

KEYNOTE INTERVIEW

A fast-growing market brings greater complexity and opportunity



*Secondaries GPs have had to get more granular in their approach through the pandemic while the competition continues to intensify, says Pomona Capital founder and chief executive **Michael Granoff***

Q Why is there so much secondaries market activity in 2021? Where do you see the best opportunities for buyers?

The market is clearly very active, with a rough equilibrium between supply and demand. Supply is a function of how much money goes into private equity over time and what percentage of that money turns over. Quite a bit of money has gone in over the last few years – broadly 2.5 times what went in over the years running up to the global financial crisis – so

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the turnover rate is against a number that is dramatically bigger. All things being equal, we expect the market to continue to grow based on those fundamentals.

If you look at the reasons why institutions sell, they are both secular and cyclical. On a secular basis, an institution may sell for a variety of reasons, including a need for liquidity, changing strate-

gy, acquisition or sale, or management turnover. Generally, LPs over time have become more comfortable with selling and now look at assets in the same way they look at any other asset, and the same is true of GPs. Of course, selling is also affected by cyclical factors, such as the broader economic environment.

An additional factor contributing to deal activity is an increasing differentiation in transactions over time. Today, we have secondary transactions coming from LPs and GPs, as well as the phenomenon

of the GP-led market, which includes GP-led restructurings, continuation funds and more. As GPs have looked to manage capital more efficiently, such deals have become a significant part of the secondaries market. We do not expect that to change.

Different market participants have different views on where the opportunities lie. We have tended to look at the market through one lens, and that is buying better-than-market quality assets at lower-than-market prices. Our approach to where the opportunities lie is agnostic: if we can find deals that meet our standards in a GP-led transaction, a preferred equity transaction, or an LP portfolio transaction, we will do it.

Q What were the key challenges for GPs navigating secondaries market volatility through the pandemic? What lessons were learned?

We have all experienced something over the past year that we have not experienced before, even if some of us have lived through multiple economic cycles. We believe the pandemic has created two key challenges which are not specific to being a secondaries GP, but apply to anybody who is investing. First, the effects of the pandemic were not monolithic. If you had a portfolio of buyout funds, some of those underlying companies may have benefited from the pandemic, while others may have been devastated. Buyers of assets have had to be very careful about looking through a more granular lens. I have remarked before that a GP might have invested in a subpar grocery delivery business and done well during the pandemic, while another GP might have invested in the best conference organizer and suffered. It did not just come down to investment decisions.

The second significant challenge was that we had to solve for quite a range of potential outcomes. No one ever did a buyout assuming zero revenues for six months, but the range of outcomes six months ago, and even today, is quite wide.

So far, we have been able to execute pretty well against those challenges – we have been very careful, yet quite active and aggressive at the same time. Those

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are the lessons we have learned so far, but the story is not fully written. Even at this point, the trajectory of the pandemic is more complicated and nuanced than previously thought.

Q LP portfolio transactions comprised a smaller proportion of secondaries deal volume in 2020 than previously as GP-led deals took off. Do you expect those portfolio deals to rebound going forward? What will drive that part of the market?

Both deal types are now permanent parts of the market that we do not expect to be transitory. On the LP portfolio side, as mentioned earlier, activity is a function of how much money has come in and how much turns over, and the impetus for selling typically depends on what is going on with the LP. We are seeing a lot of volume on the LP side and expect that to continue. As I noted earlier, we do not expect it to be easy to solve for quality and price, but that is a part of the market where we have nearly three decades of experience.

The dynamics on the GP-led side are changing. When that market started, there was generally adverse selection. In our opinion, not many good funds needed to be restructured at the time. In many ways, we saw lower quality assets managed by lower quality managers being sold at a relatively high price to convince LPs in the funds to sell. So historically, we have done more selling than buying.

But the market is not static. In recent years, we have begun to see higher quality managers participating in GP-led transactions as an opportunity to be more efficient with capital, provide liquidity to LPs that want to sell, and better manage the mismatch between fund maturity and that of the underlying portfolio companies. Better GPs have come to market and we have participated in those deals.

The market is evolving and will be impacted by results. We believe investor sentiment about GP-led transactions is mixed, and if the deals do not go so well, that may dampen enthusiasm, while the opposite is also true. We do not think GP-led transactions will go away, and we see a

more interesting opportunity for Pomona than in the past, although the segment still represents the exception rather than the rule.

Q How do you see the secondaries market evolving over the next five years? And what will the changing landscape mean for buyers and sellers?

We are not a macro player and we do not need 20 percent market share to invest because our strategy is more bottom-up. We are also not trying to time the market and predict the unpredictable. Instead, we are trying to solve for a reasonably wide range of potential outcomes so that in most cases, we may deliver attractive returns with less risk.

There are projections that the secondaries market could grow quite dramatically over the next five-year period, and I have even seen projections that by 2030 the market could be worth \$1 trillion. I have no idea whether that actually will come to fruition, but it is reasonable for the overall market to grow significantly in the coming years. This may likely also result in more complexity of deals and deal types. We will have no shortage of things to look at, but the job will not get any easier and Pomona will remain disciplined in its execution.

We believe the importance of values is going to increase for buyers and sellers as well. We see that reflected in increasing attention paid to ESG, diversity and inclusion, a broader definition of corporate stakeholders and a focus on who we are and not just what we are. These considerations have gone from being a peripheral part of the investment process to absolutely integral.

We have definitely noticed that a foundation of committed core values has been an important part of the Pomona strategy since the beginning, reflected in the way we build our team, operate as a business and partner with investors. We probably field one of the most diverse teams in the business and believe that makes us a better investor and a better citizen. We strive to be a leader in this regard, and have made this part of who we are from the start. ■



Q How easy is it to source and execute creative, high-quality transactions now? How competitive is the market, and how can secondaries GPs stand out?

One of the realities in the secondaries business is that if you really want to solve for quality and price, it is never easy. You may only be able to execute on a small fraction of what you see. You may have to limit your fund size and avoid becoming an asset aggregator, otherwise you will be pushed in the direction of paying higher prices or going further out on the risk curve to deploy capital.

At Pomona, we only buy a small, single-digit percentage of what we analyse in any year, and that is true today and was true 10 years ago. Even in a market that is expanding quite rapidly, finding the quality of assets we want at the prices we want to pay is never easy.

We have no shortage of competitors. In the past, there was a smaller market with fewer competitors, and today, the market has expanded significantly and the competitors are bigger. The nature of the competition has changed as well – the market has become more developed and differentiated, so you may see firms that focus on different segments, such as direct transactions, GP-led transactions, and so forth.

We have to provide a differentiated solution to investors. This means delivering performance across returns, liquidity and risk. At Pomona, we measure and deliver against all three of those performance indicators, and we believe that is what investors are looking for. Investors find secondaries attractive because they are looking to invest with a margin of safety – they want to reduce risk and not have to trade risk against return. We aim to deliver that.