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Magic markers

Evan Lorenz writes:

On the solemn word of the people who mark their own portfolios, highly leveraged private-equity companies outshone their lightly levered public peers in the first quarter. A closer look at this suspicious miracle is one topic at hand. A bearish analysis of Hamilton Lane, Inc. (HLNE on the Nasdaq), a class act of the p.e. industry that's valued as if it were heaven-sent, is another.

To transform an ordinary public company into a lean, mean cash-flowing machine, just add debt and new management. Such is private-equity doctrine, and if only it were true. Herewith the verdict of Bain & Co.'s 2020 Global Private Equity Report: "When we analyzed 65 fully realized buyout deals invested in 2009 through 2015, the average margin was well below the deal model forecast, and the majority failed to meet their projected margin expansion. Even more worrisome: For the deals where margin improvement was a critical factor in the value-creation plan, more than three-quarters did not meet the margin target."

In fact, according to Bain, expanding multiples delivered half the returns for American and European buyouts between 2010 and 2019: "GPs thus must find new levers for value creation," the consultants add, "whether that consists of pursuing M&A, stripping out costs, gaining market share, or entering new product lines or geographies." In other words, the p.e. titans must actually do what they say they do.

And this just in: Private equity's decade-long winning streak versus the publicly listed competition ended in 2019. It's the run that started in the bear market of 2007–09 when the honor-system valuations assigned by the p.e. promoters exceeded the public ones that appeared in the newspapers. Anyway, trailing 10-year p.e. performance has finally come to "match" public-equity performance—or not quite match, if one were to assign, as one ought to, a suitable handicap for leverage.

Just how severe was this penalty in the first quarter comes to light in a new analysis by Alexander Altmann, head of U.S. equity-trading strategy at Citigroup Global Markets. Break down performance of the S&P 500 by corporate credit quality, finds Altmann, and you see that 2020 is the Year of the Balance Sheet. Thus, in the year to date, triple-A-quality stocks outperformed double-A ones, double-As nosed out single-As and so on down the line to single-Bs.

The significance of the single-B, speculative-grade cohort is twofold. In the first place, it's just about the highest credit quality to be found in the p.e. world. Second, the single-B public-equity segment gave up around 50% of its value in the first three months of the year. Yet, in the same calendar quarter, KKR & Co., Inc., The Blackstone Group, Inc., Apollo Global Management, Inc. and The Carlyle Group, Inc. marked down their buyout portfolios by an average of only 15.8%. Altogether, private equity's first-quarter marks look more aspirational than documentable.

Then, too, in investing nothing fails like success. The higher the price you pay (high prices being the marker of prior success), the lower your future returns will be. Last year, a p.e. acquisition cost the typical buyer a multiple of 11.5 times earnings before interest, taxes, depreciation and amortization, compared with 9.9 times in 2007. How did the buyers swing it? Debt greater than six times Ebitda financed more than three quarters of 2019 deals, but that non-GAAP earnings metric is clay in the hands of inventive deal-doers. Given the common inflation of Ebitda through adjustments and add-backs, prices paid are no doubt higher, and leverage greater, than the p.e. sponsors acknowledge.

"If you look at the years in which they deploy the most capital or least capital, they generally deploy the most capital in the most expensive years and the least capital when prices are the lowest," Dan Rasmussen, founder and portfolio manager of Verdad Advisers, L.P., tells me. "I tend to be a short-term bear in that they are going to deploy capital, and a long-term bear in that the capital they deploy isn't going to be particularly well spent."

And for all the talk about $2.3 trillion of "dry powder"—committed but undrawn capital supposedly on call for future p.e. investments—there may be less on hand than advertised. A 2015 report by Preqin found that public pension funds are the single largest investor in private equity. No doubt, the states, even the blue ones like New York, will eventually recover, but not overnight. In the case of the Empire State, April tax revenues showed a 68% year-over-year decline, a consequence both of delayed tax filings and the state-ordered cessation of business activity. E.J. McMahon, research director

