How Private Equity Secondaries Squeeze Water from a Stone

Lately, tight financing conditions have limited M&A and IPO activity—traditionally the key sources of liquidity for private equity investors. An investment strategy focused on secondaries may help mitigate this risk due to the timing and diversity of their cash flows.

Key takeaways

- Investors in secondaries acquire private equity (PE) interests later in a fund's lifecycle, when the underlying companies are closer to being sold, potentially providing liquidity shortly after investment.
- A diverse mix of liquidity sources from thousands of portfolio companies can create an enhanced cash flow profile for secondaries, allowing for risk mitigation, supplemental gains and compounded returns.
- Even in challenging macroeconomic environments, the diversification profile of a secondaries-focused strategy may boost distributions and liquidity compared to primaries.

What makes secondaries different?

Primary private equity funds can provide several benefits when compared with public market investing, but receiving cash flows early from an investment typically isn't one. Since PE sponsors often focus on operational efficiency and value enhancement in the period immediately following the acquisition of a portfolio company, it may take several years before the company matures to a point where the sponsor will look to sell the business and distribute capital to limited partners.

However, secondaries investors acquire interests in PE funds that are further along in their lifecycles, typically after the investment period is well underway or even completed. It's akin to skipping the opening act and arriving just in time for the main event!

This timing works in favor of secondaries investors, as they can potentially benefit from the exit and realization phase of the underlying PE funds, when the sponsors are actively seeking to sell portfolio companies and distribute the proceeds to investors. Therefore, secondaries investors may start receiving distributions shortly after closing on their investment. For instance, since the inception of Pomona Investment Fund (PIF), the average time between an LP secondary transaction and the first distribution has been about two months.[1]

Where does liquidity for secondaries come from?

The sale of a portfolio company from an underlying fund (and the distribution of the proceeds to the limited partners) is one source of liquidity for secondaries. In PIF, such sales have accounted for more than 90% of the liquidity generated by the portfolio since inception. The remaining liquidity consists of dividends, interest and other income. This diverse mix of sources can create an enhanced cash flow profile for secondaries, allowing for greater flexibility and potential return enhancement for investors.

[1] As of 12/31/23. Distributions are not guaranteed and timing will vary. For more information about PIF, visit pomonainvestmentfund.com.

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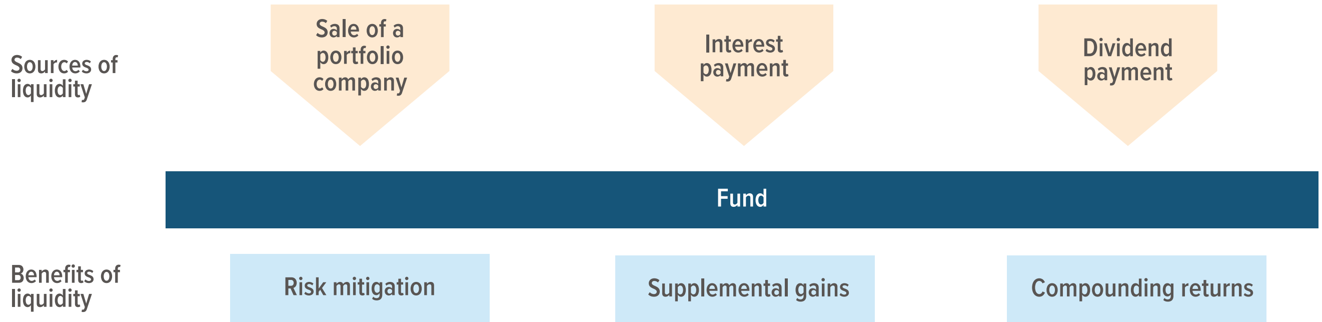
Exhibit 1: Secondaries receive and benefit from liquidity in several ways



Based on the opinions and views of Pomona Capital, subject to change. For illustrative purposes only.

Why is liquidity important?

The potential benefits of consistent cash inflows to investors include:

- **Risk mitigation:** Allows for effective risk management by reducing investment duration and realizing previously earned gains, which may enhance overall returns.
- **Supplemental gains:** Offers the potential for additional gains through the uplift in the value of a company at the time of exit. This may occur when a company is conservatively valued before its sale.
- **Compounding returns:** Specific to registered funds such as PIF, enables the continuous compounding of returns by reinvesting proceeds in new private equity interests, thereby maximizing the potential for long-term growth.

Liquidity, often even in adverse environments

Secondaries investors may own interests in hundreds of private equity funds, which in turn own thousands of underlying companies, increasing the potential for liquidity events. Even in extreme periods, such as when M&A activity is dramatically down or the IPO market is dormant, the diversification profile of a secondaries fund may result in enhanced distributions and liquidity.

