Year in Review
- 2023 -

Contents

A Letter to our Friends

Partners, family, mentors, peers and friends – Happy 2024. We hope you all were able to unplug and recharge over the holidays with your loved ones and the year is off to a great start.

Before we dive in, it's important for us to acknowledge the gravity of the events that have transpired around the world the past twelve months. What we've witnessed has been truly catastrophic. While our letter focuses on trends we're seeing in our very small corner of the investing universe, we felt remiss not explicitly recognizing that the social and geopolitical impacts of the world events in '23 far exceed the importance of any market dynamics. We are incredibly grateful for the positions we each have been afforded, and feel fortunate for our families and friends (including all of you).

As the Fed continued to dial up interest rates over the first half of 2023, stagnating private equity deal activity, a decline in exits and a meaningful slow in fundraising set the tone for a seemingly cold year in private equity. Yet, at the time of writing this, the Dow, S&P 500 and Nasdaq all have hit, or are within striking distance of, all-time highs. How can this be so? Such dichotomy, in our opinion, is a harbinger for an upcoming seismic reset, which we'll explore further as part of our anticipated theme for 2024, **divergence**.

Pitchbook's Global Private Markets Fundraising Report outlined that through Q3 '23, private capital fundraising activity is down ~28% year-over-year, and funds are taking longer to raise than they have in over a decade, with the average fund requiring 16 months from start to finish. Furthermore, per Pitchbook data, the fastest quartile for all private funds in '23 was 9.4 months, and the same metric for 'first-time private equity funds' was 11.9 months (with an 18.2-month median). Not an ideal time to be in the business of fundraising…particularly with a thesis predicated on first-time funds and a model built on an exceedingly high bar and low volume of partners. With that backdrop, we are proud of the successes our GPs achieved in '23, and thankful for those who have supported us and our focus.

We entered '23 on the heels of two successful Fund II processes for **Rallyday Partners** and **Care Equity**, but as of Jan. 1st, weren't actively 'in market' with any fundraises. A core tenet of our model has always been to keep overhead lean so that we don't feel pressure to 'chase' revenue, even if that means periods of sitting on the sidelines. That said, it wasn't until H1 '23 that we were put to the test to live this out. We had several difficult, late-diligence declines with groups we thought highly of, but ultimately did not launch with a new partner until June.

Saothair Capital closed Fund I in October at their $125mm hard cap. We had been searching for a partner in the deep value/special situations space for a few years, but struggled to solve for two elements we believe to be crucial to success in the space: 1) *the strategy doesn't inherently scale, as often* *the best results are predicated on minimal initial equity checks*; and 2) *experience navigating highly complex situations 'on the buy' (in/out of court restructurings, Chapter 11 bankruptcies, negotiating with unions, etc.) is difficult to pair with also having a growth mindset once owning the companies.* As we got to know Kevin Madden and Rich Lozyniak, we became highly impressed with their experience together, and also came to appreciate the difficulty operating as an independent sponsor in the turnaround space given the importance of speed and certainty of capital to close (i.e., best price isn't always what is being solved for in situations when a company has a finite lifespan if a new owner doesn't quickly step in). We're excited to see what Saothair accomplishes over the next few years.

As we were rounding out the Saothair process, we launched with our next partner, **Seven Hills Capital,** a healthcare services firm. Seven Hills held their first/final close at the $125mm hard cap in December. As was the case with Saothair, the fundraise was a sub-four-month process, and attracted a diversified group of endowments, foundations, family offices and OCIOs we respect. Given the size of the overall healthcare ecosystem ($4.5 trillion spend representing 17% of GDP), we had been proactively looking for another partner in the space to complement Care Equity's focus on life sciences services. Beyond our usual criteria (lower middle market, comfort with concentrated portfolio, focus on net multiple outperformance over multiple vintages vs. AUM growth, etc.), there were a few key elements we were looking for: 1) *experience and focus on building de novo assets*; 2) *investor-operator experience*; 3) *differentiated approach to solving for what we call the 'MD alignment paradox'* (Seven Hills solves for this through their 'practitioner-led' approach); and 4) *geographical intentionality*. We're proud to be partnered with Matt Pettit and his team.

