KEYNOTE INTERVIEW

Navigating in stormy conditions

While there are expected to be plenty of new opportunities in the secondaries market over the coming period, success will require experience and a considered approach, says Pomona Capital's Michael Granoff

Secondaries market activity in the year to date suggests 2022 transaction volume will reach well over $100 billion globally for the second year in a row. But how will the more challenging economic backdrop affect dealflow and secondaries market players themselves?

How does the current cycle compare to previous times of difficulty? And what is the outlook for retail appetite for the asset class?

Private Equity International spoke to Michael Granoff, CEO of Pomona Capital, to get his take on these issues.

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Q This year has seen volatility and challenging market conditions. What should investors expect from their private equity portfolios in terms of performance?

I always say that we are in the preparation business, not in the prediction business, but there are some constants in private equity that investors should keep in mind about their exposure to the asset class.

One of these is that private equity is not uncorrelated to what is happening in the world. It is not immune to economic conditions or geopolitical shifts. The industry as a whole faces the same external dynamics as any other investment area. It is also not contrarian – private equity is not about shorting the market so it won't be up 20 percent as public markets decline. Investors should take comfort from that because it means private equity is not a big bet that could go right or wrong. It is about relative not absolute returns.

While private equity is not uncorrelated, it's also not highly correlated.

Q What is on the horizon for the secondaries market?
We expect to see a robust set of opportunities over the next year or so. But investors will need to approach the market with caution, because the dispersion of returns will likely be much wider than we have seen over recent years.

We have so far only seen the market reaction – the economic reaction has yet to flow through. Companies have continued to grow so far, but there is a risk of recession. We are taking an aggressively conservative approach. We have seen that this works. During the steepest part of the covid downturn, we were able to pick up interests in high-quality funds at what we consider to be very good prices. We had to be selective, but where we had conviction, we were aggressive in the stakes we took. We think you need this aggressive-conservative combination today because if you are only one or the other, you are unlikely to be successful.

Better GPs may protect capital through downturns – and that has been shown to be true historically. They have control over companies and that is an advantage because they can change management teams or reduce leverage, for example. Private equity performed better across cycles as a result and investors have experienced less volatility, less dramatic outcomes and fewer defaults in their private equity portfolios.

LPs also need to consider that there is a different digestive rate between public securities and private equity. It takes longer for events to flow through to private equity valuations than in public markets because they are reported quarterly and in arrears. We will see increasing clarity over the next few quarters. Yet it is also true that NAVs reflect not just where the stock markets are, but a whole range of variables, so the view that just because the stock market is down, private equity will eventually catch up with that, may not play out quite that way.

"We are at a point where there is a scarcity of capital in the secondaries market relative to supply"

Q How are economic uncertainty and geopolitical instability affecting the secondaries market?
In secondaries, we are not just a victim of circumstances, we are a beneficiary of them. We are affected both ways.

All the aspects of today's world that make people nervous do create external pressures – and that means opportunities for us because, ultimately, our goal is to buy high-quality assets at lower than market prices. I think we are heading into a period of interesting opportunities because we will have more pricing power as buyers, and a greater choice of assets. We are also at a point where there is a scarcity of capital in the secondaries market relative to supply, even though there continue to be some large fundraisings. This makes it a great time to be a buyer.

None of this comes for free. Even though there will be a lot of interesting opportunities, when you are operating in challenging periods, quality and pricing matter more than in more benign times. You need to be very thoughtful and careful about what you do. That is why we will see – as we have in the past – a wider dispersion of returns among GPs and secondaries players and within portfolios.

Q You've been through a number of cycles in your career. How is what we're seeing now different from previous times of turbulence? And how does that inform your approach today?
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.

As I said, we are not in the prediction business, but we can prepare and we have experience in this. We didn't wake up in January this year and suddenly realise there were inflationary pressures, for example. For some time now, we have been transacting to try and solve for a wide range of potential outcomes. We were not extrapolating 2021 conditions to the future, but rather, we made conservative projections.

Q The secondaries market continues to grow. What are the main drivers for this today?

We are seeing the supply of deals increase substantially. This is a function of how much capital goes into the private equity market and how much of this turns over. The first number is a large one, given the significant amount of capital that has been raised in private equity over the past 10 years, and if we are aiming to buy assets that are around five to seven years old, we can see a very healthy trajectory from today into the future.

The turnover rate is subject to secular and cyclical factors. In the former, we see market acceptance and adoption of secondaries as a tool for portfolio management, and we have now reached the point where we have bought from the same sellers multiple times. In the latter, there is definitely more distress out there than there was two years ago and that clearly affects turnover rate.

Dealflow does not keep me awake at night. At the same time, the market has evolved substantially over the years to provide many different types of deals and structures that meet a variety of sellers' needs, including those of GPs. Pricing and quality remain the most important factors for us, but we continue to adapt to meet sellers' needs, especially in challenging environments.

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Q What's your view on GP-led deal opportunities in today's market?

We are agnostic to deal types but remain cautious around GP-led deals. They account for a smaller portion of our portfolios, so we do complete these deals, but only where we have very strong relationships with the GP, where we believe the asset is high quality and where we can pay an attractive price.

However, you don't have as much pricing power as a buyer in GP-led deals and the barriers to entry are lower for buyers than in LP-led deals. In some instances, you are taking highly concentrated positions and liquidity can be extended further out. On the whole, we have found that there are usually better-quality assets at better prices in the LP-led market.

This area of the market continues to evolve and today pricing spreads are widening and some transactions are not gaining investor support. But it's worth noting that GP-led transactions are a current source of significant liquidity for us, too. We frequently opt to sell, especially where we have achieved our target return and can sell at NAV.

Q Many firms are now looking at raising retail capital. You already have a retail product, so how would you characterise demand and how can you ensure the needs of these investors are met?

Capital from institutional investors will largely grow only organically – we are not seeing the establishment of many new pension funds, for example. Given this dynamic, the industry is looking at new sources of funding. We think large flows of capital will come from retail, where individual investors have historically had little or no ability to gain exposure to private equity. Individual investors will increasingly seek ways to access private equity, which has also tended to outperform public assets.

We see secondaries strategies as being well suited to individual investors. There are significant differences between owning a portion of a new buyout fund and owning a seasoned and diversified portfolio of assets. From day one, through secondaries, investors can gain access to a portfolio that is diversified by vintage year, geography, asset type, sector and company. The cashflow dynamics of secondaries is also different when compared to the primary market. Secondaries can offer a good risk-return profile for individuals.

Retail is a fast-growing segment of our business. However, it does require a different operational set up given the complex regulatory requirements, which are distinct from the institutional market. ■