

K E Y N O T E I N T E R V I E W

Maintaining discipline in secondaries



With a rapidly growing market in an increasingly volatile environment, secondaries investors need to creatively focus on the basics, says Michael Granoff of Pomona Capital

Q This year is clearly shaping up to be different from previous years. What does this mean for private equity and secondaries sponsors? Is now a good time for LPs to invest in secondaries?

2022 is thus far proving to be anything but an extrapolation of the benign market dynamics of the past several years. We are experiencing changes that are more revolutionary than evolutionary; geopolitical changes as we deal with the Russian invasion of Ukraine; macro-economic change as we confront inflation rates we have not seen for decades, along with a potential

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energy and food crisis; and the twists and turns of the covid epidemic.

The opportunity set is growing rapidly. The secondaries market has been the fastest growing segment of the private equity industry for the past seven years and volume exceeded \$100 billion for the first time in 2021. Increasing volatility has the potential to create attractive investments.

We are not uncorrelated to world events and we are not market timers. While we are not in the prediction

business, we are surely in the preparation business. What that means in the current environment is solving for a wide range of potential outcomes as we invest. It includes taking proactive steps to provide downside protection and positioning to capitalise on the upside.

It does not mean simply extrapolating recent history into the future. It means further tightening of our existing focus on quality assets as the dispersion of return in private equity expands in more challenging markets.

We need to be price makers not price takers, as we consistently acquire assets at a higher discount to NAV than the market averages. We have very limited

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exposure to geographies like emerging markets or sectors such as early-stage venture where it is difficult to assess risk. And diversification is even more important just as many market players are becoming more concentrated.

The opportunity in secondaries is growing and discipline is key.

Q The secondaries market is growing fast and saw record transaction volumes in 2021. What is driving that growth?

From what we have seen, the secondaries market may reach \$150 billion in 2022. Supply is a function of how much capital goes into private equity over time and how much turns over. Capital in private equity is now measured in trillions of dollars and not just billions. Limited partners typically sell due to circumstances affecting them and not the assets they own. Catalysts may include changes in ownership, management changes, needs for liquidity, over-allocation or changes in regulation.



Q Will GP-led secondaries activity continue to grow? How do you approach GP-led deals?

My guess is that the growth of the GP-led market will be determined by the increasing interest of GPs in selling assets bounded by the interest of investors in acquiring those assets. If the assets perform, demand is likely to increase. If the assets do not perform, demand will decline.

GP-led transactions tend to be much more highly concentrated than LP transactions. Most GP-led transactions are still quite young, so we do not yet have many realised transactions. Because transactions are almost all intermediated, syndicated and priced, one could invest almost unlimited sums if one took that position. We do not.

We are agnostic about where we find value among deal types, but we tend to find more value on the LP side of the market with a number of exceptions.

When GP-led transactions began, our sense was that we did not see too many good funds that needed to be restructured. So, if you were being asked to buy mediocre assets managed by mediocre managers trading at a high price, we likely had better places for our investors' capital. As better quality assets and managers began to reach the market our interest increased, but carefully.

Our approach to transactions is always the same: bottom-up analysis of every company in every fund and top-down analysis of managers and markets. There are good reasons to be cautious.

Analysis

Another major contributor to the secondaries market over the past few years has been the emergence of GP-led sales. GPs are using the secondaries market to hold onto assets beyond the typical life of funds and provide liquidity.

Pomona invested more than \$1 billion last year for the first time. At the same time, we are acquiring a steady or even declining percentage of dealflow. Ours is not a market share strategy. We do not own a slice of the generic market.

Q With more and more retail investors looking to access private equity, how is that changing the asset class?

The retail market for private equity is undergoing revolutionary change. On the one hand, capital flows are increasing dramatically while no one is creating a new pension fund in the US, for example. Private equity has performed well over long periods of time and investors of all stripes are increasing allocations. On the other hand, individual investor access to private equity has been very limited to date and exposure levels are very low. This combination is creating a large opportunity set.

The retail market is not the same as the institutional market in that it is more fragmented and much more highly regulated. Product structures and operations are more complex. Individual investors usually require more liquidity than institutional investors, for example.

Individual investors also are best served by the same attention to diversification and risk as institutional investors.

All of these changes add up to an interesting challenge. Pomona began an experiment in this area a few years ago and it has blossomed into a leading position. Our NAV in this area doubled last year for example, and the product is providing leading performance. We have been able to provide investors

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with what we believe is an appropriate investment diversified by vintage year, fund, company and industry.

Today, I think it is more and more clear that this area will likely experience the largest increases in capital flows over the next few years.

Q What do you think will be the determinants of success in secondaries going forward? What does your history and experience tell you during these times?

It is easy to do well when everything is moving in the right direction. It is not nearly as easy when that is not the dynamic. The general determinants of success are similar throughout the business world. We need to make sure our value system is unchanged as others are blown in the wind. And, at the same time, we need to foster change and adapt continuously and creatively. Neither is easy to achieve. Both are even more difficult to achieve simultaneously.

More specifically in the secondaries market, I suspect that diversification will likely prove to be more important. Asset quality will be more crucial as the dispersion of return widens. Pricing discipline will make the difference between returns. Leverage will be a two-edged sword, especially as interest rates rise.

Our goal at Pomona is to focus on the fundamental value proposition of the secondaries business, which is to provide a private equity investment with strong returns and strong risk control in positive and negative markets.

Our ability to execute is determined by people and teamwork. Our scarcest resource as always is investment judgment and not capital or dealflow. High-quality investments and high-quality people are our watchwords. ■

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Michael Granoff is founder and CEO of Pomona Capital, a private equity firm specialising in secondaries investing