Year in Review

- 2022 -

Contents

A Letter to our Friends

Partners, family, mentors, peers and friends:

2022 marked the overt reckoning we've collectively been anticipating since the onset of COVID in early '20. While 'normal' has looked different since, markets generally held up, despite the frequent whiplash. We consistently heard of darker times ahead, but overall, sentiment hadn't fully been priced into the public markets, and private sponsors were seemingly still comfortable paying record multiples.

That said, with inflation concerns driving a series of interest rate increases by the Fed over the course of the year, a movement out of tech stocks marked what felt like a breaking point. The war in Ukraine, growing concerns of global market stability, rising energy costs, broad crypto selloffs and supply chain disruptions all further exacerbated this sentiment. Recession feels imminent, and real effects have started to permeate through American lives, not just in investment portfolios, but increased costs of living and unemployment that, while still historically low, seems to be top of mind as companies look to get leaner. It's become clear that a reset is underway, and that reality will continue to intensify through 2023.

We wrote about the 'Year of the Re-up' in our '21 letter, and this reality has also become widely acknowledged. Fundraising has never been more competitive, and we continue to hear LPs speak to their lack of capital for new relationships. With that backdrop, we feel extremely fortunate for the successes our partners have achieved in '22, both on the fundraising front, but more importantly, on team building and investment execution.

Rallyday Partners closed their Fund II in March at the $205mm hard cap. **Care Equity** closed Fund II in October just north of the $300mm hard cap. Both Rallyday and Care raised their funds without broadly going to market, each closing in roughly three months and adding exclusively blue-chip endowments, foundations and family offices as new partners. Perhaps what we're most proud of is the fact that both could have raised drastically more capital but chose to keep fund size judicious in the spirit of strong LP alignment and desire to generate exceptional returns. **Cuadrilla Capital** has made three platform investments out of their Fund I that closed in September, and we continue to be extremely excited about their strategy and team. **RTC Partners** closed their fifth pre-fund platform investment in December, a continuation of their thesis-driven approach to lower market buy-and-build, and will likely be raising Fund I in '23.

Beyond fundraising, there were also a handful of personnel moves we're proud to have been a small part of in '22. What began as a simple introduction of two like-minded investors ultimately resulted in Rallyday welcoming three new team members who made the move from Portland to Denver.

Similarly, four LP relationships made new team hires on the heels of introductions from our network. We've joked internally that we have no interest in building a talent placement vertical, but there is no denying how proud it makes us when conversations between individuals and institutions we think highly of ultimately result in new endeavors for both.

On the Pacenote personnel front, we are very excited to announce our first hire. Tristan Sperry will join Pacenote on January 1st as a Principal based in Los Angeles. We have known Tristan for years, and after an exhaustive process, could not be more proud to have him as part of the Pacenote team.

On a less positive note, we were sad to say goodbye to one of our partners, Bill Braxton, who earlier this year made the decision to transition into a role at Goldman Sachs. Bill moved onto our Pacenote Advisory Board, but we will genuinely miss his positive spirit and vibrant smile in daily interactions. We wish Bill and his family nothing but the utmost success and good health in the future.

And, most importantly, we'd be remiss if we didn't also mention the addition of three new Pacenote family members this year. Matt and Tyler welcomed their fourth, baby boy Dylan Matthew, in May. Casey and Caroline welcomed their second, baby girl Shea Stone, in August. Sam and Chelseanne welcomed their third, baby girl Pepper Thellie, in October. Needless to say, it's been a busy year across the board!

We're very excited about our partner(s) coming to market in '23, but will forever feel a tremendous sense of gratitude for the aforementioned groups who believed in us early.

Wishing you all a happy holiday season with your loved ones. We are grateful for your support.

- Team Pacenote

Matt Evans

Observations and Trends

We're fortunate to spend our days speaking with thought-leaders across industries, both visionary GPs as well as stewards of capital representing top university endowments, mission-driven foundations, family offices, asset managers and others within our network. By design, working with a limited number of partners allows us to avoid the need to push opportunities onto investors, and instead, spend more time listening to what they are seeing in the market and where the puck seems to be moving.

As such, we don't expect you to hold the thoughts and observations that follow as proprietary to Pacenote. Instead, our hope is to neatly curate some insights we've gleaned over the past twelve months that hopefully are insightful, or at the very least, enjoyable to peruse over a holiday beverage.