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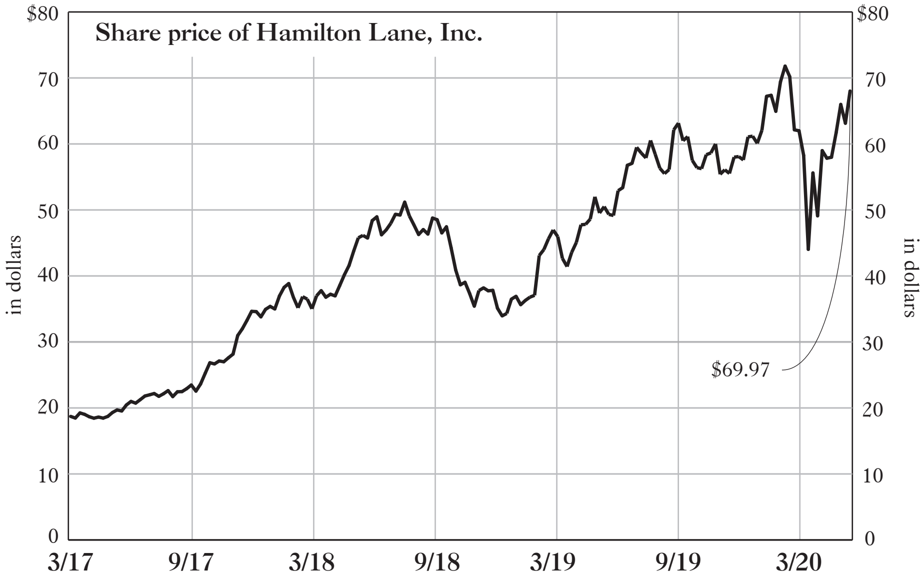
Heaven-sent?



source: The Bloomberg

of the Empire Center for Public Policy, says that, based on official estimates, overall tax receipts will not regain 2019 levels until 2024.

Gregory Mennis, who directs the work of the Pew Charitable Trusts on public-sector retirement systems, tells me that, whatever else they may do to make ends meet, the states are likely to pare back pension contributions.

In the years bracketing the First Great Recession, those pension funds ramped up their allocations to alternative assets, especially private equity and real estate, from 11% in 2006 to 26% in 2017, where they largely remain today.

Will those p.e. earmarks increase? For that matter, will torrid p.e. growth continue? From 2007 to the present, as PitchBook reports, the number of U.S. companies in private-equity portfolios has doubled to 8,785 from 4,381, while the population of publicly listed U.S. companies has dwindled to 4,397 from 5,109.

Whatever public pension funds might believe in their hearts, they assert on paper that they can earn 7.3% a year, elevated equity valuations, rising defaults and the 0.69% 10-year Treasury yield notwithstanding. In December, Pew reckoned that every 1% decline in that assumed rate of return would boost actuarial liabilities by 12%, or by more than $500 billion—the lower the rate of return, of course, the greater the capital required to pay the pensioners. The public funds increased their exposure to private equity to hit those hurdle rates. If p.e. disappoints, they will cut exposure. In 2014, the California Public Employees' Retirement System (CalPERS) announced it was ditching hedge funds following poor performance post-2009.

Because heavy leverage is the essence of the private equity M.O., a p.e. bull could take heart from the whiplash recovery of corporate credit a decade ago. In 2009, high-yield defaults crested at an all-time high of 12.09%, only to plunge the next year to 3.06%, which, remarkably, is below the long-term average of 4.08%. "I would submit that is physically impossible," Marty Fridson, chief investment officer of Lehmann Livian Fridson Advisors, LLC, told a 2014 *Grant's* audience. "But, it did actually happen, and I think that the only conceivable explanation is the Fed's extraordinary intervention."

Though today's central-bank rescue is still more extraordinary, the lockdown-induced economic coma may prove less susceptible to a monetary cure than the mortgage difficulties of 10 years ago. Fridson, reached last week, said he expects a more drawn-out credit recovery cycle this time around. If so, p.e. managers may be putting out fires in their portfolio companies for years to come.

And in what may or may not point to a changing political zeitgeist, a new Washington think tank, American Compass, last week took aim at private equity. "[T]he buying and selling of companies, the mergers and divestments, the hedging and leveraging, are not themselves valuable activity," the think tank declaims. "They invent, create, build, and provide nothing." It happens that American Compass is the brainchild not of Alexandria Ocasio-Cortez but of Oren Cass, the domestic-policy director for former p.e.-man Mitt Romney's 2012 Republican presidential campaign and a one-time management consultant at Bain.

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Founded in 1991 as a private-equity-management consultant, Hamilton Lane flourished in that role before flourishing even more, starting in 1997, as the sponsor of a private-equity fund of funds. Advisory work as well as investments soon followed in private credit, real estate, infrastructure, natural resources, growth equity and venture capital.

