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STATE OF THE MARKET

Staying nimble in secondaries

Pomona Capital's chief executive officer, Michael Granoff, reflects on the evolution of the secondaries market, today's environment and what 2018 has in store

***Granoff:** dealflow is robust but pricing remains tight*

Since Michael Granoff founded secondaries firm Pomona Capital nearly a quarter of a century ago, the market has grown significantly. With some funds expanding in size, Pomona has strategically and deliberately kept its fund sizes modest, with the most recent closed vehicle, Pomona Capital VIII, being $1.75 billion.

Typically buying only 1 to 3 percent of the dealflow it sees each year, Pomona believes in the importance of being disciplined and selective. Pomona tends to focus on niche, mid-size transactions where it can take advantage of inefficiencies, capitalise on its edge and steer away from buying a slice of the generic secondaries market.

In a recent interview, Granoff explains what makes Pomona different, his views on GP-led transactions, the state of the secondaries market and opportunities from retail investors.

Q What differentiates Pomona in this market?

In today's market there is no shortage of dealflow. Increased volume brings with it increased variability in transaction size, asset type and quality, and liquidity profile. What differentiates Pomona is our ability to seek opportunities where we believe we have an edge and not compromise on asset quality or price.

Our modest-sized funds provide us with the ability to be deliberate in our investment decisions without the pressure to deploy capital and sacrifice our strategy and risk/return objectives. Typically, our sweet spots are transactions $100 million in size, but our flexibility keeps us focused on selectively buying quality assets at good prices. If you look at our last secondaries fund, Pomona Capital VIII, the largest transaction was over $400 million and the smallest was about $10 million. Being able to be that nimble is a real benefit to us. If we could only buy tiny little pieces of things, I think we'd be really limited in what we would see. If we could only buy the largest transactions, we would end up in the more efficient side of the market and have to compromise on quality or price.

Q What type of transactions do you pursue?

Pomona focuses on uncovering opportunities where we believe we have or can create a competitive advantage. We seek transactions where we have the ability to capitalise on an informational advantage through existing relationships and in-depth knowledge of particular assets and/or funds or leverage our status as approved buyer on a general partner's restrictive list.

We invest mostly in LP stakes and take a targeted approach focused on acquiring high-quality and mature assets that have identifiable near-term liquidity and downside protection. We maintain a disciplined pricing approach in our efforts to provide a margin of safety on the downside and to enhance returns on the upside. We actively seek ways to enhance liquidity for our investors while also achieving a lower risk profile by targeting mature assets that are typically five-to-seven years old and funds that are 70-90 percent called. Often assets in these portfolios have substantially de-levered, are demonstrating positive operational performance and are preparing for liquidity events.

Q Do you invest in GP-led secondaries transactions?

I haven't seen too many good funds that needed to be restructured, so the barrier for our participation is high. We have been sellers in many more cases than we have been buyers. Pricing is generally high and close to NAV. There is usually not much growth »

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» left in the assets. If you told me I could take my money off the table today and lock-in returns for our limited partners, or wait years for the same amount of money, I would rather take the money now, especially in the current environment.

Q How important is primary investing to secondaries?

Our relationships with GPs are important. Primary investing is one element of the multidimensional relationship we seek with GPs. We've built a lot of critical mass in the primary asset class over the years. Today, we manage over $3 billion in primary commitments and deploy approximately $250 million a year on the primary side. We do some co-investing as well. Over the past 23 years, we have developed relationships with over 600 GPs from around the world. As a primary investor, Pomona is able to leverage those relationships and create an informational edge that we can apply to our secondaries investing platform. This informational edge is invaluable in today's market, where GPs tend to avoid giving insight into underlying portfolios and are becoming even more restrictive in consenting transfers to many secondaries players. In our last fund, nearly half of the transactions were in one way or another directed to us by a GP. Having that critical mass really helps.

Q How can a secondaries firm buy quality assets at an attractive discount?

The market is not monolithic. It's a big market. Sellers sell for many reasons. We're buying only 1 to 3 percent of the dealflow we see. We know the funds, we know the assets, we know the GP and we might even know things that others may not about what's happening to the underlying companies. As a result of our targeted approach, we are able to consistently buy at a price below the market averages. For instance, Pomona Capital VIII, which we invested between 2012 and 2016, has now returned over 90 percent of drawn capital and has experienced many

WHERE DO YOU SEE THE SECONDARIES MARKET HEADING IN THE NEXT 12 MONTHS?