The Tech Music Stops

COVID moved millions of employees from offices to work-from-home settings, and the hyper-connectivity that can make technology so appealing was in full swing. Zoom meetings became an everyday occurrence. Peloton stock rose ~760% from mid-March '20 to mid-January '21. Netflix added 36 million subscribers in 2020, a record year by a long margin. The technology-of-everything ("ToE"?) was red hot, tech company valuations soared and investors, both public and private, drove trillions of dollars behind this surge. Suffice it to say, that ascent has come to a screeching halt.

There have been many eerie parallels drawn between the dot-com bubble and today's tech market environment. As of late November, FAANG stocks returned -41.68% YTD, meaningfully trailing the broader stock market pullback (S&P 500 ETF down ~19.1% over the same horizon). An October Forbes article entitled, "FAANG Softens it's Bite", described this phenomenon. This is all without mentioning the most dot-com-esque elephant in the room: as of Nov. 22nd, total cryptocurrency market cap has declined ~$1.4 trillion YTD (source: CoinMarketCap).

While we can debate the degree to which Fed rate increases, the war in Ukraine and other variables have further exacerbated the tech and crypto selloffs, one net output will remain true for the foreseeable future (regardless of how resilient tech stocks are in the years ahead): institutional LPs will never approach their tech exposure the same again.

The frenzied pace at which venture capital firms have raised new funds, both flagship funds and ancillary funds…and more ancillary funds…(often requiring their LPs to participate in all strategies), coupled with a similarly rapid velocity of deployment, ultimately led to a meaningful overexposure to tech for most institutional LPs. This obviously works well during periods of 'growth-on' sentiment, but as the tech tide began to quickly pull out, many were left with their proverbial shorts down.

One endowment CIO described to us, *"while the full effects may not be reflected in marks yet, my expectation is that FTX exposure is going to 'rip through' many of our peers' portfolios."* As a WSJ article described, Sequoia Capital publicly apologized to its investors for the roughly $213 million loss it claimed due to investments in FTX and FTX US. By no means do we think this is an issue unique to Sequoia (quite contrarily, we think Sequoia is arguably the most impressive investment organization out there from a historical returns perspective), but it was interesting that as the news broke, we couldn't help but think back to their infamous "RIP Good Times" shared with portfolio companies in 2008 and the unnerving parallel to the "crucible moment" Sequoia had warned its founders of earlier in 2022.

While the importance of tech in our society cannot be understated, and the sector's historical resiliency has been on full display with many of the most sought-after Silicon Valley firms aggressively buying shares of recently battered publicly traded tech companies, **our prediction remains that LPs will be far more discerning as to how they invest in tech going forward.**

Capital Raising Cycles Shorten + Distribution Cycles Lengthen

Last year we wrote about a noticeable exhaustion in the LP community with the accelerated pace at which their existing managers were returning to market. This trend continued through '22, arguably to an even more apparent degree than before.

As Pitchbook's Private Fund Strategies Report described, GPs are raising funds at an accelerated pace, with the average time between funds falling below three years for the first time in a decade. And while fundraising has slowed on the margin over the course of H2 '22, most LPs we speak with feel like this figure has actually been sub two years (i.e. twenty-four months or less between vintages).

While this frenetic pace has hastened on the fundraising front, capital market conditions generally also have been favorable for sponsors investing over the past decade. The rising tide across most industries has allowed funds to generate strong (or at least average) realized results, and distributions to LPs reached record levels in '21. Until this year, the truncated time between fund vintages felt at least somewhat manageable for LPs as distributions from their portfolio buttressed the accelerated need for dry powder. **That said, the problem we've witnessed this year is when distributions begin to slow as the capital raising cycle continues to roar along.**

The past decade marked a dramatic increase in institutional LPs' target private markets allocations, and leaning into new private investments was the major trend that carried. The commitment-distribution cadence allowed LPs to feel comfortable with their pacing models, and most groups continued to drive a larger portion of their overall portfolio into privates. As this [Cambridge Associates piece] describes, "since the beginning of 2011, LP distributions have averaged $1.49 for every PE dollar drawn, enabling new PE commitments." That said, our expectation is that distributions will continue to slow, and LPs will be more mindful of their existing unfunded commitments.