Hamilton Lane, Inc. at a glance

all figures in $ millions unless otherwise indicated

	TTM*	2019**	2018	2017	2016
revenues	$264.1	$252.2	$244.0	$179.8	$180.8
profit before taxes	125.0	129.6	139.6	74.8	56.7
assets under management ($ bns)	66.0	61.0	54.0	42.0	40.0
assets under management ($ bns)	422.0	422.0	397.0	300.0	215.0
cash	81.6	49.4	47.6	32.3	68.6
investments	193.2	154.5	137.3	120.1	102.7
debt	67.2	71.0	84.2	84.3	243.3
total assets	469.4	360.6	240.6	240.6	196.6

* For the 12 months ended Dec. 31, 19.
** For the fiscal year ending March 31.

source: company reports

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It's investment-related earnings that bring home the bacon today. Thus, in the three months ended Dec. 31, customized separate accounts (managing clients' private-market investments) and specialized funds (fund-of-funds in private markets) accounted for 46% and 40% of revenues, respectively. As of Dec. 31, AUM in separate accounts and specialized funds footed to $52 billion and $14 billion. The legacy advisory segment chipped in the remaining 13.8%.

Hamilton charges a base fee and an incentive fee, subject to a hurdle rate, on $66 billion in assets in separate accounts and specialized funds, and a fixed fee for advisory services. It exacts management fees on invested capital and not on the appreciated value of assets under management. In the December quarter, management fees averaged 0.56%.

The Hamilton Lane balance sheet shows net cash of $14.4 million as well as $193 million in investments ($171 million in its own funds and $22 million in financial-services tech start-ups) and $409 million in unrealized carry. Would you like to work there? It's one of the very best places to draw a paycheck, says *Pensions & Investments*.

Few firms have capitalized on the growth in private markets as well as HLNE. Between 2010 and 2019, assets under management compounded at 14.8% per annum. Peering out to March 31, 2022, the Street projects topline growth of 11.3% per annum. To accommodate it, Hamilton Lane signed a lease for a new headquarters in Conshohocken, Philadelphia's premier suburban commercial hub, beginning 2021.

Growth doesn't come cheap, however, as the stock is priced at 37.4 times trailing earnings and 34.4 times enterprise value to Ebitda; the dividend yield is 1.6%. With two buys, five holds and no sells, the Street likes the story but not the valuation. Short interest comes to 5.5% of the float, and the insiders have sold 242,248 shares for net proceeds of $14.5 million over the past 12 months.

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Valuation is the heart of the bear case: Blackstone, Apollo, Carlyle and KKR trade at an average of 18.4 times trailing earnings versus Hamilton Lane's aforementioned 37.4 times multiple, though the bulls may say it's worth it. Year-to-date, HLNE has generated a 17.4% positive return versus a 3.8% decline for Blackstone et al.

Even so, with the market extrapolating uninterrupted growth and limited partners facing the prospect of depressed returns, p.e. might very well confront the kind of resistance that hedge funds began to encounter a decade ago.

If leverage-adjusted p.e. returns do continue to fall below public market returns, the fees that Hamilton Lane charges (on top of the ones the p.e. managers themselves assess) may well begin to stick in the clients' craws. While HLNE's specialized funds have lockups that match those of p.e. funds, i.e., around 10 years, separate accounts can be canceled with 30 to 90 days' notice.

Hamilton Lane will report its March quarter results after *Grant's* has gone to press, on May 28. If the results of other alternative managers are anything to judge by, HLNE will face markdowns in its own investments as well as in its unrealized performance fees. Blackstone, for one, marked down its performance fees by 44% in the first quarter.

Then, too, in case of a slowdown, Hamilton Lane's rapid growth may present problems. The company will incur an extra $4 million to $5 million in rent expense when the new HQ is opened versus $125 million in trailing profits before taxes. For another thing, HLNE's rapid growth has resulted in a large cohort of employees who have not had the pleasure of living through a complete economic cycle. "The firm is very young," Erik Hirsch, vice chairman and head of strategic initiatives, declared at the Morgan Stanley Financials Conference on June 11, 2019. "So the average employee is in their early to mid 30s. I could count the number of older people on two hands."

The current financial backdrop, which features elevated stock valuations and rising defaults, could, in fact, be the worst possible combination for private equity. Managers will face losses as portfolio companies restructure in or out of bankruptcy, but, owing to elevated valuations, will find fewer opportunities to put fallow cash to work in cheap companies.

One thing taken with another, that 37.4 times trailing price-to-earnings multiple almost looks like a typo.

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