As we enter 2024, we recently launched the **Cuadrilla Capital** Fund II process, and given demand to-date, expect to close at the $300mm hard cap in the spring, adding a handful of new LPs. Cuadrilla has done an excellent job with what many Fund I's struggle doing – building a cohesive team and relentlessly sticking to their strategy. When software prices were skyrocketing, Cuadrilla was patient, and we believe they will be rewarded for that. We're excited for what '24 holds in terms of new partners, but as always, we feel an enormous sense of gratitude to all our existing partners who have entrusted us to be their capital formation sherpas, particularly when pitted against such strong fundraising headwinds.

2023 also marked the formal launch of **Pacenote Equity**. While we've been cultivating the strategy for several years, we held our Fund I first close in December and are humbled to begin investing on behalf of our institutional partners. We're including a more fulsome introductory section below, but the TLDR is that <u>we'll be investing with independent sponsors in 'pre-Fund I' opportunities</u>. This extension is highly complementary to what we'll continue to do on the Pacenote Capital side (identify and represent world-class sponsors in raising their Fund I), and we believe that this tool will meaningfully augment our sourcing efforts (more below). For the avoidance of doubt, we have zero aspirations to be asset managers. Rather, Pacenote Equity is the manifestation of an opportunity we continue to see in the independent sponsor landscape (particularly down market), and our desire to build a better mousetrap. We're hopeful this structure enables us to attract the best of the best investors who have entrepreneurial aspirations, but aren't in a position to leave their current firms and take any form of fundraising risk. While not a prerequisite, our hope is that many sponsors with whom we invest 'pre-fund' from Pacenote Equity, ultimately 'graduate' to become partners for whom we raise Fund I and beyond (and with whom we continue to personally invest).

On the Pacenote personnel front, 2023 marked a special year for us as we made our first hires. Tristan Sperry joined Pacenote on January 1st as a Principal based in Los Angeles, and Eric Leibrandt joined the team on July 1st as a Principal based in New York. Tristan worked with Casey at Mercury Capital, and Eric worked with Sam at Global Endowment Management, and both have already made meaningful impacts for us. We could not be more proud to have them both onboard.

Wishing you all a peaceful, healthy, safe and prosperous 2024. We are grateful for your support.

- Team Pacenote

Observations and Trends

As we mentioned above, conflicts and crises through 2023 continue to test the economy and people globally. While all of us have our own challenges we're navigating in our lives and with our families, the truth is we have it exceptionally *good*. The unfortunate reality, however, is that these are not happy times for many. While what we'll explore herein are certainly far from life and death matters, we do think that '24 will mark a reckoning for private equity.

Is it just us, or does it feel eerie that ~nine months later, the market seems to have already brushed off the fact that three namebrand regional banks with ~$525 billion in assets failed, seemingly overnight, followed by a forced takeover of Credit Suisse by UBS the following week?

Our 2022 Year in Review was titled, "*Winter is Coming*" (2021 was the "*Year of the Re-up*"), and with 2024's theme of *divergence*, we found 2023 to be a year of can kicking. A penultimate, twelve-month filler episode, if you will (Editor's Note: by no means are we suggesting that 2024 is the series finale for private equity, but rather, the hard reset post low-interest rate boom era that's persisted since '08-'09). The beauty, as we'll discuss further, is that it's in times of market disruptions and pullbacks when real alpha can be generated. Let's explore.

What's an Exit?

Per a Harvard Law School piece, global private equity deal volume in 2023 totaled $1.3 trillion, compared with $1.7 trillion in '22 and $2.2 trillion in '21. In the U.S., private equity deal value was down 29.5% YoY, and total exit value dropped 26.4% over the same period, per Pitchbook's annual report. We've talked about the rising interest rate environment and other drivers of this dealmaking lull, but as we enter '24 and pressure mounts for sponsors to generate liquidity for their LPs, how will this urgency manifest? With a record $2.59 trillion of global private equity dry powder at the end of 2023, and the supposed imminent rate reductions by the Fed we keep reading about, it should be no problem for the '24 transaction market to start flowing, right?