While 're-up calendar' was the '21 hymnal, the message we most frequently heard from LPs in '22 related to an 'awareness of unfunded commitments'. This scrutiny intensified by the aforementioned public market pullback reducing overall AUM (transitively further increasing the relative allocation percentage to private markets, the proverbial 'denominator effect'). **Our go-forward expectation is that most LPs' sensitivity analyses that ultimately drive annual private markets allocations will be significantly more bearish on the whole, both in public market downside scenarios as well as tempered expectations around private markets performance as managers inevitably adjust their valuations to more reasonable levels.**

LPs Sharpen their Re-up Pencils

As the competition among top LPs for unearthing the next generation of upper echelon GPs continued to intensify over the past decade, the unwritten rule of thumb was that barring something egregiously negative during Fund I, LPs generally defaulted to investing with their sponsors for at least two vintages. The logic was in the spirit of demonstrating the organization's long-term approach to partnership, and while we can appreciate the sentiment, the issue that arises, particularly for Fund I's looking to raise their second vehicle, is that very few, if any, 'data points' have been hung on the scoreboard. Said differently, the likelihood of realized returns in the first few years of a fund are low. **As such, LPs are often left underwriting their re-up candidates on the basis of less quantifiable key-performance metrics:** ***have you stayed on strategy?; have you executed your initial post-close goals at each of the portfolio companies?; have you built (and maintained) a broader team as planned?***

It might seem obvious, but when you overlay the shortening of fundraising cycles, the set of data points available to LPs for their re-up decision-making is further truncated. As a result, the default decision often had been to err on the side of investing for a second vintage rather than getting off the train after one trip. As one LP jokingly said to us earlier this year, *"well, you're not tripling your fund size, and you haven't veered too far off-strategy, I guess that means you're worthy of re-up commitments."* Obviously the sarcasm makes the statement feel exasperated, but the reality holds that over the past few years, LPs more often than not shirked from difficult re-up decisions with existing managers. **Prior to '22, our sense was that the majority of Fund I to Fund II re-ups felt inevitable.**

That trend is officially over. **If '21 was the 'Year of the Re-up', and '22 was a year of playing defense on the public markets front and keeping your head above water triaging private markets re-ups, '23 will be a year of portfolio pruning.** As one Director of Private Markets described, *"I expect my re-up rate over the course of '23 and '24 to be sub-50%. Flat/slightly down re-up is the new equivalent of a step-up in commitment size."* As such, the advice we have been giving sponsors is that if an existing LP does re-up with you, even if for a reduced commitment size, this should be viewed as a meaningful vote of confidence.

While the degree to which investors sharpen their pencils on re-up decisions will vary by institution, in our opinion, expectations around existing LP support will increasingly be driven by (in order of importance): 1) Performance – either via <u>Distributions</u> or underlying financial data – are your portfolio companies performing at or above your underwriting expectations?; 2) <u>Discipline</u> – is your upcoming fund size indicative that you appreciate LPs' desire for more moderated fund size growth?; and 3) <u>Differentiation</u> – is your strategic edge/'moat' still uniquely compelling? As one investor we think highly of described, *"my appetite for getting off the bus one stop too early will be drastically bigger. If I even subtly sense a GP is shifting towards 'AUM aggregation' in lieu of their hunger for deal outperformance we will not feel obligated to renew our vows."*

Personnel Trends

A noticeable development on the LP team front has caught our eye in '22. **Over the course of the year (inclusive of moves that are not public but will be announced in January), over two dozen senior investors (Head of Private Markets or CIO) we know well have moved to new institutions.** We mentioned the four examples we played a small part in, and generally, this trend seems to be a real current driven by real forces (re-up fatigue at the top of the list).

In sports the expression 'coaching carousel' is used to describe the phenomenon of a coach leaving for a new role leaving a vacant seat, a position that needs to be filled by another coach who has to leave their current team to make the move. And so on and so forth, the carousel spins. These self-perpetuating cycles of vacancies creating new vacancies spin most rapidly in times of uncertainty in the world of sport. After a tough season the administration is more likely to make a coaching change. When everyone is happy (whether it's winning games or in times of bull markets), folks are less likely to be looking elsewhere.