Despite challenging macroeconomic environments, PIF's portfolio has demonstrated resilience and has consistently generated distributions.

PIF has an average annual liquidity rate since inception of 29%.[2] In addition, PIF was able to produce a higher percentage of cash flows in 2023 than in 2022, despite a reduction in liquidity in the broader financial markets.[3] This strong liquidity profile is a result of Pomona's targeted approach of acquiring well-diversified portfolios managed by top-tier general partners with identified near-term liquidity.

[2] As of 12/31/23. Source: Pomona Capital. For each full calendar year, a percentage calculated as the quotient of (a) total dollar amount of all distributions received by PIF for the 12-month period ended December 31 and (b) the average value of PIF's portfolio for the 12-month period ended December 31. The average noted above represents the arithmetic mean of the annual liquidity percentages calculated for each full calendar year since PIF's inception.

[3] As of 12/31/23. Source: CityWire, "PE Exits Hit Lowest Point in More Than a Decade," January 4, 2024. https://citywire.com/new-model-adviser/news/pe-exits-hit-lowest-point-in-more-than-a-decade/a2433371

A note about risk

Investing in private equity is a risk and there is no guarantee that an investment in private equity or in a Pomona-sponsored fund will be profitable. The above scenarios are for illustrative purposes only and are theoretical; there is no guarantee an investment in a Pomona-sponsored fund will exhibit any of the above characteristics or return profile.

Discussed below are the investments generally made by Investment Funds and the principal risks that the Adviser and the Fund believe are associated with those investments and with direct investments in operating companies. These risks will, in turn, have an effect on the Fund. In response to adverse market, economic or political conditions, the Fund may invest in investment grade fixed income securities, money market instruments and affiliated or unaffiliated money market funds or may hold cash or cash equivalents for liquidity or defensive purposes, pending investment in longer-term opportunities. In addition, the Fund may also make these types of investments pending the investment of assets in Investment Funds and Co-Investment Opportunities or to maintain the liquidity necessary to effect repurchases of Shares. When the Fund takes a defensive position or otherwise makes these types of investments, it may not achieve its investment objective.

The value of the Fund's total net assets is expected to fluctuate in response to fluctuations in the value of the Investment Funds, direct investments and other assets in which the Fund invests. An investment in the Fund involves a high degree of risk, including the risk that the Shareholder's entire investment may be lost. The Fund's performance depends upon the Adviser's selection of Investment Funds and direct investments in operating companies, the allocation of offering proceeds thereto, and the performance of the Investment Funds, direct investments, and other assets. The Investment Funds' investment activities and investments in operating companies involve the risks associated with private equity investments generally. Risks include adverse changes in national or international economic conditions, adverse local market conditions, the financial conditions of portfolio companies, changes in the availability or terms of financing, changes in interest rates, exchange rates, corporate tax rates and other operating expenses, environmental laws and regulations, and other governmental rules and fiscal policies, energy prices, changes in the relative popularity of certain industries or the availability of purchasers to acquire companies, and dependence on cash flow, as well as acts of God, uninsurable losses, war, terrorism, earthquakes, hurricanes or floods and other factors which are beyond the control of the Fund or the Investment Funds. Unexpected volatility or lack of liquidity, such as the general market conditions that prevailed in 2008, could impair the Fund's performance and result in its suffering losses. The value of the Fund's total net assets is expected to fluctuate. To the extent that the Fund's portfolio is concentrated in securities of a single issuer or issuers in a single sector, the investment risk may be increased. The Fund's or an Investment Fund's use of leverage is likely to cause the Fund's average net assets to appreciate or depreciate at a greater rate than if leverage were not used.

The Fund is a non-diversified, closed-end management investment company with limited performance history that a Shareholder can use to evaluate the Fund's investment performance. The Fund may be unable to raise substantial capital, which could result in the Fund being unable to structure its investment portfolio as anticipated, and the returns achieved on these investments may be reduced as a result of allocating all of the Fund's expenses over a smaller asset base. The initial operating expenses for a new fund, including start-up costs, which may be significant, may be higher than the expenses of an established fund. The Investment Funds may, in some cases, be newly organized with limited operating histories upon which to evaluate their performance. As such, the ability of the Adviser to evaluate past performance or to validate the investment strategies of such Investment Funds will be limited. In addition, the Adviser has not previously managed the assets of a closed-end registered investment company.

Closed-end fund; liquidity risks. The Fund is a non-diversified closed-end management investment company designed principally for long-term investors and is not intended to be a trading vehicle. An investor should not invest in the Fund if the investor needs a liquid investment. Closed-end funds differ from open-end management investment companies (commonly known as mutual funds) in that investors in a closed-end fund do not have the right to redeem their shares on a daily basis at a price based on net asset value.