The answer is certainly not that simple, and while we do expect the secondary market to continue growing, let's focus on the private equity holy grail – *exits*. Private investing first principles suggests over the course of a hold period, a sponsor is paid by its LPs to drive improvements and enhance the value of a company such that it can eventually sell said company to its next owner(s), generating a return for its investors (and itself). While the definition of a standard hold period can vary meaningfully (dependent upon strategy, stage of investment, etc.), let's assume that in decades past the oversimplified average hold period was five years (per Preqin Pro, between 2014 and 2023 the average hold period for U.S. and Canadian private equity funds was 5.8 years, and was 4.9 years in the preceding decade). Through Nov. 15th, the same metric for 2023 spiked to 7.1 years. While there is sentiment among many that 2024 will see a meaningful rebound in exit volumes, we're not expecting an immediate snap back to the average five-year hold, but rather a continued spread between buyers and sellers regarding perceived fair market valuations.

The timing for sponsors to sit tight with their existing portfolios couldn't have been worse, as their LPs are still feeling the aftershocks of the tech rollercoaster denominator effect, leaving patience in short supply. Simply put, GPs don't want to be the first movers among their peers selling their companies for less than what they believe they're worth. LPs, meanwhile, have never been more desperate for liquidity, and as a Bloomberg article outlined, in some cases, telling their GPs they'll, "*only commit to their upcoming fundraises if their capital tied up in old funds is released*." But, again, GPs want to get paid for what they believe their companies are worth. Enter continuation funds, synthetic DPI via NAV loans and all sorts of other gamesmanship. Suffice it to say, this stalemate is quite the conundrum, and it's our belief that there will be some sponsors left 'holding the bag' (more below).

For the avoidance of doubt, long duration asset ownership is nothing to scoff at. Warren Buffet's strategy is predicated on this core tenet, and we've spent time with a handful of sponsors over the past few years we think highly of who are executing their strategy via a long-dated or evergreen vehicle. But, through the lens of the 'typical' LP/GP relationship (and the 'self-funding' cycles even the most long-dated LPs have built their pacing models on), **we expect to see a heightened level of scrutiny, pre-commitment, from LPs to better understand how each sponsor thinks about hold period**.

The way in which we've synthesized these dynamics and tried to ringfence future 'exit risk' can be distilled into one question that's now at the top of our diligence list, *"what are you doing at your companies that is so unique that a future owner **'has to have it'**? Regardless of whether they need to pay a premium multiple to acquire it from you."*

"Fund 0.5"

It's not lost on us that the niche where we focus our time, effort and personal capital is hyperspecific - 1) private, 2) small cap, 3) control-oriented strategies only - an approach many might argue is too myopic. Furthermore, while we're exclusively solving for "*can we consistently generate net MOIC outperformance over a three-five-year hold?*," we're fully cognizant of the fact that this approach does not account for a plethora of other inputs institutional investors are solving for (minimum check sizes, necessary co-investment ratios, appropriate risk/return appetite given annual spend, etc.). We gravitate towards asymmetric return opportunities that are inherently capacity constrained, with sponsors who are 'early' in their respective firm's lifecycle. Most of you understand why we focus on partnering with sponsors at this inflection point in their careers, but rather than elaborating on our why, we want to underscore the fact that our approach, and what we're about to describe as an extension, is not universally appropriate (and only time will reveal if we're correct).

That said, within our lane, among the subset of institutional LPs we spend the most time with, we think we're on to something as it relates to how LPs will construct their private equity portfolios in the coming years versus how historical convention has delineated portfolio diversification.

