KEYNOTE INTERVIEW

Exploring advances in secondaries

The market is only starting to scratch the surface of opportunities around AI and retail capital, but these developments must be approached responsibly, says Pomona Capital chief executive Michael Granoff

Q To what extent have private markets valuations reset in the current macro environment, and why has this lagged public markets so significantly?

One of the issues with trying to compare private market valuations and public market valuations is that net asset value, which is used to value private equity portfolios, is not the same as fair market value. NAV does not represent the price you would achieve if you had to sell the asset today. That goes some way towards explaining why private markets valuations have been less volatile than the public markets.

Of course, public and private valuations are not completely uncorrelated and what is happening in the broader economy with rising interest rates and geopolitical uncertainty will ultimately need to get digested through the system. But it is important to note that GPs only get paid when they realise returns, by actually selling an asset. It remains to be seen, therefore, whether today's valuations are appropriate. That can only really be determined at the point of exit.

Q Against that backdrop, how would you describe the secondaries dealflow that you are seeing today, and what is driving those sales?

Secondaries dealflow continues to be strong, and we would expect that to remain the case. Supply, in the context of secondaries, is a function of two variables: how much money goes into private equity, and how much of that money turns over. The amount of capital raised in private equity funds over the past five years or so can be measured in the trillions, and for the third year in a row, over $100 billion of secondaries dealflow is projected to close.

In fact, secondaries is one of the fastest growing segments of the private markets industry.

Meanwhile, the fact that there is currently so much volatility is increasing the motivation to sell. One of the biggest catalysts for secondaries sales today is a lack of liquidity caused by a decline in M&A activity and IPOs. Until recently, many private equity portfolios were self-funding, meaning capital calls could be funded by distributions received. But now that liquidity has declined to a point where, when capital is called, investors are having to liquidate other assets to meet them. I would say this is a stronger motivation for sales than the denominator effect where investors have become theoretically overallocated to the asset class.

Q What will it take for a secondaries investor to outperform the market in this kind of environment?

A generic approach or shifting your strategy is probably not the right approach in this market. In a dynamic environment, we believe keeping your values constant and at the same time being flexible to access and purchase quality assets is key.

Our approach has not changed in the nearly 30 years we have been investing. We are not in the prediction business, but we can prepare. When making investment decisions we are solving for a wide range of potential outcomes so that we build in a margin of safety. We have always been risk-conscious investors, and we need to make sure we are protecting capital. Investors rely on us to do that.

We also want to be adaptable and flexible to deliver on the fundamental premise of secondaries – consistently buying better than market quality assets at lower than market price with near-term liquidity. That starts with bottom-up, top-down, granular analysis to make conservative valuations. It also means being flexible to move across the market to source and provide creative liquidity solutions for potential sellers in order to access quality assets.

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"Like their institutional counterparts, retail investors need access to diversified portfolios. They also often require access to liquidity"

Q Does selectivity become even more paramount in a volatile environment?

Private equity research shows that in times of volatility a wider dispersion of returns can occur, which means you need to be more careful about what you buy. You cannot buy the market. This market puts more emphasis on the quality of assets as the dispersion of returns between assets rises. We typically transact on around 1 percent of the dealflow we see, which means that 99 times out of 100, either the assets do not meet our quality criteria or someone is willing to pay more than we are.

In order to maintain that selectivity, we have kept our fund sizes fairly modest so as not to be pushed to play where the market is more efficient or further on the risk curve.

Q What are your thoughts on the evolution of the GP-led secondaries market?

When the GP-led market first appeared, it mostly involved troubled funds that needed to be restructured. The idea of buying mediocre assets managed by mediocre managers at a high price was not appealing. Over time, higher quality GPs began to look at the secondaries market in order to generate liquidity for their LPs and remain involved with their best assets.

At Pomona, we are agnostic about where we find value and are not driven by transaction type. If we come across a GP-led transaction that offers attractive value, we are happy to pursue it. But in reality, we more often find value on the LP side.

Investors like secondaries because it offers them diversification, the opportunity to buy at a discount to NAV, and the ability to potentially receive liquidity quicker than they would get with a primary investment. In my view, not many GP-led transactions meet those criteria.

Q What role do you see artificial intelligence playing in private equity, and in the secondaries industry in particular?

Technology is already playing a huge role in secondaries. We invest in hundreds of funds and thousands of companies, so we are in possession of a large amount of data. We work hard to learn from that data in order to make us better investors. AI is the next step in developing that technology. It is still early days, and while there is clearly large potential, nobody quite has their arms around it completely yet. Nonetheless, we are aggressively exploring the possibilities, and experimenting with how it could help our business.

Fundamentally, AI could enable the industry to analyse data quicker, be more accurate in projections or even allow us to communicate better with our investors. The potential applications are both broad and deep, and we are only just beginning to scratch the surface. But we do, of course, need to acknowledge that technology has its risks as well.

Q Pomona has been active in developing a PE product for retail investors. Why is the secondaries market a good fit for the democratisation of private assets, and what challenges can that process present?

If democratisation is referring to the ability to give individual investors the same access to alternatives as institutional investors, then I do think that secondaries is the right place to start. Like their institutional counterparts, retail investors need access to diversified portfolios. They also often require access to liquidity. They don't want their capital locked up in long-dated funds.

The challenge, therefore, has been to bridge the gap that exists between pent up retail demand and the structural realities of private equity. We have been able to do just that through the secondaries market, offering a diversified private equity portfolio for a relatively small amount of committed capital.

We are also able to offer access to high-quality assets bought at attractive prices, as well as enhanced liquidity. By buying interests that are five-plus years old and that may be 70 to 90 percent funded, our programme creates a lot of natural liquidity, thereby representing a strong proposition for the retail market. I also believe we are still only in the earliest stages of what this opportunity can become.

It is highly unlikely that we are going to see new pension funds created in the US, for example, and so while the institutional side of the market is vast, it is unlikely to meaningfully grow. The major capital flows over the coming decades are going to involve retail investors. I would add, however, that it is critical that we adequately protect the interests of all investors, both institutional and retail, taking the risk side of the equation into account. While retail investment represents a large and growing opportunity set, it carries with it an enormous responsibility as well, and we take that very seriously.

Q Overall, what do you see as the biggest risks and the biggest opportunities that will characterise the market in 2024?

The secondaries industry will of course be impacted by everything that is happening around us. We are not uncorrelated with the wider world. But what is different about this industry is that we are not victims of circumstances. In fact, those very circumstances create opportunities. The volatility that we are likely to continue to experience in the near and medium term is creating more motivated LP sellers. Furthermore, higher interest rates and the decreased availability of leverage may reduce valuations, and we should benefit from that as well.

The challenge, of course, is to ensure we balance those opportunities with taking appropriate levels of risk. You need to play defence to ensure you are protecting your investors' capital in what will undoubtedly be a challenging market. But you also need to play offence, being aggressively opportunistic in pursuing great investments. ■