KEYNOTE INTERVIEW

Illiquidity challenges shape secondaries opportunities

An uncertain world is pushing more investors to seek liquidity, requiring ongoing innovation in the secondaries market, says Michael Granoff, founder and chief executive of Pomona Capital

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Q What key trends in alternatives do you see shaping the PE secondaries market over the next few years?
The trends affecting the secondaries business can be divided into two broad categories: macro trends affecting private equity in general, and trends specific to the secondaries market itself.

The first category encompasses emerging trends, everything from the increasing influence of AI and the future cognitive industrial revolution, to macro concerns about the global economy and geopolitical stability.

Another macro trend is the growing dominance of individuals as a major source of capital flowing into private equity. Given that we are unlikely to see new US pension plans emerge, for example, new capital will increasingly come from individuals and private wealth channels.

The potential volumes unlocked by the democratisation of private equity are vast, but the challenge lies in aligning the inherent illiquidity of private equity with vehicles that offer liquidity. In this context, secondaries provide a natural solution that is particularly appealing. And that's why we created a secondary-focused '40 Act vehicle, to solve for both the investment and structural challenges facing retail investors.

Then there are the trends shaping the secondaries market itself, where one of the biggest dynamics is the current constraints on liquidity. If you look at both the breadth and depth of liquidity constraints right now, they are greater and more dramatic than during the global financial crisis.

Capital calls have outpaced distributions for many consecutive quarters, which creates both challenges and opportunities. We are not uncorrelated to broad market dynamics, and our portfolios are clearly affected by industry dynamics. As investors begin to recognise that realised and unrealised gains are not the same, and that DPI may be the new IRR, an approach that prioritises liquidity will naturally stand out.

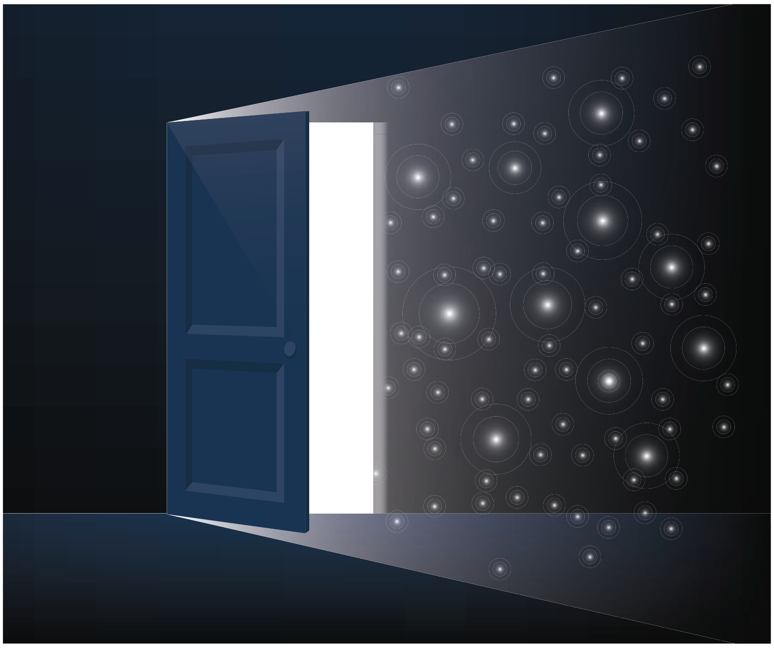
Liquidity constraints also present opportunities to play offence and not just good defence. The secondaries market has seen an increase in dealflow and supply because of heightened motivation among sellers, a trend that seems unlikely to be short-lived.

And illiquidity is also playing a role in the further broadening of the secondaries business itself, with the rapid growth of the GP-led market. The pressures created by illiquidity have influenced the range of transactions that make up the secondaries market and, if this trend continues, there will be ongoing drivers for liquidity creation via different mechanisms.

Q Appetite from both buyers and sellers for secondaries has grown over the past few years. Do you see that changing? What will be the drivers?

For buyers, the secondaries business has become much more differentiated. Not all investors are seeking the same thing, and the market is increasingly catering to this diversity. Investor appetite is shaped by a complex mix of fear and greed, which fluctuates depending on the broader worldview at any given time.

