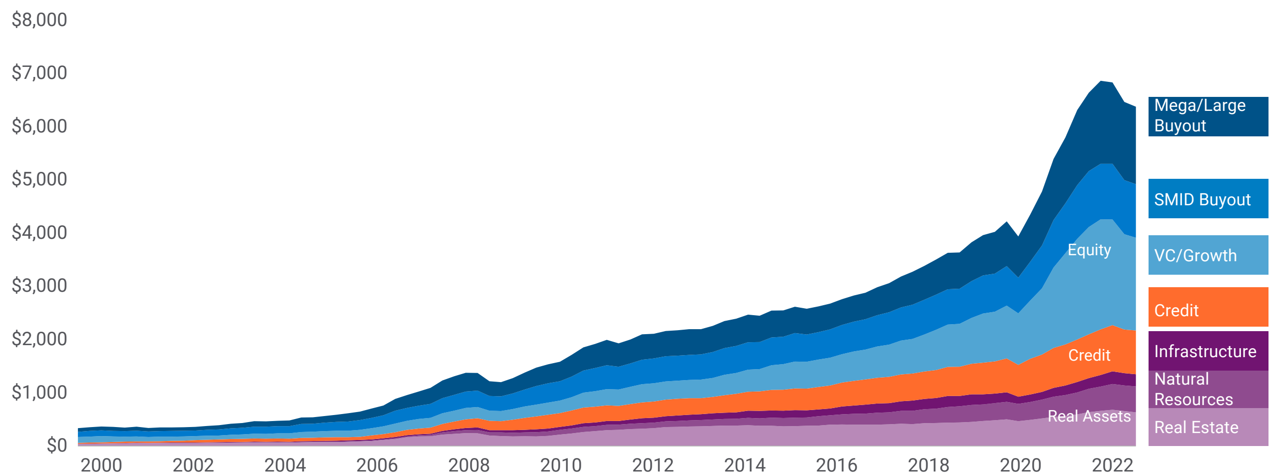
This Truth Revealed series explores private market investing with three objectives in mind:

- To dispel some of the incorrect notions about private markets
- To help investors and advisors better understand private markets' potential to outperform public markets
- To assist investors and advisors as they consider how private markets investing may align with their investment objectives

Private Equity Overview

There's no denying that private markets are often misunderstood. Private equity refers to an investment model where institutional investors, ultra-high-net-worth individuals, and other accredited investors pool their money to invest in privately held companies or acquire controlling stakes in public companies. Private equity firms are responsible for managing these investments on behalf of their investors.

The Composition of the Private Markets
NAV by Strategy
USD in Billions



Source: Hamilton Lane Data (January 2023)

Private markets comprise private equity, private credit, and real assets. Because private equity – which includes buyout, venture capital and growth equity strategies – tends to represent the largest segment of private markets, the terms "private markets" and "private equity" are sometimes used interchangeably.

Over the years, private equity was the exclusive province of institutional and accredited investors, and only recently are investors and advisors starting to better understand private equity. Below we touch upon some facts about private equity that you should know.

Private equity misconception: it's all about the leverage

With the mounting data supporting the cause for private equity, there's been an increase in investor interest. Notwithstanding the evidence supporting the argument that private equity has a strong risk/return profile, there's still a notion that private equity is more about leverage, engineering financial returns or intricate corporate transactions.

Some people look at private equity and assume it's a game of replacing management teams, cutting costs, and then selling the company at a price that doesn't reflect its intrinsic value. In this scenario, it seems like everyone loses except the private equity firms.

This type of scenario makes for a riveting story, but it doesn't reflect reality – especially today. The private markets have evolved over the past decades, and one key reason private equity does better than public equity is because of different governance structures.

Private Equity Governance: a long-term, active management philosophy

Establishing governance structures includes everything from creating strong boards of directors with clearly expressed roles and responsibilities to hiring the right management team and creating the right incentive structure.

In private equity, when a fund buys a company, they control both the company and the board. This makes it easier for management to create a capital structure that gives companies the flexibility to adjust - no matter the market conditions. This is especially true for buyout deals, where private equity firms take a controlling interest in a private company.

Private equity firms typically have a management team and a board of directors that oversee the portfolio company's operations and investments. The board of directors usually includes both internal and external members, including representatives from the private equity firm, independent directors, and possibly representatives from the portfolio company.

Private equity firms have a fiduciary responsibility to their investors, meaning they are legally obligated to act in their investors' best interests. This includes making investment decisions that they believe will generate a positive return, as well as ensuring that the portfolio companies operate ethically and in compliance with laws and regulations.

To ensure good governance, private equity firms often implement various measures, such as conducting due diligence on potential investments, implementing strong risk management policies and procedures, and monitoring the performance of portfolio companies. Additionally, private equity firms may engage with management teams to improve governance practices and implement best practices for financial reporting, stakeholder engagement, and the like.

In short, private equity firms are typically long-term investors as well as managers who are actively involved in the day-to-day operations of the business. As opposed to stock price, there's a tendency in private equity to focus on operational efficiency and growth. Because private equity firms typically have huge stakes in the company, they are all motivated and aligned for one very specific thing: improving the company.

How does this compare to public companies? Oftentimes public companies' management teams are less involved in the business' operations to the same extent as they are with private companies. It's also common to see public company managers compensated based on cash or rapid stock price appreciation, translating to a substantial payout for options holders. However, this doesn't mean that the actual company is performing well.

When it comes to investing, the past is no guarantee of the future, but the data is compelling. By most measures, in the private equity world, there are more companies, stronger growth, better governance models, and overall better use of leverage. If you're interested in learning more about how the private markets universe is less concentrated and larger today than any other time in history, read fact one of our Truths Revealed series.

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