

SECONDARIES

Consistent adaptation

Secondaries firm Pomona Capital celebrates its 25th anniversary this year. Chief executive and founder **Michael Granoff** discusses how the secondaries environment and Pomona have evolved and what he sees for the future

Q What is Pomona Capital's general approach to the secondaries market?

We are willing to commit capital only if we receive an adequate margin of safety, which can come from several factors: purchasing assets at a discount significantly higher than the industry average, quality and maturity of assets, near-term liquidity events and hedging of potential foreign currency exposure. These are all important characteristics we consider at Pomona prior to making an investment.

Q Pomona is 25 years old this year, how have the firm and its strategy evolved?

Since its founding in 1994, the firm has grown to a 40-plus person shop with a global presence in New York, London and Hong Kong. In our 25 years thus far, we have been nimble as market conditions evolved, open to uncertainty, and consistently challenged our own assumptions – which can be hard. As a learning organisation, I anticipate Pomona to continue this trend as we adapt our business in an increasingly complex environment. While our core strategy investing in private equity secondaries has not changed in all this time, our tactics to take advantage of opportunities have.

Q Can you give some examples?

The way we source transactions has become increasingly proprietary. Recently, nearly half of the transactions in our current fund represent Pomona providing a

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complex liquidity solution to either funds of funds, listed funds or other kinds of structured vehicles; 20 percent involve repeat sellers and approximately a third of the transactions are GP-directed. In the prior fund, almost half of the transactions came to us from GPs that are restrictive regarding transfers. Lastly, almost all of the funds we buy are already on the target list of funds we want to own.

The majority of generic secondaries transactions trade in big auctions, and our sourcing has become more customised to find better than market quality assets at lower than market prices. That part of our business has had to adapt over time and will continue to do so.

The second example is on the analysis side. We are doing more and more complicated transactions that have more structure to them. We have to understand what is happening to the underlying portfolio companies to a much greater degree. Overall, our relationships with GPs and the way we use data has evolved quite a bit over the past 25 years.

Q What else is different?

The third part that has shifted is what we do after we buy assets. We have become more proactive about portfolio management post-acquisition in several ways. We have figured out how to effectively hedge currency risk, given that our typical exposure to European assets is around 20 percent. Currencies have been volatile



Granoff: constant change is required

in recent years and, because of our hedging, we have been able to protect investor returns despite double-digit swings.

We have also become more proactive in managing the portfolio and have become sellers of assets, particularly older assets that have already achieved their target return. We did not think there was much growth left in certain older assets as we surveyed the environment, but buyers appeared to be paying high prices in auctions. So, we tested the market and the process. Today, we have sold half a dozen times, totalling nearly three-quarters of a billion dollars in assets over the last four years.

We have become more strategic in what we do after assets are purchased. Each part of our business is evolving in quite a significant way in order to continue to execute the strategy.

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Q What do you think of the level of risk taking in the secondaries market?

In the secondaries market, generally, you are not rewarded for taking more risk. Some managers are buying billion dollar portfolios at auctions at very high prices, from my perspective, and some are taking large, concentrated bets on assets. Given Pomona's risk conscious approach to secondaries investing, we tend to be very deliberate when making investments and currently, we do not believe the data supports a thesis that elevated risk taking necessarily correlates with higher returns.

Q What other types of secondaries transactions is Pomona avoiding?

We have not been so interested in GP-led restructurings, emerging markets, or stapled transactions. The market is changing, but we generally have not been interested in GP-led transactions, because we believed that there was adverse selection and few good funds needed to be restructured.

If you are going to be dealing with mediocre assets managed by a mediocre GP that you had to pay a high price for, you may be taking more risk for potentially less return. When I look at all these types of transactions, I do not see them generating higher returns. We believe there are better places for our money.

Q Could that change in the future?

If the market develops in a different way, where better GPs are beginning to think about restructuring, then I think it could be an interesting opportunity for us. If the market evolves so that good funds start to reorganise as they get to the end of their lives – and we are able to get involved in restructurings in order to unlock good assets rather than mediocre assets – our »

Q Pomona has focused some of its efforts on courting retail investors. How do you anticipate they could change the private equity world?

If you assume that retail investors include individuals and defined contribution-type plans like 401Ks, it is clear that it is the fastest growing customer segment in the financial world. Companies today are rarely creating a pension fund for their employees. Second, for the most part, retail investors have little to no access to alternatives.

Third, if you look at most of the sophisticated institutional investors in the world, a majority of them have pretty significant exposure to alternatives and, particularly, to private equity. As a result, we believe that these sophisticated investors have the kind of returns that the traditional retail investor has limited ability to achieve.

Retail investors have the potential to be an enormous source of capital for private equity in general if the industry can tap into it. But, it is not as easy to access as institutional markets due to the nature of retail investors and their liquidity expectations – you cannot click a button and get out of a private equity fund. There is a way to go before you have a fit between the two, but we believe the opportunity exists. It is a little bit like a round peg and a square hole.

Q How is Pomona Investment Fund addressing some of the issues you mentioned?

We are not a square or a round peg, but we have come closer to what fits for retail investors than most traditional private equity, buyout or venture capital funds. We are buying mature assets at a discount and receiving liquidity relatively quickly, and we can provide that to retail investors (perhaps not 100 percent on demand, but more than others are able to).

The Pomona Investment Fund is growing and so far has been performing quite well, outpacing the public markets and other similar products. We believe it is an interesting area to continue pursuing for Pomona.

It may be worth noting that every big financial institution is trying to tap into the retail market. They are talking about it and it is going to be a significant portion of capital flows going forward – it is inevitable. There is such a huge potential, but it is complicated.

The whole regulatory aspect of marketing to retail investors has been a learning process for us. It is not what we are typically used to given our traditional institutional investor base.

We have gone through a learning curve and it is something managers interested in this market will have to navigate.

» investment team may be interested in pursuing those transactions. We require those elements and sometimes we will find them in bits and pieces, but, today, that is the exception rather than the rule. We are involved with the restructuring of funds of funds, listed funds and other complex vehicles and there you have a separation between the structure and the assets.

This is an example of how the way we see the market today may not necessarily be what happens in the future. The secondaries market has grown in the last 10 years at a faster rate than any other part of private equity. There has been a 20 percent growth rate since 2009, and the industry continues to evolve. The reasons investors seek liquidity are also going to be fluid, and we will

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continue to understand what they are and seek assets that meet the criteria that we have.

Q What are some of the main challenges with stapled transactions?

If we are only able to purchase the secondaries in a fund if we also give primary money to the GP, in our opinion, that is a red flag. It raises the question of why money cannot be raised in a normal way. It also dilutes the secondaries effect of what we are buying. We have done some stapled transactions in the past where the particular opportunity presented was attractive, but, in general, these are not the most desirable transactions. I do not think that is going to change for us. ■