Interestingly, we've actually seen the inverse as it relates to turnover on the GP side. While the initial onset of COVID left folks working from home and in the office with their current team less, many entrepreneurial investors began pondering their next move. In '21 we saw a surge in inbound introductions to individuals who wanted to get our thoughts on what spinning out entails. Conversely, we've actually had a handful of individuals with whom we had previously discussed the potential of launching their own firm who have reverted to us over the course of '22 and communicated that they no longer have those aspirations, and instead plan to be 'lifers' at their current GP.

Looking Ahead

Winter is Coming

As the background image on this year's cover reflects, we are preparing for a cold reality check in '23.

Last year we wrote about exceptionally strong fiscal year returns of many university endowments, driven largely by their early-stage venture capital portfolios, a red-hot IPO market and appetite for high-growth tech companies. The average FYTD '21 gain across all endowments was 30.6%, and the vast majority of thought-leading programs returned somewhere in the 40%-60% range. That said, as a Forbes piece describes, "In a sharp turnaround from a record year in 2021, many elite universities are reporting that their endowments lost value in fiscal year 2022." A Reuters piece further explains, FYTD '22 outcomes at most top endowments for the twelve-month period ending June 30th generally ranged from (8.0%) on the low end to slightly above flat on the upside, with the median across all endowments a loss of (7.8%). Obviously, the headline figures represent a stark reversal from '21, but it is worth mentioning that these returns certainly can be viewed favorably against the backdrop of the broader market declines, as endowment portfolios were largely insulated by their relatively large exposure to alternative asset classes (read: private markets).

The hope would be that post such a stark reversal, performance in the year to come would pick up again. But as a Barron's piece describes, "for college endowments, this has been the worst year since the financial crisis – and next year might not be much better." We, unfortunately, tend to agree.

The lag from quarter-end to audited financials being published to LPs is typically ~three months. While LPs have seen Q3 marks from some of their GPs, consensus among the LPs we speak with is that meaningful portfolio markdowns, indicative of the broader macro conditions in H2, will not be fully reflected until Q4 marks are shared in the back half of Q1. **Expectations across the LP universe seem to be that there will be meaningful write-downs in their private equity and venture capital portfolios, particularly given a heightened focus on fair market value vs. 'mark to marketing' which seems to have been the prevailing method over recent years.**

We outlined the long list of macro contributors to this year's market pullback. Public market comparables have come in meaningfully, and record high valuations in the private market will be more difficult to justify. As a November Bloomberg Law piece described, controlling-stake private equity M&A deal volume has fallen by 46% compared to last year. **As performance of existing portfolios continues to decline and pace of dealmaking continues to slow, coupled with overexposure to private markets, LPs are going to be very slow to allocate with new GP relationships in '23.**

Fundraising Fatigue Crossroads

As we described earlier, ’23 will be a year of portfolio pruning for LPs. LPs have reached their boiling point with respect to the crazed fundraising markets of the past few years. Frustration that’s been intensified not only by shorter re-up cycles and growth of future fund sizes, but also by the productization of new fund strategies (e.g. a GP raising a small cap or mezzanine fund alongside its flagship offering) and requests for premium economics/terms.

As one LP described to us regarding an imminent ’23 re-up decision, *“You’ve raised multiple funds with separate strategies, while continuing to meaningfully grow the size of the flagship fund and sold a stake in the GP management company to a third-party. Come on guys. What more could you possibly do to be more antithetical to my principles of interest alignment?”*

As another family office conveyed, ***“I think groups looking to raise next year are going to be in for a rude awakening. One of our existing GPs just clearly not getting the message, it’s not the same environment as when you raised two years ago. You can’t come to us with double the fund size and premium economics. Alternatively, you can slow down on fundraising and get out ahead of the message with your LPs and recalibrate from a position of strength, after you’ve demonstrated your primary focus is the existing portfolio. Now is the time to be building goodwill with your LPs, not looking to cash chips. Goodwill is going to be in extremely short supply with LPs the next two years.”***

We expect most LPs to spend a disproportionate amount of time in ’23 with their existing portfolio, likely in-person, walking through the fundamentals of each company. One dynamic we found elucidating was when an LP described, *“I’ll be able to tell a lot about who the GP really is based on how they react to my request to spend a full day walking through the existing portfolio, arguably even more so than the actual details about the companies themselves.”* Sometimes it’s the ‘how’ that’s more important than the ‘what.’

