KEYNOTE INTERVIEW

Seizing opportunities in secondaries

Falling distributions and increased capital calls are catalysing sellers, serving up some interesting prospects for discerning buyers, says Pomona Capital's Michael Granoff

Private equity secondaries firm Pomona Capital has adapted and navigated through the uncertainty of the 2020 landscape shaped by the global covid-19 pandemic. As we head into 2021, Pomona's founder and chief executive, Michael Granoff, outlines his expectations for the secondaries market moving forward, and explains how his team has been able to journey through the crisis and leverage its longstanding relationships and execution experience to find attractive buying opportunities.

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Q How has Pomona Capital handled the transition to the covid-19 environment?

If you had asked me a couple of years ago whether Pomona Capital, across our offices in New York, London and Hong Kong, could operate 100 percent remotely for an extended period of time and achieve everything we need to, I do not know whether that answer would have been yes. However, we have been able to do just that. During this time, we have exercised every aspect of the business, from sourcing deals and conducting due diligence to closing transactions.

Throughout this period of unprecedented uncertainty, we have been able to execute on the things we need to do to operate effectively and efficiently as an organisation. I think that has been a function of two things: first, our team quickly understood the challenge, adapted and stepped up to it; and second, we leveraged the powerful tool of technology to stay connected with our people, third-party service providers and investors on a daily basis.

While we have a responsibility to navigate the crisis and demonstrate our resiliency, our job is not just limited to weathering the storm. Our job is to identify opportunities. We are not simply a victim of dislocation, particularly in the secondaries corner of the private equity industry – we are also a beneficiary. A significant part of our role is to identify where the opportunities are arising out of this situation. How do we get comfortable? How do we execute? What does that look like going forward? These are the questions that we needed to consider, but our responsibilities encompass all of those elements, not just one.

Q How can secondaries managers navigate market uncertainty effectively?

At Pomona Capital, while we did not predict a crisis of this kind, we also did not wake up in March of this year and discover risk. We had already anticipated that the next few years would not be a linear extrapolation of the last few years. Our decision-making, therefore, needed to take that expectation into account. We think of ourselves as very granular and bottom up. But, of course, we are not operating alone on an island. We need to respond to the world around us and make decisions that have a macro aspect to them as well. Many of the decisions that we made over the last few years have put us in a position to be able to navigate current market uncertainty.

One of the things that private equity research tells you is that the dispersion of returns between funds widens in times of dislocation. What that means for us as investors is that it puts even more emphasis on the quality of assets. Pomona's focus on quality includes not just the calibre of the underlying portfolio companies and the GPs who are managing the funds that we buy interests in, but also the types of transactions that we choose to do or not do. Not all secondaries transactions have the same risk/reward characteristics.

Of course, none of us know how the crisis is going to continue to unfold in terms of duration and depth. My guess is that there will be several more turns of the wheel; it seems unlikely it will

Q What factors are currently motivating limited partners to sell?

We have observed a dynamic where investors tend to sell due to some combination of what is happening to the overall assets they own (eg, their current financial circumstances), which is usually the dominant reason, and what is happening with respect to their forward obligations (eg, capital calls). Particularly this year, distributions had fallen and capital calls were increasing. Investors either could not or did not want to fund all those capital calls.

It is an interesting scenario in the sense that if an investor had a private equity programme that was fairly mature, over the last few years it would have been largely self-funding. Distributions could pay for all the capital calls, so the investor never really needed to fund anything out-of-pocket. It was sort of a perpetual motion machine, which led limited partners to make larger and larger forward commitments. But, if there is a dislocation where the distribution side goes down and yet the capital call side goes up, pretty soon it is not a self-funding programme anymore. That was the catalyst for selling in a recent transaction our team executed this year. We will see if that trend continues or accelerates in the future.

move in a linear path. At Pomona, we are well positioned to weather this evolving landscape. Since the firm's inception in 1994, we have made cash distributions to investors every quarter; in fact, we have continued to make cash distributions in the first, second and third quarter of this year.

Q What has the opportunity set been like since the start of the crisis?

From a macro perspective, the opportunity set for us is a function of two variables: how much money goes into private equity and how much of that ultimately turns over. If you compare the current covid-19 situation with that of the global financial crisis, there is about 2.5 times as much money in private equity today as there was back then. The turnover of private equity assets is much bigger today than it was during the financial crisis, and the potential opportunity set for secondaries managers is quite large.

However, in our world, things do not unfold as quickly as they do in the credit market or the stock market, for example. I would expect opportunities in private equity to unfold over the next couple of years. At Pomona, we apply a disciplined approach to secondaries investing and we are not going to bet the farm based on an array of unknowns; we are not a macro hedge fund. It is not our business to make a bet like that.

Q How active has Pomona Capital been on the buy side since March?

We are aggressively looking for opportunities and seeing how we can take advantage. Since March, we have been able to purchase pieces of very high-quality funds at discounts between 40 and 50 percent. In the last few years, pre-pandemic, we have been buying at an average discount of 16 percent. These are LP transactions with upper quartile to decile performers. We are laser focused on quality of assets. Further, our modest fund sizes afford us the ability to only deploy capital when an opportunity is truly compelling.

It is important to note that we do not get to discounted prices due to tough negotiations with sellers. Rather, we seek to make sure we are adequately protected or compensated across a wide range of potential outcomes. During the underwriting and due diligence process, the team at Pomona makes generally conservative projections about underlying portfolio companies in funds, and identifies an appropriate price that Pomona is willing to pay.

Pomona has closed several transactions in the last few quarters and is building a robust pipeline of deals heading into 2021. We have bids outstanding on some interesting transactions that were referred to us by the GPs. The recently executed transactions were proprietary and not competitive. Some were small, targeted portfolios and others were single-line transactions.

Q As 2020 draws to an end, what are your expectations for secondaries dealflow going forward?

Last year was a record year for the secondaries market with $85 billion in transactions. It is clear that 2020 is going to close with significantly lower secondaries volumes than 2019, even with a good fourth quarter. Part of that is because the world was essentially closed for a considerable amount of time this year. Looking ahead, we do see dealflow ramping back up. Our pipeline today is significantly larger than it was 90 days ago. However, I believe it may take a little while to get back to the same level as 2019's $85 billion record. ■

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