We continue to be surprised by the number of sponsors we speak with (reminder, these are often the best of the best PE investors with intense attention to detail) who have the same misconceptions about 'what LPs want.' This is somewhat a function of the fact that the individuals/teams we partner with rarely have been LP-facing in their prior roles (typically one level removed from the most senior brass at the organization). *"LPs need a diversified portfolio of 8-10 companies, right? And I need to build a big enough team before I can raise a fund, right?"*

A question we've found ourselves asking sponsors this year, ***"if you were to raise a $150mm fund, instead of the $300mm fund you're quoting, and invest in half the number of companies over a shorter investment period, would you lose any crucial hires? Or would it impair your strategy?".*** After some quick mental math on half the management fee income, the answer has almost always been a resounding no. What's more, is that as we've shared this feedback with LPs we're close with, they're even more stunned by the misconceptions than we were. As one LP responded, ***"smaller funds are a feature, not a bug."***

While small funds investing in small companies can be a powerful approach, we are cognizant that small businesses are often far less resilient than large businesses, and the dispersion of returns is greater as a result. One idiom we try to remind ourselves of during diligence (read: keep ourselves sober when thinking about the high-octane upside) is that small companies are closer to zero. While this is true, we feel confident that 'boxing small company risk' is a feat experienced sponsors can accomplish. This is a **sentiment we've seen shared by a large majority of the thought-leading LPs, as evidenced by their increasing comfort with small, concentrated portfolios (~four companies on average), even in the framework of a new Fund I relationship.**

LPs often have existing portfolios that are 'overdiversified', and while we frequently hear groups speaking to their goal of concentrating the roster of managers, this is predominantly in the mid and large cap portfolio. Contrarily, within their LMM allocation, LPs are hunting for new relationships to augment the rest of their roster. Furthermore, as 'blind pool risk' is a top consideration for LPs, the prospect of committing to a portfolio that's three-four companies (vs. ~eight), invested over three years (vs. ~five), feels far less daunting when considering a new manager relationship, a point we believe is particularly salient given the current distribution challenge (and subsequent protracted fund lives limping along 12+ years). Which leads us to our theory that in short order, **the nomenclature 'Fund**

0.5' will no longer have a negative connotation, suggesting that a sponsor couldn't raise a full-sized fund. Rather, Fund 0.5's will be a staple in top institutional LPs' private equity portfolios as a means to increase their allocations to smaller companies via a greater number of LMM partners (at the expense of larger sponsors).

Rise of Private Wealth Channels and 'PE Democratization'

Perhaps the most noticeable trend in the PE ecosystem is the burgeoning RIA landscape, and the corresponding interest from asset managers to tap into these channels. To us, the movement makes sense, particularly as the feat of attracting investments from institutional investors becomes increasingly more difficult. Per a Bain analysis, individual investors hold roughly 50% of the estimated $275 to $295 trillion of global AUM, yet, those same investors represent only 16% of AUM held by alternative investment funds. If there's one thing PE does well, it's move quickly (and en masse!) when an opportunity presents itself, and those figures certainly seem to make the case glaringly obvious.

The industry arms race is already meaningfully underway. Digital technology platforms designed to reduce friction for individual investors have become table stakes for large asset managers. Qualified individuals now have streamlined access to log into a portal and shop a variety of investment strategies offered by some of the most blue-chip investment behemoths in the world. On the sponsor side, GPs' insatiable appetite for growth exceeds available capital from the historically reliable institutional LPs, and we continue to see firms strategically targeting RIAs and wealth management platforms to backfill the white space. Whether via strategic relationships with RIA feeders, specialist IR professionals focused on the space and/or utilizing aggregator technology platforms such as iCapital or CAIS, GPs continue to explore all conduits to tap into these dollars.

While we're believers that this trend will persist (it's rare that there is demand on both sides of an equation - high-net-worth individuals increasingly seeking alternatives exposure + asset managers seeking fee-paying clients), we'll share our thoughts as to why we believe our niche is insulated (and why we have no intentions of creating or utilizing an aggregator platform). We're often asked, *"do you think the placement industry will be disintermediated by tech-enabled platforms?"* Our answer: it depends on what you're placing. Part of why the equation outlined above makes sense is that there is no finite cap on 'supply.' Asset managers (and the vast majority of the GP landscape) are literally trying to raise as much money as possible. Conversely, as we've expressed, it's our strong opinion that **the highest return potential investment opportunities are capacity constrained.** As thoughtful LPs are hyper-focused on judicious fund sizes for a given opportunity set (and hence, the intense competition among these groups to access the highest-quality, appropriately sized GPs), **we don't envision a sandbox in which blue chip LPs are coexisting with open-ended, retail blank checks**. Furthermore, while many GPs seek to scale AUM at all costs, we've found that sponsors who are optimizing for returns vs. AUM aggregation are increasingly thoughtful about wanting partners who can be dynamically valuable beyond just their capital.

