KEYNOTE INTERVIEW

Sticking to fundamentals in the secondaries market

Secondaries managers will excel if they remain focused on key market fundamentals while continuously adapting, says Pomona Capital's Michael Granoff

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Q Where do you see the biggest challenges and opportunities for secondaries firms as we move towards a post-covid environment?

The secondaries business operates in a paradox: the fundamentals do not change a lot, but at the same time, everything is always changing and if you do not adapt then you may be left behind. The key to success over a long period of time is somehow managing to bridge those two seemingly contradictory forces.

The fundamental goal of being a secondaries investor never changes, and that is to buy higher-than-market-value assets at lower-than-market-value prices. People invest in secondaries funds not because they want an open bet on an index, but because they believe such funds provide a margin of safety and combine value and growth. That was the same in 1994 when I started Pomona, in 2020, and today. We have to look at market changes through that lens.

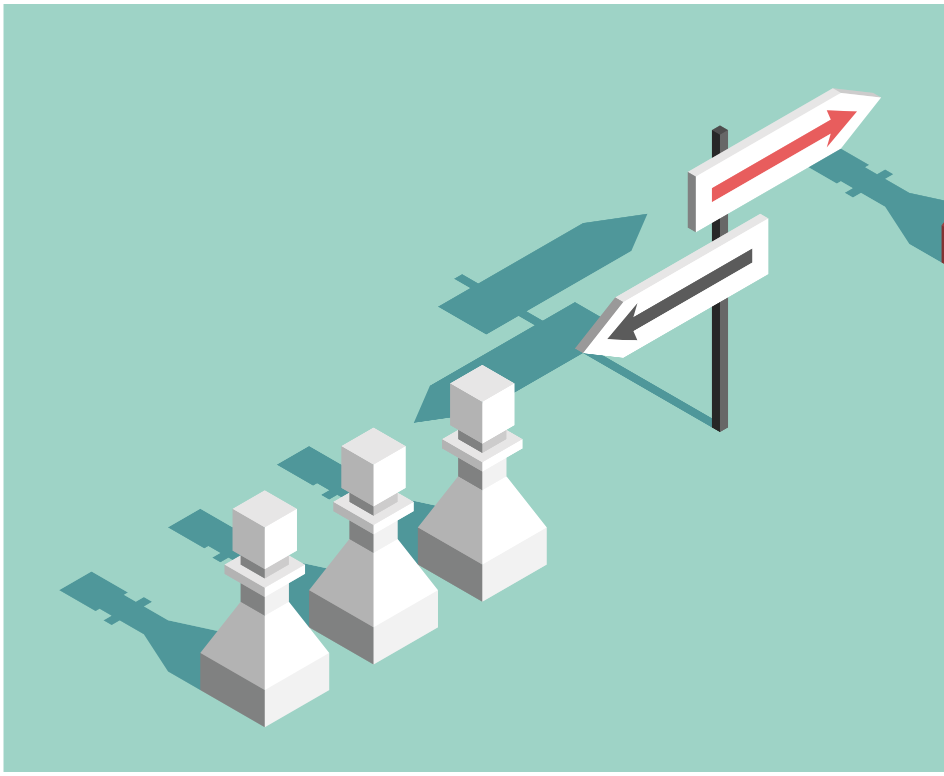
At the same time, none of us has lived through a pandemic before; we have lived through economic cycles, but nothing like this. One of the hallmarks of the past year has been the wide range of potential outcomes possible at any point. As we come out of the pandemic there are many economic forces at play, but we do not yet know whether there will be so much pent-up demand that we will see strong economic growth and inflationary pressure, or the opposite. With so much volatility, sticking to your core values while continuously adapting is key.

Q Do you anticipate a shift in seller sentiment?

Seller sentiment is generally driven by two variables: how much money goes into private equity over time and what percentage of that turns over. Approximately $8 trillion has been raised in private equity in the past decade, and the turnover rate of those assets are influenced by secular, cyclical and idiosyncratic dynamics.

At a secular level, over time, LPs in private equity funds have become increasingly willing to sell. That was not the case when I first started in this industry nearly 30 years ago, but it explains why we believe secondaries has been the fastest growing segment of the private equity market and could soon exceed $100 billion a year in dealflow.

Cyclically, not everyone has been affected equally by the pandemic, with some investors – for instance, US university endowments – facing more challenges than others. Finally, there are individual, idiosyncratic dynamics, where for the most part LPs are selling because of something that is happening to them, rather than because of the assets. For example, investors may need liquidity due to regulatory changes or they may be restructuring their portfolio. Seller sentiment is always changing and it is not always clear-cut.



Q There has been a growing trend of retail investors looking to enter the PE market in recent years. What is behind this interest and how will it impact the asset class?

First, to our knowledge, the US has not seen a new employee pension fund created in a long time. Existing pension funds might be growing, but no one is creating new plans. Instead, it is clear that the bulk of future capital flows will likely come from individual retail investors rather than institutions.