From our perspective, it's clear that investors expect us to deliver on four pillars: diversification, asset quality, price and liquidity. This is the lens through which we evaluate potential investments. We seek to create a diversified portfolio of high-quality assets purchased at a material discount to net asset value, with the potential to generate liquidity, and provide investors with a margin of safety.



Q Do you see trends in exit strategies evolving in the secondaries market?

Exits can be realised in two main ways: organically, where the funds you own generate liquidity from their portfolio companies via M&A, refinancings and so on; and by managing the portfolio to generate liquidity inorganically, as sellers and not just buyers.

For instance, if we own assets where we have generated our return target, we do not see much growth ahead and someone will pay us a compelling price for them, we sell. It's about actively managing your portfolio to accelerate realised returns and liquidity, and to minimise risk.

"Liquidity constraints present opportunities to play offence and not just good defence"

However, these criteria are not necessarily reflective of the broader secondaries market. For example, many secondaries funds are becoming less diversified, and asset quality is mixed. Our experience tells us that high-quality assets drive the majority of returns, and in more challenging times the dispersion of returns tends to widen significantly.

Next, there's price. On average, historically, we have been able to acquire assets at a discount of approximately 1,000 basis points better than the market average, which can provide an additional layer of safety for our investors.

Liquidity is another critical factor

– not just the ability to generate it, but also having visibility into what will happen with individual companies over the coming years.

As for sellers, we see two factors driving supply: how much money is flowing into private equity and how much of that turns over, with turnover being a function of both secular and cyclical dynamics. Secular dynamics refers to the growing comfort investors have with transacting in the secondaries market, which continues to increase over time. If investors have a need to sell, they are turning to the market.

From a cyclical standpoint, private equity investors find themselves in a more challenging environment, one marked by liquidity constraints, valuation questions and heightened macroeconomic and geopolitical risks. These challenges are in part prompting more investors to seek liquidity, leading to a significant increase in dealflow.

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Q Deal volume in secondaries is at record levels. Where do you see the most attractive opportunities in a busy market?

The aim is always to buy higher-than-market quality assets at a lower-than-market price. There are areas where we can underwrite the risks and areas where we cannot: we avoid emerging markets, early-stage venture and commodity-related investments, for example.

On the other hand, we live in a competitive environment, and quality and price are not easy to solve for. We won't be going from buying 2 percent of what we see to 20 percent, but we are going to have more to look at and more options to choose from.

Another key focus for us is sticking to the bottom-up fundamentals of secondaries transactions. It's easy to be pushed towards more risky, peripheral investments in order to deploy capital as this market grows, but that is not our approach.

Q What will be the biggest factors affecting secondaries' performance over the next year?

Like any player in our industry or across private equity, performance will be shaped by the cost of assets, the growth of the underlying assets' value over time and the ability to generate liquidity.

Navigating asset pricing and quality is challenging. The appropriate valuations of private equity assets are unclear in many instances, with some being sold above NAV, some at NAV and others below. Most returns come from the appreciation of the underlying assets during the underlying GP's holding period. So, we need to be selective about the types of assets we invest in and assess their potential for growth, particularly when considering broader macroeconomic factors affecting the portfolio.

Performance over time is also going to be a function of an investor's ability to generate liquidity and at what valuation.

All told, then, there are numerous variables at play today, and my expectation is that the volatile macroeconomic environment is unlikely to settle down significantly in the near to medium term.

Q Has the nature of what it takes to be a successful manager in this market changed over time?

In some ways, the age of the small investment boutique is over. When you look at what it takes to compete today, managers need to be more like medium-sized corporations, handling numerous investors, managing extensive data and complex transactions.

We give a lot of thought to what a manager in our business needs to look like in order to compete and thrive. We need to solve for a combination of scale and a disciplined investment approach.

Going forwards, we will need an increase in systems and agency. We need more advanced tools, whether data-driven or powered by AI, and systems to leverage and improve our operational capabilities.

We will simultaneously need greater agency too, maximising the human potential of each of our team members and our collective potential as a team. The secondaries business will always be a relationship-driven business, whether in terms of attracting investors, working with GPs or engaging with sellers.

We think our scarcest resource is solid investment judgment. Systems without agency can lead to a mindless machine, and agency without systems can lead to chaos. The magic and the challenge are in that combination. ■