Continued…

Some of our observations in ’22 persisted, and a few of our predictions for ’23 did in fact transpire. At the risk of lazily copying and pasting, we’d be remiss not to underscore that we continue to monitor these trends and believe them to be meaningful dynamics in our ecosystem.

We focused on the latter part of the **Capital Raising Cycles Shortening + Distribution Cycles Lengthening** equation above, as well as the discernment with which LPs began **Sharpening their Re-up Pencils** in ’22 as part of the broader **Fundraising Fatigue Crossroads**. Suffice it to say, no re-up decision is a rubber stamp in the current environment, and we’ve observed a growing willingness among LPs to ‘get off the bus’ after just one vintage if a GP is not meeting expectations (obviously on the performance front, but increasingly more so on the less quantifiable - if fund size growth feels too rapid, or strategy shift feels imminent, or even disappointment in the cadence of regular course communication).

Personnel Trends continue to be an interesting phenomenon we’re monitoring. While the tally of senior-level LP moves in ’23 did not quite reach the figure we saw in ’22, we did observe a meaningful number of investors continue to leave for new homes. As new family offices are created, and LPs who historically had been reliant on consultants cross AUM inflection points where it makes sense to build internal investment teams, we expect to see a heightened number of departures in ’24.

Interestingly, we’ve continued to see a relative slowdown on the GP side. While there’s certainly no shortage of new firms being formed, between continued fundraising headwinds and uncertain sentiment regarding how markets will move over the next year or two, we’ve been privy to a few examples where the ripcord has been pulled on spinout plans. We’ve also observed several departures who initially intended on launching their own firm, but ultimately made lateral moves to another established GP after testing the fundraising market. We’ve also heard a few potential spinouts (impressively pragmatic, in our opinion) self-acknowledge that their deal history should “*be taken with a grain of salt*” given the low interest rate environment that persisted following ’08 and the multiple expansion that ensued over the subsequent PE boom.

Looking Ahead

2024's word of the year: Divergence

As the background image on this year's cover reflects, we are preparing for a year (or more likely, years) in the private equity ecosystem stamped with deviating paths. We mentioned it in our coaching carousel analogy last year, when times are good, changes are less frequent. "Winning cures everything," as the saying goes. But when the good times aren't rolling, when negative outcomes start dialing up the temperature, pressure to reassess the inputs begins to mount. In our humble opinion, we're entering a period where the spread between quartiles will widen, and market participants will be forced to take a step back and ask themselves, "*is the way we've been doing it for the past decade the best approach going forward?*"

Performance Disparity

Simply put, we expect more stark performance dispersion between GPs to begin coming to light in '24. Transitively, we expect the range of fiscal year returns at LPs to also begin widening. As McKinsey's "2023: Private Markets Turn Down the Volume" notes, "*the dispersion of fund performance in PE also presents the greatest opportunity for LPs to outperform (or underperform) through optimal fund selection.*" We agree.

We're all industry participants, so no need to sugarcoat anything, 'mark-to-marketing' by GPs is a real phenomenon. The degree to which just how brash unrealized investments are marked depends on a variety of factors (not least importantly, whether a GP is actively trying to raise their subsequent vintage), and as we all know, you can make a financial model spit out whatever output you're looking for if you're bold enough on the inputs. Over the course of '22 and into '23 we frequently heard LPs commenting on how their VC managers, specifically, were handling what they deemed to be 'appropriate' writedowns of their existing portfolios as tech valuations pulled back dramatically (some more *appropriately* than others). Yet, we have not seen a comprehensive acknowledgement across the buyout GP landscape that, perhaps, valuations at which investments were being held 18-24 months ago may no longer be appropriate. Much like the aforementioned reluctancy to sell companies at what sponsors perceive to be a discount, there's also reticence around being the first mover in dampening unrealized marks. While this phenomenon is more pertinent to pre-2022 vintages than to funds of the past few years, as we expect to see an increased scrutiny from LPs regarding each of their GP's approach to hold period, **we also expect to see a heightened level of discussion around valuation inputs and how managers are appropriately sobering their expectations of future buyers.**