By definition, as LPs spend a larger share of their time understanding what they already own, that leaves less time for new shopping. What about vintage diversification? There is no denying that ’09 and ‘10 were excellent vintages across most sectors. As the Bain Private Equity Midyear Report 2022 describes, “returns from investments made during recovery years has consistently outperformed the long-term averages, especially in top-quartile deals.” While LPs are acutely aware that you can’t participate in these rebound type years if you’re fully sitting on your hands with respect to new commitments, as deal volume has slowed this year, LPs expect that a majority of their unfunded commitments from ’21 and ’22 vintages will be invested in ’23 and ’24, providing a natural smoothing of their vintage year diversification.

In short, fundraising for new GPs is going to be exceptionally competitive in '23. So what does that mean for a small business that's predicated on raising capital? At surface level, it definitely doesn't sound great! But there is a silver lining…

Differing Definitions of 'Top-grading'

Throughout the year we heard LPs describe the concept of 'top-grading' their portfolio. The idea, generally, is that LPs will look to concentrate their private markets book by making larger commitments with fewer GPs. This makes sense, particularly for LPs who appreciate conviction when it comes to their GPs running concentrated portfolios, and do not want 'over-diversification' across too many managers. We agree with this approach (for established institutional LPs who have been actively investing over the past decade, this logic obviously does not hold for new LP programs), even if it means less slots for new managers.

The second leg of 'top-grading' is the premise of getting access to historically oversubscribed GPs who have not welcomed new LPs, but given the current fundraising slowdown, are open to doing so. There's a GP you've been tracking, they consistently deliver great returns, stay on strategy, etc., this makes sense to us also. But where we differ from many is that while we fully understand this phenomenon as it relates to early-stage VCs (cycling out of an existing manager for an allocation to one of the blue-chip Sand Hill Road GPs), we do not think that this premise is widely applicable in private equity buyout. The reason why: fund size.

If Benchmark Capital's new vintage goes from $425mm to $450mm (or even a reduction in fund size from the prior vintage), or Sequoia Capital's new flagship fund goes from ~$700mm to $800mm, there is a real argument to be made that these funds are inherently capital constrained due to their early-stage strategy. The same cannot be said for buyout groups. The more common progression for top tier buyout funds goes something like this: Fund I in '19 at $750mm, Fund II in '21 at $1.5bn, Fund III in '23 at ~$2.25bn. That's a tripling in fund size in four years and a GP now managing ~$4.5bn in capital likely without much to show in way of milestones (beyond fundraising and deploying). While there are a handful of buyout GPs we think extremely highly of, and confident they'll generate above average returns regardless of how much capital they raise, there is an even shorter list of buyout GPs who have been successful across vintages and kept fund size moderated. These are the golden geese. If you can get access to one of these groups, we'd fully encourage an LP to 'top-grade' into their next vintage.

One of our competitors recently expressed to us that they *"will not be working with any Fund I's in '23"* as a result of these 'top-grading' market dynamics. Said differently, their expectation is that LPs will migrate away from new GPs and towards more established groups. Where do we differ? **More established GPs does not equate to higher quality. In fact, our sense is that there is a growing**

sentiment among top institutional LPs, particularly given the tightening credit backdrop, that fund size is the antithesis to net multiple outperformance.

While some sponsors don't appreciate when we share this opinion (we can understand why!), and by no means does smaller unilaterally equate to higher quality, we feel strongly (and the data agree) that it is much harder to generate a 2.5x+ net on a multibillion-dollar fund than it is on a smaller fund. Throughout the year we've spent time answering the question, *"so does that mean you guys will never work on a fund north of $500mm?"* No, not at all. There are strategies that necessitate a billion-dollar steady state fund size, and if we're convicted enough to personally invest, we would be excited to partner with such a group.

Independent Sponsors as a Growing Asset Class

We wrote about the proliferation of independent sponsor deals as a distinct asset class in our Review last year. At the risk of redundancy, suffice it to say that this trend has continued to gain steam.

There were over one thousand attendees at the McGuireWoods independent sponsor conference in October. **While there was a continued growth in the number of sponsors, perhaps the more telling proxy is that six endowment LPs attended the conference for the first time this year.** It's clear to us that a growing number of LPs who historically only considered direct deal efforts via existing GP co-investments are contemplating what direct deals with independent sponsors would look like in their portfolio.

