KEYNOTE INTERVIEW

Navigating secondaries shifts

Secondaries buyers must be selective as more assets come to market amid liquidity pressures, says Pomona Capital's Michael Granoff

With 2023 secondaries deal volume topping $100 billion for the third year in a row, it is clear that the secondaries market has now cemented its position as an important feature in the private markets landscape. Activity for 2024 looks set to be even more robust, with Jefferies predicting transaction volume of at least $130 billion as sellers seek liquidity in what has been a challenging exit market.

Against this backdrop, Michael Granoff, founder of Pomona Capital, gives his take on how the industry is evolving, where new capital is flowing from, and what a more complex market means for secondaries firms.

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Q Many LPs have faced overallocation issues and slower than expected distributions over the past 12-18 months. How has this shaped seller attitudes to the secondaries market?

The market is very robust today, with sellers increasingly turning to secondaries – we have looked at more than $100 billion of dealflow annually for the past three years. When I started 30 years ago, investors mainly sold their private equity investments when they were in distress. Today, it is a commonly used tool by both investors and GPs to manage their portfolios.

Contrary to what we might have expected, the denominator effect has not been a significant catalyst for activity today. Instead, the more dramatic shift has been in the need for liquidity. Many LPs with mature portfolios previously had private equity programmes that were self-funding.

Essentially, they could finance capital calls using the distributions they were receiving from their private equity investments. As exits have slowed, liquidity has dried up and LPs are

Q Is the current environment different to previous cycles? How permanent do you believe some of these dynamics are?
History is a good teacher, but it doesn't repeat; it rhymes. No two cycles are exactly the same.

Today's cycle does have some commonalities with the past – we know what inflation and interest rate rises look like. However, we are seeing a confluence of geopolitical, energy, economic and inflationary pressures today that we didn't see in previous cycles. We have also clearly seen liquidity pressures in past cycles, but until recently, we had not seen this for quite a few years.

In terms of permanence, there are secular trends here. Secondaries market volumes derive from the supply of capital invested in private equity funds over time and the rate of turnover of those interests. Trillions of dollars have flowed into the primary market over the past five years and some of that will turn over for various reasons. Most importantly, the fact that GPs and LP sellers and buyers are now more comfortable using secondaries as a tool to manage their portfolios is adding to the growth of the asset class.

accessing the secondaries market to generate cash to make capital calls and commit to new funds.

GPs are also seeking to create liquidity through GP-led deals and NAV financing – in part to ensure they can get LPs to re-up to their next fund.

Q The secondaries market has bucked the general trend of more challenging fundraising. Why is this and how have investor attitudes to the market changed?
A few years ago, when we talked to investors there was far less generic interest in secondaries. We were asked a lot of questions about unicorns and very few about bulls and bears. There wasn't much fear, but there was a lot of greed. Today, we see a mix of fear and greed.

We are getting more incoming calls from investors as secondaries have become an important part of building and managing private markets programmes. Secondaries offers the potential of attractive risk-adjusted returns, especially in today's market.

Q What will determine secondaries returns over the coming period?
I always say that we are in the preparation business, not in the prediction business, but there are some constants in secondaries private equity that investors should keep in mind about their exposure to the asset class and potential returns.

One of these is diversification. Many secondaries portfolios are more concentrated than they were historically, and that can lead to potentially greater volatility and wider dispersion of returns. Pomona focuses on constructing well-diversified portfolios, typically purchasing higher quality assets through LP portfolio-type transactions instead of GP-leds, which usually don't meet our targeted risk and return profile.

Another constant is selectivity. There is plenty of opportunity and dealflow in secondaries, but that also means you need to be far more selective on the assets you purchase. While the size of the market has increased, the proportion of deals Pomona completes per year has not changed much over our 30-year history.

We use our modest fund size to our advantage to be flexible in seeking the assets we want and purchase less than 1-2 percent of doable dealflow annually. We do not take a generic approach to the market.

Q Of these factors, which would you say is more influential today?

Today, liquidity will be a key and influential factor. There is a backlog of assets and the highest quality companies will sell more quickly, while lower quality assets will have a much harder time. It is like a game of musical chairs, particularly given the more challenging M&A backdrop, where there are not enough chairs for everyone.

This is why it is important to be a careful and selective secondaries buyer. Pomona seeks to purchase funds managed by the highest quality GPs with underlying companies that are resilient, growing at a reasonable pace and are not overvalued. We want to buy these funds at a material discount to NAV. We need to be proactive about finding these opportunities and be diligent in understanding what we are buying. We are prepared to pass on deals we do not want to do, but to be aggressive on those we want to pursue.

I believe DPI is the new IRR. At Pomona, we focus on purchasing funds in which there is identified potential near-term liquidity. Over the last decade, we have meaningfully outperformed secondaries private equity benchmark averages in terms of DPI. We also evaluate our own portfolios and will take advantage of market trends, and may sell underlying funds to help realise and lock in returns. We have sold more than $1 billion of assets this way.

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Q You launched a retail offering nearly 10 years ago. What has surprised you about this part of the market?

The biggest surprises for me are just how large the individual investor market is today and its potential future growth. Institutional sources of capital are unlikely to grow dramatically over the years to come.

We are unlikely to see the creation of a new US pension plan, for example. However, the flows of capital from individuals, in particular via defined contribution 401(k) plans in the US, are enormous and growing.

Individuals' exposure to alternatives is currently low, in part because of the difficulty in matching private equity with the way that traditional retail markets work. But it will grow tremendously, and I do not see that growth coming from individual investors investing in a couple of buyout or venture funds. Individuals need a seasoned portfolio that is diversified and that can offer liquidity. That is the profile of our secondaries funds. Secondaries can answer both the investment and structural challenges for retail investors, in our opinion.

Q Pomona celebrates its 30th anniversary this year. What do you think it takes to sustain a firm over the long term, particularly in the secondaries market?

It is not easy – you are not just making one big decision; you need to make many decisions over many years to stay on top. You also need to balance two apparently contradictory things. The first is a values system that doesn't change and that people believe in. That is true even when others around you are doing things differently. The second is the ability to adapt and change all the time in other ways, while keeping the culture constant.

Team dynamics are an important success indicator. Execution determines whether a firm is successful or not and that relies on the team's investment judgement. In fact, the scarcest commodity in our industry is not capital or dealflow; it's investment judgement, and so you want to nurture and retain that.

The secondaries market is changing fast, and it is becoming more complex. As a result, the days of the small investment boutique are probably over. We started out as a team of three, but Pomona's operations today are more like those of a mid-sized corporation because of this complexity. You do need critical mass today.

However, if you are just going for scale, you lose some of the important ingredients to deliver on the fundamental premise of secondaries – creating a mature, diverse portfolio of high-quality assets purchased at a meaningful discount to net asset value with enhanced liquidity and a lower risk profile. It is about adapting and growing to capitalise on opportunities, while retaining the culture that made you successful in the first place. ■