One interesting anecdote, albeit to the extreme case of 'suitably marking your portfolio', per S&P Global Market Intelligence, bankruptcy filings by PE and VC-backed companies in the U.S. totaled 104 in 2023, the highest annual total on record (compared to 38 U.S. portfolio company filings in each of '21 and '22). Which begs the question, if existing owners (sellers) and future owners (buyers) can't close the bid/ask spread, and sponsors can't keep packaging up existing assets into continuation vehicles, how do sponsors start treating companies that are long in the tooth, that they still believe in, while managing resources for more recent and new investments?

Asset Allocation and Strategy Dispersion

Much like dispersion of returns seem to compress in good times, LP investment strategies and approaches to asset allocation also regress toward…whatever is hottest. Contrarily, when the proverbial stuff is hitting the fan, we expect to see a broader range of what institutional investors deem best tactics.

A March WSJ article entitled "Some Public Pension Funds are Pulling Back on Private Equity", noted that Maryland's $65 billion retirement system is investing less new money into PE, and Alaska's $77 billion state plan canceled a planned PE allocation increase, among others mentioned with similar pare backs. "*We think you can get to the same destination with just public market assets and your real estate and infrastructure portfolios*," a consultant for state pension plans was quoted. Contrarily, four of five NYC public employee pension funds voted to increase allocations to illiquid investments, specifically private equity, to "*hopefully have a higher probability of achieving our 7% actuarially assumed rate of return with a lower amount of volatility,*" said Steve Meier, NYC's CIO. In June, the UTIMCO Board agreed to increase its allocation to PE from 25% to 30% while reducing public equities from 35% to 27%. Across LP types, we've continued to observe divergence in courses being charted as to how significant (or not) a role PE should play in the overall portfolio going forward.

We've also seen internal dichotomy among investment team members (and Board/IC members) regarding how efforts should be prioritized within private markets portfolios. An Institutional Investor piece published in August dubbed, "Small, Esoteric Private Equity Strategies Keep Crushing It" outlined **data that suggests private equity strategies that have less than $350 million in assets, and that focus on investing in esoteric industries or businesses, continue to meaningfully outperform their larger peers**. Suffice it to say, we agree. Yet, we've received feedback regarding previously quiet colleagues and/or Board members voicing how they feel about allocations (by fund size, by vintage, by strategy, etc.), and expect to continue witnessing nonconformity in the LP community.

Consolidation of the Middle Market

As a Harvard Business Review entitled "The Consolidation Curve" describes, nascent industries are typically highly fragmented, but as they mature (and become more efficient), most industries progress predictably through a clear consolidation life cycle. Ironically, it's a playbook the private equity industry arguably knows best of all (see: dental, HVAC, car washes, etc.).

To way oversimplify, the LMM serves up platforms (after doing the hard work of consolidating small players) to the middle market players, MMBO firms continue to find synergies and optimize efficiencies to justify interest from large cap sponsors, who then…do the same before taking public and cashing out before market sentiment can whipsaw share price (EN: we kid!). Joking aside, the sustained sale of baby boomer businesses will undoubtedly continue to create significant opportunities for private equity, and the vast ecosystem warrants a plethora of investors. That said, as the industry becomes more and more talented, and intermediated sale processes become more and more efficient (even down market), the spread on potential alpha has become increasingly narrow. Said differently, as PE sponsors become more well-resourced (as a reminder, most of these firms are armies of the brightest, most competitive people on the planet), and the industry at large becomes 'more efficient,' why wouldn't returns begin to asymptote? While we're mindful that this change will take years to unfold, **we believe there will be a consolidation of GPs, particularly in the middle and upper market (as defined by funds greater than ~$1bn).**

