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Information arbitrage

Michael Granoff, founder and CEO of Pomona Capital, discusses raising capital from Asian LPs, how GPs can be differentiated in a crowded secondaries market, and why he's not keen on fund restructurings

Q: How significant is Asia as a fundraising destination for Pomona?

A: About 20% of the capital in our most recent fund comes from 15-20 Asian investors, with the largest concentration in South Korea. We were one of the earliest private equity secondaries firms to have investors from Korea, it goes back to 2001. The Asia share of our funds has increased gradually and these LPs have become an important part of our business. In general, they want more support than US or European investors – they ask more questions, they require more information. It takes a lot of effort, but these investors also have their fingers in a lot of places, so for us it is a two-way street. We have investors in Asia who are investors in funds we are not in, who are aware of things we are not. We have also seen deal flow coming from investors in Asia.

Q: Can you give an example of this?

A: We had a chance to buy a secondary in a Korean buyout fund from a Middle Eastern investor a few years ago. We were not too familiar with this particular manager, but it turned out many of our investors knew this fund and the assets, so we had an information advantage. That enabled us to get comfortable buying an interest in this fund and we got back 100% of our capital within a year. Do we have an overwhelming number of those situations? No. But when they come, we want to take advantage of those opportunities and our investors can help a lot.

Q: To what extent are you buying positions in Asia-focused funds?

A: It represents a smaller part of our portfolio. If you look at performance and liquidity over time, it is hard to match the risk-reward ratios of the best-performing assets we can buy in the US and Europe. In Asia, we believe the risk is higher, but the reward may not necessarily be higher, so you must look more at special situation cases.

Q: How do you stand out in an increasingly crowded market?

A: Our sweet spot are transactions of $50-500 million and we believe that represents 80-85% of the secondary market. Supply has increased over time – in the last 10 years, the secondaries market has been the fastest growing part of private equity. At the same time, demand has certainly met supply; we have no shortage of competitors. When it comes to sourcing, we must use every method at our disposal to secure transactions that meet that criteria. We only buy 1-3% of the deal flow we analyze every year. In our previous fund, almost half the transactions were directed to us in one way or another by GPs with LPs that wanted to sell. Relationships are important to us – they decide whether they want to share information with us, whether they will give consent to a transfer, which can be difficult to get if you are not on their approved transfer list. We also commit $250 million a year on the primary side, and it's gone from being a nice thing to a necessary thing. We also do a lot of structured transactions that are liquidity solutions for fund-of-funds and listed funds. A fund-of-funds makes a tender offer and wants to sell a portion of it, so we work closely to find a solution that works for them and us.

> **"People haven't been punished for taking more risk in all kinds of ways, including leverage, since the global financial crisis"**

Q: Have GPs become more restrictive on transfers?

A: Mid-market buyout firms in the US, certainly. Why? It could be several things. Maybe they want to control their destiny – they want someone they know or someone who could be an investor in their next fund. Maybe they don't want to share information. In the past year, there have been multiple situations where we were able to buy things that dropped out of larger auction processes because the GP would not consent to the buyer of the bigger portfolio. In another situation, there were five funds, all of them restrictive, and we were the only secondaries manager that could buy them all.

Q: Are there things you won't invest in?

A: We can't be ideological, there are always exceptions. But take GP restructuring transactions – I don't know too many good funds that needed to be restructured. If you told me I'm getting mediocre assets managed by a mediocre manager and I'm paying a higher price because I must convince existing LPs to sell, it would take some convincing that the risk-reward is not better elsewhere. If in the future, it's not just mediocre assets but good assets, not just mediocre managers but good managers, and the price is compelling, there could be a tremendous opportunity for us. But to date, most transactions we have seen don't meet our risk-return criteria.

Q: What about other transaction types, such as staples, strip sales, and preferred equity?

A: Staples we approach with similar bias. If a manager is having difficulty raising money in a normal way, we may not be so sure about investing. With strip sales, there is no inherent bias, you just decide whether you want to own the strip and if it's at a price you are willing to pay. As for preferred equity, it will be interesting to see how those develop. Is there a way to bridge risk and reward? Can you buy yourself a bit more safety, cushion on the downside? We

are looking at various ways to protect against the downside.

Q: What can you do to differentiate yourself during the holding period?

A: There are two main things. First, we have figured out an effective way to hedge currency risk. Most of private equity is unhedged and currencies have been volatile over time. In our last couple of funds, we've had 20-30% exposure to Europe and minimal currency effect while the currencies themselves have fluctuated by double-digit percentages. Second, we are dynamic in how we manage the portfolio. A few years ago, we identified a group of assets where we had achieved our return target, we didn't think there was much growth left and people seemed to be paying high prices in auctions. We hired an intermediary and sold the assets to a competitor at a very compelling price. We have done this half a dozen times on $750 million in assets.

Q: Are you concerned by how quickly the secondaries market has grown?

A: It's growing because of the amount of money that's gone into private equity, especially after the financial crisis, and because of the broad turnover rate. If we were at a cyclical place where people were struggling, the turnover rate would be artificially high. That hasn't been the case in recent years; cyclical factors are not impacting turnover. The market has grown because of non-qualitative factors – you can't say it's too fast or slow, it is what it is. You can just choose what parts of it you want to buy. We have the right amount of capital for our strategy. Could we execute our strategy with four times as much capital? No. We would be pushed to where the market is more efficient. In the most recent fund, which is 70% committed, we bought at an average discount of 15% and the industry average reported discount during that period has been 4%. We would end up paying a higher price and losing our margin of safety. Alternatively, we would be pushed further out on the risk curve. As the market has grown, secondaries managers have raised capital against it, and they have delivered good returns for the most part.

Q: What about leverage levels?

A: It's something we are concerned about. We have competitors that use a lot of leverage, but we use it conservatively. Leverage can be a great benefit to returns on the way up, but a pretty dangerous thing on the way down. If you look back at why companies blow up, it's often because of leverage rather than changes in the fundamentals of the business. In our opinion, people haven't been punished for taking more risk in all kinds of ways, including leverage, since the global financial crisis.

Q: Will more LPs take secondaries investment in-house as the market grows?

A: There are many institutional LPs that have more than enough money to be in our business. You would think, given the rate of growth in the market, there would be more competitors. But it takes more than money. Transactions today provide less and less information, so you need data on all these funds, you need relationships. Execution is not simple. A handful of big LPs have gotten into the business. Most don't have the staff and capabilities to do it. LPs have certainly become more interested in co-investing. We offer it. For example, if we are buying a portfolio for $400 million and only want to take $300 million, we may give out some in co-investment.

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