Second, if you look at individual investors and compare them with large institutions for asset allocations, they have historically had little or no ability to gain exposure to alternatives, including private equity. Alternatives have also tended to outperform public assets. So, we believe the growth in capital flows will come from retail investors and they will increasingly seek access to private equity.

Given that opportunity, at Pomona we looked at how we could best provide retail investors with a high-quality product. It is important to note that it is not just mid-sized firms like Pomona looking at this space – some of the largest asset managers in the world are also paying attention to the retail market because that is where the money is.

What we have tried to do at Pomona is think about not just how to access retail investors, but about the most suitable products for them to be investing in. Small venture capital funds might not be appropriate, for example. Retail investors need a degree of diversification, and that fits with the approach of our secondaries funds, which typically invest in over a thousand underlying portfolio companies.

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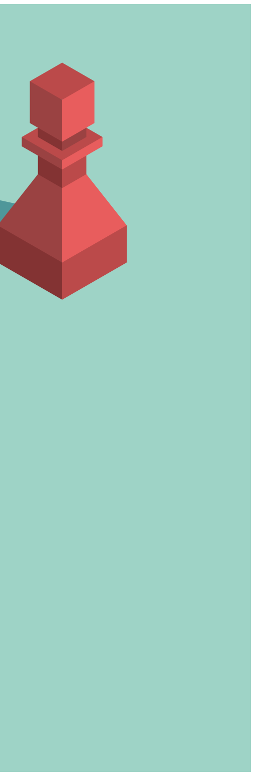
We also have a cashflow dynamic that is very attractive. A couple of years ago, Pomona created a fund that is registered with the US Securities and Exchange Commission to be able to provide private equity secondaries investment strategies to retail investors, and that is now starting to get to critical mass. It is still very early days, but I believe we have a good offering.

Q GP-led deals have recently become a key driver of secondaries deal volume. For secondaries firms that focus more on LP portfolio transactions, what would you say are the key elements to consider?

GP-leds are a good example of the



Q For LPs looking to invest in secondaries, what advice would you give for evaluating secondaries firms? How should investors think about differentiation between managers?

We are often asked if now is a good time to commit to a secondaries fund. Fundamentally, we navigate markets and we have to be both defensive and offensive – we are not market timers. We invest our funds over a long period of time, and if someone commits to our fund we are going to invest over several years, so today's situation is relevant but not determinative.

People may get lost a bit in discussions about big data, technology, GP-leds and so on. It is important not to be distracted by trends and stay focused on the fundamentals. Investors should judge secondaries funds by their ability to buy good assets at compelling prices, and if they are doing that right, then great. If secondaries funds are using too much leverage, placing large bets on single companies, choosing mediocre assets or losing pricing power, then the equation for investors may not hold up.

Additionally, investors should also look at the general factors that are important to assessing all funds, such as track record, style drift, alignment of interests, conflicts and team dynamics. However, the fundamentals need to be right.

> *"I would expect a continuation of the trend towards differentiation – not every secondaries fund is doing the same thing"*

paradox that we just discussed – the fundamentals do not change, but the market is always changing. GP-led transactions were rare even five or six years ago, but we are seeing today they make up a significant percentage of the total market, with that growth set to continue.

Our job, as I see it, is to buy better-than-market-quality assets at a lower-than-market price. We need to be both agnostic and creative about how we do that. We need to look at all transactions through that lens – whether those are GP-leds, restructurings, LP portfolios, co-investments or preferred equity. In some sense, all transactions should be judged in the same way, even if you are looking at different means of getting protections and dealing with risk.

The GP-led market has been dynamic, and in the early days of its development we were certainly happier to be sellers. At the time, we thought there was a reasonable amount of adverse selection. However, today, we have seen that the number of high-quality GPs doing GP-led transactions involving high-quality assets at more compelling prices has increased, though we would say that it is still the exception rather than the rule. Our team has probably analysed well over 100 GP-led deals and you can count the ones we have done on your fingers. Where those deals meet the test for us, we are more than happy to be buyers.

Q Pomona is now approaching nearly 30 years in the secondaries business. How has the industry evolved over that time and where do you see it going in the future?

When I started Pomona in 1994, I thought that these transactions – if we could do them – would be interesting, but I had no idea the business would grow to be what it is today. We have grown with the industry, taking advantage of what has happened and generally avoiding the pitfalls.

Looking forward, I do not believe that the amount of money in private equity is going to go down, and more money in private equity probably means more secondaries volume. I would expect a continuation of the trend towards differentiation – not every secondaries fund is doing the same thing – with more types of transactions and ways of getting to the end-goal. We need to be at the forefront of being creative in finding ways to offer both value and growth. Pomona recently did its first European preferred equity deal and will continue to drive forward new ways of doing things.

I think we will see different types of products and different kinds of investors coming into the market. Our job will not become easier: today we purchase about 1-3 percent of the dealflow we see, and I do not expect that to change much. We need to stay ahead of the curve by using a combination of hard power and soft power, with our hard power coming from capital, data and granular analysis, and our soft power coming from GP relationships, team dynamics and the way we look at things. Those are the real drivers of success. ■

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