Over the course of '23 we observed a growing number of new GP stakes firms entering the landscape. As fundraising lulls continue to persist, and GPs seek capital from alternative means (vs. traditional LP commitments), we expect to see a continued increase in GP stake sales. While this prediction is far from bold, how we envision the medium-term to play out as an extension of this trend is more audacious. As we've joked with some of you, we totally see the attractiveness in owning a piece of a GP (highly lucrative, largely uncorrelated to broader markets, etc.). But, for the cash flows to be sustainable, it must be the right GP. Before we continue, it's important we reiterate that while we understand the merits of GP stakes, we 1) have/will not take stakes in our GPs (whether management company ownership or otherwise), and 2) have a strong preference for the day-to-day team to own 100% of the management company and fund economics. **To us, the best GPs in the world shouldn't have to give these up to raise a judiciously sized fund and garner a diversified group of LPs** (we also feel that in most cases, selling a stake in the GP signifies a desire to scale AUM vs. singular focus on driving exceptional returns).

What's specifically more interesting to us, is that there seems to be a perception in the market that once a GP gets to a critical mass of AUM and garners a minority investment from a Blackstone or Petershill or Dyal or Blue Owl, that they're 'too big to fail.' In the GP stakes' presentations we've seen, there is minimal (if any) downside acknowledgement that the underlying GPs could cease to exist. Rather, the downside scenarios speak merely to muted fund size growth. This is a meaningful miscalculation.

Throughout the year, friends have sent us headlines regarding suboptimal fundraising outcomes. Spinouts from highly regarded firms raising meaningfully less than their initial target, failed spinout launch attempts, established GPs sputtering in market for re-up capital and shuttering of ancillary strategies. It feels like market perception is that the 'floor' is having less capital to invest or having to focus exclusively on a single strategy under one roof (a tragedy!). But what happens in a few years as we continue pulling the string on this trend? What happens when a previously well-regarded GP who wound down their auxiliary strategies in '23, continues struggling to raise re-up capital for its flagship strategy? As investment professionals leave for larger, more secure platforms (or launch out on their own), what happens to these legacy funds?

We've already begun to see a version of consolidation within the infrastructure space. General Atlantic acquired Actis, BlackRock acquired GIP, Investcorp bought a controlling stake in Corsair Capital's infrastructure business, CVC acquired DIF Capital Partners. Not simply a proliferation in GP stakes investments, but rather an outright consolidation of GPs. **As LPs continue to concentrate their mid and large cap private equity exposure with fewer, larger managers, while focusing their higher alpha-seeking efforts down market with specialist LMM groups, we expect to see a meaningful consolidation of middle and upper market GPs over the next few years**. Said differently, while large/mega cap managers may not be able to generate 2.5x+ net MOIC fund-level outcomes given sheer fund size constraints, the best of the best (TA Associates, CD&R, H&F, etc.) have continued to demonstrate their value by generating consistent, attractive returns. As they continue to scale (and attract more and more talented resources), and the majority of MMBO firms fail to deliver performance that even matches returns of the aforementioned heavyweights, why wouldn't LPs sleep well at night consolidating their commitments from a dozen middle and upper market managers to a handful? **Where/when PE returns start feeling more commensurate with public market equity beta, we expect LPs to start concentrating those positions.**

Introduction to Pacenote Equity

In our '21 letter we wrote about the proliferation of independent sponsor deals as a distinct asset class, and in the '22 edition, reiterated that this trend has gained steam. Over the course of 2023 we've continued to observe the growing interest in the space, across all constituents of the ecosystem – number of independent sponsors, number of institutional LPs interested in the space and number of capital sources (both equity and/or debt) in the market. **We continue to believe there is an extraordinary opportunity to generate consistent, risk-adjusted 'net-MOIC outperformance' by investing with talented independent sponsors. That said, we also feel strongly that investing in the space is not for tourists. Investing with a mediocre independent sponsor is much riskier than investing with a mediocre fund manager, and without a hyper-focused approach + keen sense of pattern recognition, compelling entry valuations (on what are typically smaller companies) can intoxicatingly mask other issues.**

To-date, our approach to partnering with independent sponsors has been the same as our approach to working with 'funded' sponsors: invest personal capital + raise the necessary equity for the sponsor to execute on what we believe to be a differentiated opportunity. For the independent sponsors we have represented to-date, we've successfully helped them raise the required capital to get their respective deals closed, all with LPs we believe to be high-quality, long-term partners. That said, a constant factor has remained (in each of these deals, as well as the broader opportunity set, including opportunities we personally invested in but did not formally engage on to raise capital), the *supply* of compelling independent sponsor deals far outweighs the *demand* of equity sources. Specifically, the *required demand* for an opportunity, particularly given the short fuse timeline most independent sponsor deals are subject to, has fallen short, even with the continued growth of LP interest in the space. Why is this the case?

