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Pomona’s private equity niche

Where hedge funds have fallen by the wayside, private equity continues to attract insurer interest like never before. Pomona Capital’s founder **Michael Granoff** explains how his own company has tapped into the niche and how it is preparing for a potential turn in the cycle. Interview by **Sarfraz Thind**

Private equity has traditionally been on the fringes of insurer portfolios but there is no doubt about its current popularity. According to Goldman Sachs’ insurance investor survey private equity was the most favoured new asset allocation choice last year, with 32% of insurers planning to maintain or increase their private equity investments in 2018.

While still small—2% to 3% of the average portfolio—the interest is growing driven by the performance of private equity funds in the last decade or so. According to JPMorgan Asset Management, in the 15 years to the end of 2017 private equity generated a 14.4% net annual return against 8.8% for the MSCI World equity index. And, clearly private equity funds are less prone to suffering blow ups like their unfavoured cousins, hedge funds.

One such fund to have tapped this demand is Pomona Capital. The 25-year old asset manager has found a niche by focusing on private equity secondaries, investing in holdings sold by other investors in private equity funds. Its insurance clients are interested—the company has some 20 insurers invested with it, which has helped grow it to $10.6bn in assets under management.

The fund takes a “value approach” to private equity investing, says founder and chief executive Michael Granoff. The aim is to find undervalued opportunities which arise when existing owners need to shed their holdings—not a distressed asset but distressed investor focus.

“Some subset of sellers—whether it be pension funds, insurance companies, endowments, foundations, sovereign wealth funds or high net worth investors—will have some need for liquidity,” says Granoff. “This could be due to regulatory changes, restructuring of portfolios, exiting of non-core relationships, and so forth.”

Granoff worked at different private equity companies for eight years before setting up Pomona, which is where the idea of buying interests in secondary private equity was formed.

Prior to that, Granoff was on the staff of the US House of Representatives Appropriations Subcommittee on Foreign Operations and for President Clinton's transition team in the treasury. He has had ties with most of the presidents since, as attested by the photos which line the walls of his office.

The focus on secondaries is an interesting niche and potentially gives the company added allure for the insurance investor.

The aim is to buy into assets that are five to seven years old which means Pomona is able to cut down the time investors are required to wait for their money.

"We thought if you could buy into these funds well into their life it wouldn't be a blind pool," says Granoff. "If you could look into the companies you could see what you thought of them, decide how much you wanted to pay for them and wait a lot shorter time for liquidity. If it's a 10 year fund and you are buying in around the seven year mark you're going to have to wait a loss less time than the original investors to get your money."

Last year the company looked at $42bn of deals of a total record deal flow of $74bn in the secondaries market. Most of this is concentrated in the US market which has provided the best private equity returns for a long period.

Insurer appetite

One of the challenges of investing in private equity is the lock-up period. Private equity companies do not generally allow investors to redeem their money before the contracted period, usually ten years.

Which may potentially dissuade some.

"Unlike things which are liquid you can't push a button and change your mind tomorrow," says Granoff. "So you had better be sure."

He says the focus on purchasing assets that are typically three to five years old means a shorter investment horizon and more insight into the portfolio and its underlying companies. The cashflow profile of Pomona's funds is "quite different" to other private equity firms, and Granoff believes the "constant liquidity" is a comfort for insurance investors.

"Private equity in general is a fairly illiquid investment since you give someone money and it is locked up for a long time," he says. "However, we have made cash distributions to investors in every quarter since inception. The liquidity pace looks a lot more like what insurers are used to looking at."

The longstanding experience with insurers has also given Pomona an understanding of the sector's regulatory framework, reporting needs, capital charges and reserve requirements.

At present, Pomona's insurance investors range across the globe stretching from the UK to South Korea.

"They like it because they like the value approach to private equity," says Granoff. "They have a value approach to most things. On top of that the cashflow dynamic is attractive."

As far as dealing with global insurers across geographies, Granoff says the sector is probably more similar than different.

"Insurance is the same concept everywhere. There are lots of commonalities in the regulatory framework. I don't think Asian insurers' reasons for investing are different to anywhere else."

Risk mitigation

While private equity will always be in the riskier bucket, mitigating some of the downside, while delivering strong returns, is an important skill for attracting insurers. Indeed, according to Granoff, the search for returns is not predicated on increased risk taking.

"Return expectations of insurance companies are not huge," says Granoff. "They want to be in private equity to outperform what they hold, which are not all such high performing assets. We can give them this return with a much

lower risk profile. In our experience with insurance investors, they tend to care more about risk than some other private equity investors.”

To manage risk the company diversifies across funds— it holds positions in hundreds of funds and hence owns interest in thousands of private equity companies.

“I don’t think there is a high-quality private equity manager out there that we haven’t gained exposure to at some point,” says Granoff. “We own a portfolio of over a thousand companies so diversification is a big way to mitigate risk.

At the same time, the company looks to buy assets at a discount to net asset value—usually somewhere in the mid-teens—so it maintains a “margin of safety,” says Granoff.

“Investors invest with us because they expect us to provide them with a margin of safety. They are not investing with us to own a private equity index. They want to buy better than market quality at cheaper than market price.”

Turning cycle

Granoff says it is an “anxious world we live in” right now and the potential of a downturn in the markets is a real consideration.

As investors there are three options. Firstly, is the cash retention take—essentially keeping cash and limiting allocations—the safest and probably most fearful option.

Second is carry on as usual method which involves little change to the work.

Finally, comes the willing but only at the right price play. He says that Pomona fits into the third category. The company will focus on getting assets with enough margin of safety—if it gets this it will commit capital.

“If you can get the highest quality private equity assets managed by good people, history suggests you do well in good and bad times.”

Indeed, the diversification of risk and careful assessment of value means the company should be in a risk control mode going into any turning cycle. In the long-run the company could also be a beneficiary of disruption.

“If the world becomes a more challenging place it will increase our supply. Our pricing power would increase.”

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