There are certainly a few benefits to investing with independent sponsors on a single deal, namely no fees on unfunded commitments and no blind pool risk with full visibility into the underlying asset(s). That said, simultaneously underwriting an independent sponsor and their current deal opportunity, often in a meaningfully condensed timeline, is not for the faint of heart, and fund selection expertise is only one of the necessary skillsets. As one endowment who attended the conference for the first time shared, *"Another takeaway for me is that if someone wanted to create a fund of independent sponsor deals that could be a very compelling offering."* While this requires a dedicated team build, we agree with the attractiveness, and have been discussing with some investors what a standalone independent sponsor strategy, complementary to their existing private market fund investing, would look like.

In addition to growing LP interest, we've also continued to witness a rise in number of newly formed sponsors. Raising capital for a first-time fund is time consuming, and there is opportunity cost in not executing investments or focusing on the existing portfolio. This feedback rings particularly true today given the imminent fundraising headwinds in '23 coupled with our expectation that the year or two to come will be excellent times to buy well. As such, we've found ourselves giving advice more frequently the past few months to sponsors that they should consider executing as an independent sponsor for another deal or two. It's not lost on us that juggling final deal diligence, negotiating with lenders, raising equity capital and negotiating the terms with equity providers is daunting, but given the continued evolution of LPs interested in the space, we do feel strongly that this path will be in the long-term interest for many sponsors. As a result, expect Pacenote to continue to work with independent sponsors in 2023.

Pacenote Events

Work travel has noticeably picked up in H2 '22, and this Fall marked the first time since the onset of COVID that we consistently heard LPs speaking to a hectic AGM travel schedule. While Zoom certainly has created more efficient logistics for a fundraising process, there is no replicating time spent in-person, whether kicking the tires in diligence or in an informal setting with peers.

We hosted our first Pacenote event in October around the McGuireWoods independent sponsor conference, and what was originally supposed to be a small gathering of LPs and GPs we knew were in town ultimately resulted in 85 like-minded private equity constituents gathered for a night of idea sharing.

In 2023 our full team will be together for the following events, and we look forward to spending time in-person with as many of you as possible.

- February 27th-28th – Hugo Conference (Salt Lake City)
- March 29th-31st – Rallyday Partners AGM (Denver)
- Spring 2023 (dates TBC) – Cuadrilla Capital AGM (Santa Barbara)
- May 16th-17th – McGuireWoods Emerging Manager conference (Dallas)
  *If you haven't signed up for this conference already, we'd recommend you do so before they reach capacity. We're going to be hosting an event on Tuesday night at the same rooftop venue we did in October.
- October 3rd-4th – McGuireWoods Independent Sponsor conference (Dallas)
- October 20th-22nd – Pacenote-sponsored event around the Circuit of the Americas F1 (Austin)

Themes of Interest

While we will be introducing our next partner to the market imminently, we're constantly on the hunt for exceptionally motivated teams with differentiated strategies and/or approaches. The following are themes we have identified as areas with sustainable market tailwinds and attractive white space for new entrants, particularly in the lower middle market. To the extent you know any groups who fit this description, we would love to meet them!

As an aside, it's worth noting that while our core competency at Pacenote is in private equity markets, we have fielded a growing number of LP requests to discuss whether we'd work on a private credit opportunity if it fit all of our other Pacenote key tenets. The short answer for the time being is no, but this does not mean we don't acknowledge the likely attractiveness of the private credit asset class in the years to come given the current macroeconomic backdrop, namely the tightening availability of debt capital and rising cost to finance as such.

If the themes that follow feel similar to last year, it's because they are. While we have other areas we are exploring as potential themes of interest, we are still most bullish on the below.

Industrial Technology ('Industry 4.0')

Old economy businesses that are benefiting from technological upgrades—manufacturing automation, 3D printing, precision machining, logistics monitoring, etc. There is value in unlocking efficiencies in these types of businesses, and while there are a handful of industrial tech GPs we think highly of, we have found that certain opportunities that might sound sexy or 'sell well' with LPs aren't financially viable.

