KEYNOTE INTERVIEW

Adapting to uncertainty in secondaries

In the face of macro headwinds, asset quality and price are more important than ever, says Pomona Capital chief executive Michael Granoff

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Q After a volatile 2022, this year seems to be likewise beset with uncertainty. What does this mean for PE and secondaries managers?

This year, we are experiencing the aftershocks of a volatile 2022. In volatile environments, people find that assets are usually more correlated than they think. No one is immune to volatile markets, including us.

Our goal is not to be contrarian and take more risk but to be careful and resilient. Pomona thinks about the environment in two ways. First, when making investment decisions, we are solving for a wide range of potential outcomes so that we build in a margin of safety. We didn't wake up this year and discover volatility. We have always been risk-conscious investors, and we need to make sure we are protecting capital. Investors rely on us to do that.

Second, we are not just a victim of circumstances; we get to benefit from volatility. In these markets, there may be motivated sellers, more pricing power, and more ability to pick and choose assets we would like to buy.

It's not our job to predict the future, it is our job to be prepared for the future. All the indicators suggest we are in for a prolonged period of volatility. As such, a generic approach or shifting your strategy is probably not the right move. This market puts more emphasis on the quality of assets, as the dispersion of returns between assets rises. If you can get it right, you will probably do okay; but the penalty of not getting it right is much greater than it is when everything is going up.

Q How is Pomona picking opportunities in a busy market?

We buy somewhere between 1 percent and 3 percent of the doable dealflow we see. In an overwhelming majority of situations, either the assets don't meet our quality criteria, or someone will pay more than we will. In more volatile times, your hurdles are higher, and you need to pay even more attention to the quality of assets and to price.

I believe we have a couple of advantages. First, is our strategy. We do not seek to own a slice of the generic market. We're not buying the universe of private equity; there are thousands of private equity funds we have no interest in because their track records do not meet our quality criteria. There are significant categories we are less interested in, such as emerging markets, commodity-related investments and early-stage venture.

We are not interested in areas where the risk-reward ratio is against you. We're looking for situations where, in fact, the actual risk is lower than the perceived risk.

Second, is our modest fund size. It enables Pomona to be nimble, flexible and creative to source what we believe to be higher than market quality assets at compelling prices. We construct a portfolio of choice, and selectivity is key. We do not need to buy the market.

Q Are you interested in opportunities in the GP-led secondaries space?

It's more the exception than the rule, not because we have a philosophical view about it, but because currently we're more likely to find assets we would like to own at a price we are willing to pay on the LP side. GP-led transactions tend to be highly concentrated, while we are aiming for a high level of diversification.

We're already seeing pressure on the GP-led side of the market. There was a perfect storm of GPs wanting to create continuation vehicles and buyers being willing to pay high prices, thereby seemingly making all parties satisfied. Now, buyers are less willing to pay those kinds of prices, LPs are less willing to sell, and so the rate at which those deals happen is lower.

I think GP-led transactions are now a permanent part of the secondaries market. We'll see how the market evolves. We are agnostic about where we find value. For Pomona, our approach to any transaction is always the same: driven by the quality of assets, we do a bottom-up analysis of every company in every fund and top-down analysis of managers and markets.

Q What will be the key to success in the secondaries space in the next decade?

The challenge in a changing environment and growing market is keeping your values constant when others around you don't seem to be. At the same time, you need to push change in a fast, adaptable way. Both of those things can be difficult to do. Our people at Pomona understand that, and so do investors. Investors have a good sense of authenticity and I expect there will be a premium for that going forward.

There's a hard side to success, the numbers side, and there's a soft, subjective side. One of the things we learned from the pandemic is the importance of the subjective side, of relationships. People trust us with capital for quite a long time, and they need to feel confident in what we're doing. It's true of investors and it's true internally of all our people.

In secondaries, there is no secret algorithm that distinguishes managers. The difference is execution and it is determined by people and teamwork. We have to be able to attract and retain the best people possible. To do that, they need to be in an environment where they feel mentored, supported and challenged. It isn't easy, but it is a pretty interesting place to be.

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Q What are LPs looking to get out of their secondaries investments in today's environment?

Prior to last year, we were in a period where people had much more greed than fear, so they were looking only at the upside and not paying so much attention to the downside. Obviously, that situation has changed. Investors today have, at the very least, equal doses of fear and greed. This translates into a search for investments that balance risk. They are asking questions about risk when it comes to concentration, company profitability and liquidity. They are seeking downside protection. As a result, there is rising interest in the Pomona strategy.

Q Can secondaries be a good downside protector?

I believe a differentiated secondaries strategy can provide downside protection. At Pomona, we focus on consistently acquiring higher-quality assets at better-than-market prices. Diversification is also important. Our funds tend to own interests in over 200 funds and more than 1,000 companies across multiple industries and sectors. We also hedge currency risk. All these factors can make funds like ours compelling to investors in environments where they are trying to balance risk against return.

Q How is the higher cost of debt affecting Pomona?

In general, Pomona is a conservative user of leverage, and we carefully monitor it. Increasing debt costs have an effect across the chain of private equity investments from individual companies to funds. And we are not immune.

A few years ago, we were living in a time where debt was essentially free or close to it, and that was an anomaly. The cost of debt has risen, but the absolute cost in historical terms is not all that high.

You should expect that if you want to borrow money, you're going to have to pay for it. And the more you pay for debt, the more it could impact your return and increase your risk. I don't know where interest rates are headed, but I would doubt they're headed back to zero. And if they are it would mean a dramatic economic deterioration.

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Q Pomona has been offering a product to retail investors for some time now. How is demand for these products changing the PE landscape?

First, no one is creating a new pension fund in the US, for example. The amount of institutional capital in private equity, while very large, is unlikely to see dramatic inflows. The largest sources of new capital flows into financial markets are likely to come from individuals.

Second, individual exposure to alternatives in general is in the low single digits.

Third, individuals are coming to the same realisation as institutions that alternatives aren't alternatives anymore; they're important parts of core portfolios. Those three elements together create a significant opportunity.

As retail investors move into private equity, we believe their investment criteria should be similar to that of institutional investors: they should own a diverse portfolio of high-quality assets with a healthy risk-return balance that is likely to generate good returns over time, and not expose them to inordinate risk. We believe that a differentiated secondaries strategy can be a prudent, attractive opportunity for individual investors.

It is not so easy to create and manage private equity structures for individual investors. You can't just take a round peg and put it in a square hole, as they say. We were ahead of the game in trying to work on those structural questions to develop an appropriate product for individual investors. The Pomona Investment Fund now has about $1 billion of assets under management with leading performance, outpacing the public markets and other similar products. ■