Dealflow is quite robust. It may be that we are entering a period where we are going to see more dealflow because of the amount of capital that went into private equity after the financial crisis. Pricing is tight, but because we don't need to deploy too much capital, we believe we can pick our spots and buy better than market quality assets at lower than market prices. The most probable outcome at the beginning of 2018 is a continuation of what we've seen in the second half of 2017.

That's subject to some macro considerations about what other markets and the rest of the world look like, and that's hard to predict. Europe is doing better than people thought. The US is doing fine. People were concerned about Asia and China and they seem to be doing okay. But, there are also a lot of anxieties and things percolating that could interrupt the growth. This could include what our Congress is able to do in terms of legislation, what happens to tax and healthcare reform, geopolitical concerns, and the many other unexpected events that we can't predict.

In the next four years, it's more likely than not that we will enter a period of distress and disruption. In this case that will create more opportunities for us because there will be more distressed sellers. However, we also need to be very careful. Disruption will create opportunities, but we will need to have a lot of conviction before jumping into it. It will take a little bit of time for us to make sure we are comfortable, but we believe our nimbleness and selective approach to secondaries investing will allow us to take advantage of opportunities as they arise. ■

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realisation events. The average discount to NAV in that fund was 14 percent.

It all goes back to fund size and selectivity. Could we deploy twice as much capital in the same strategy? No, we'd be forced into where the market is more efficient and we wouldn't be able to buy at the right prices, or where we would have to take more risk. Neither is a place we want to be for our limited partners.

Q Why would someone sell a good asset?

This is one of the seminal questions of the secondaries market going back to its roots. For the most part, institutions tend to sell not because something is happening to a fund they own, but because something is happening to them. Reasons to sell could be regulatory, organisational changes, proactive portfolio management or liquidity needs. Sellers tend to sell what may even be better assets to get a better price, rather than selling underperforming assets at a poor price. We believe we can be effective in selectively cherry picking good assets that tend to be mature, with near term liquidity events, at compelling prices.

Q What's your view on the current state of financial markets?

We're facing a dichotomy of extremes that I'm not sure I remember ever seeing. On the one hand, we have markets pricing assets to perfection, assuming that the world is a very benign place. On the other hand, when I wake up in the morning and read the newspaper, the world seems anything but benign. People are more anxious than I have seen in a long time, and that probably extends to how investors are feeling these days. My guess is that dichotomy won't persist over the long term. Either markets are right and we have to get used to a noisier President or markets have significantly underpriced geopolitical risk and at some point they're going to have to adjust to the realities.

Q What is the retail opportunity in private equity and particularly secondaries?

In general, retail investors have no exposure to alternatives. There's a reason that the world's most sophisticated institutions have allocated large sums to private equity because it's delivered over time. You have this huge segment of retail capital, probably larger overall than the institutional segment, that has no access to private equity. For many retail investors, it is difficult to lock up capital for extended periods and finding a product that gives frequent liquidity is difficult.

Today, you're seeing more of the biggest players in private equity trying to provide access to retail investors. They're doing it for a reason. Certainly there are hurdles to get there and no one has it completely figured out. Hopefully, one day it will get to a point where retail investors can easily access private equity, opening up trillions of dollars in capital not just in the US, but in Europe and Asia as well. It will be interesting to see how it plays out.

Q How has Pomona tackled the retail offering with its listed Pomona Investment Fund?

We believe that being a private equity secondaries manager brings us closer to being a good fit with the retail and retirement markets than other private equity strategies. Is it a perfect mouse trap? No, but I would argue that we have come closer than buyout or fund of fund strategies. With secondaries, investors have the ability to mitigate the J-Curve completely and instantly diversify across strategies, GPs and vintages. We are finding a way to introduce private equity investing to a new segment, and it is an ongoing exercise. The Pomona Investment Fund is an open-end fund that has been growing, and we are looking forward to the opportunities ahead. ■

***Michael Granoff** founded Pomona Capital in 1994. Granoff has previously served on the staff of the US House of Representatives Appropriations Subcommittee on Foreign Operations and was a member of the 1992 Presidential Transition Team for the Department of the Treasury.*