This year we also spent time hunting for a partner in two sub-specializations within industrial technology: specialty chemicals (developers/manufacturers of chemical analyzers, reagents, lab samples, etc.) and photonics (all things related to the generation, detection and manipulation of light). We've been impressed with the scope of each of the specialties, namely that there seem to be enough transactions in each space and breadth of end-market use cases to merit a dedicated, standalone fund exclusively focused on each.

Thematic Buy-and-Build

While this is a resource-intensive strategy, we find that thematic buy-and-build investors can achieve strong risk-adjusted returns. This strategy is best executed at the micro-cap level where sponsors can sell to mid-market PE firms who can't afford to spend time on small initial equity investments but are willing to pay up for a larger, more mature enterprise. We are continually surprised by how long some of these trends can last (e.g. dental and HVAC roll-ups), and also have had our curiosity piqued by newer focus areas such as white collar services and government services.

The question we've received most often the past few months while working with RTC Partners on their fifth pre-fund deal is *"how do higher interest rate environments going forward affect buy-and-build strategies?"* It's a great question, and in our opinion, groups who 1) can continue to execute their add-on strategy in a capital efficient manner, and 2) have developed strong relationships with their lenders who won't squeeze them on terms or covenants going forward will be the winners. In the end, if you can buy down to an all-in entry multiple that's 40-60% of the average exit multiples professionally scaled platforms in an industry can command and build a strategic enterprise that is more valuable than the sum of its parts, the buyer universe is large and well capitalized.

"Electrification Services"

We wrote about this theme in our '21 Review, and over the course of the year it has been the most actively inquired about by LPs who share our excitement. Transition from traditional fossil fuels to renewable energy, data communication and other critical infrastructure, electric vehicles. The world is getting more 'electrified', and our expectation is that the Inflation Reduction Act ("IRA") will only further supercharge this trend.

Rather than accessing this opportunity by directly investing in wind or solar farms, or buying data center real estate, we are looking for groups 'servicing into' this tailwind who will be needed regardless of who wins the EV race, the next spectrum auction, the debate between types of alternative energy (wind, solar, hydrogen, biofuel), etc. Datacenter servicing companies lay/maintain fiber optic wiring, smart meters and sensors across countless industries enable consumption monitoring, there are even companies that specialize in servicing extra-large wind turbines! As some groups describe it, "picks and shovels" or "second order" investing into this trend.

Healthcare Innovation

Healthcare is a space where most LPs have been active the past few years, but continue to reiterate that there will "always be a slot for someone doing something truly differentiated and orthogonal to our current portfolio." Whether that's a unique insight into true size of a market, ability to capture market share or ability to see step-function change in margins over time, sector specialization is rewarded for experts with compelling sub-sector themes and operational experience. For the most part, physician roll-ups are crowded, but we see significant opportunity in companies servicing into life science innovation (e.g. Care Equity), as well as certain payor and provider services.

Health & Wellness, Personal Care, Food and Beverage Trends

While consumer growth has largely been overshadowed by tech and healthcare efforts among many LPs over the past few years, we've begun to hear more interest in identifying new partners in the space. There is no denying the prevailing trend of heightened attention to personal health & wellness, and sub-trends such as superfoods, organic products (baby, household, beauty), plant-based alternatives, prebiotic beverages, non-alcoholic spirits and quality pet care have all become more in vogue. For us, an intense focus on underlying unit economics and business model expertise is imperative to a potential partner's strategy.

European Market Specialists

While we think traditional European middle market private equity is every bit as competitive as North American PE, there are compelling microcap opportunities in the European market, be it in specific geographies or sub-sectors. Certain regions provide exceptional workforce talent at a reasonable compensation level that has not been 'private equitized' as much, particularly in the LMM. We hear consistent feedback from LPs *"feeling light"* in Europe, and they are starting travel abroad again with pandemic travel restrictions having abated. With that said, like many of our investor relationships, the Pacenote 'bar' in Europe is higher.

Special Sits, Carveouts, Turnarounds

Despite the traditional Limited Partner *"disdain for financial engineering,"* we've seen it be used successfully by several middle- and lower-middle market investment firms. This strategy is typically not scalable given the focus on minimizing equity capitalization, which inherently somewhat negates the justification for a dedicated comingled fund, but the cash-on-cash returns when done properly can be compelling.

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