In our opinion, regardless of how compelling an independent sponsor opportunity might be, the external factors (read: pressures unrelated to the investment opportunity) such as LPs' existing pipeline, travel schedules, priorities across other asset classes, etc. have proven too difficult to overcome. For an LP to first meet a sponsor, simultaneously underwrite said sponsor and their live deal (typically while the sponsor is still completing their own diligence), and ultimately close in a ~45-60-day timeline is tough. Mix in a host of LP-specific requirements (e.g., minimum equity checks, preference for a sponsor to commit to a predefined number of future investments prior to raising a fund, veto rights on future add-ons, etc.) and the following insight becomes even more true: <u>an exceptional investment opportunity sourced by an independent sponsor does not, on a probability-weighted basis, equate to successfully raising the required equity, regardless of whether you're meeting all the right potential capital partners.</u>

As our team went through the Traction EOS process this year, our "purpose" was defined as follows, **Pacenote: identifying and evaluating entrepreneurial investors early, and eliminating friction for them to build world-class firms.** Expressed differently, our north star is: 1) identifying the highest quality investors in their respective sectors/strategies and advising them on their 'launch'; and 2) empowering them with key foundational ingredients to build lasting firms.

Arguably the most important element to #2 is a comingled fund (on behalf of a diversified roster of high-quality LPs). That said, there is no #2 without first accomplishing #1 (both the *identifying and evaluating*, but also the *advising*, <u>after</u> the sponsor has made the decision to launch). One of the most daunting risks for an individual or team contemplating launching their own firm is 'fundraising risk.' Leaving a lucrative, secure, existing gig in the name of building something new is not for the faint of heart. Typically, the investors we speak with who have entrepreneurial aspirations have *"no doubt that if I had capital I'd be able to drive exceptional returns."* So, Pacenote, go raise them a fund and that issue is quelled. The problem, unfortunately, is not that simple. Bear with us as we explain.

There have been multiple examples of potential spinouts with whom we've spent real time who are still at their existing firms. A number of these groups have some combination of the key ingredients required to successfully raise a Fund I (impressive 'on-strategy' deal history, uniquely compelling sector, exceptional reference calls, a team who is ready to jump ship with them, 'killer instincts', etc.). And yet, with 9 out of 10 key ingredients present, there have been multiple groups we've had to pass on working with over the past few years (even with an enormous amount of conviction to personally invest), as we couldn't in good faith tell them we were confident we could raise their Fund I in six months or less (EN: we don't think it's the highest and best use of a sponsor's time, or in the best interest of the LPs' ultimate returns, to spend more than this raising a judiciously sized fund). Something was missing. One or two key components would have impeded a successful fundraise. Perhaps the aggregate bid for a certain sector among the LP landscape was muted. Sometimes, as we refer to it, the *"mosaic"* isn't <u>quite</u> there. There's not a linear equation when it comes to raising a first-time fund.

In several of these situations our advice has been to first launch as an independent sponsor and execute on a deal or two under their own flag. *"If the opportunity is compelling enough, you'll most likely be able to get the equity raised,"* is the advice we often hear given to independent sponsors. You read our thoughts on *"most likely"* above…

'Fundraising risk' is meaningfully more difficult to probabilistically underwrite for an independent sponsor deal raise than for a comingled fundraise. Said differently, **we have a high degree of confidence in our ability to predict whether a potential spinout could raise their Fund I in six months or less, but our assessment as to whether a sponsor could raise the required equity for a 'pre-fund' deal is far less precise (regardless of how compelling we find the opportunity to be). Hence, Pacenote Equity.**

We did not take the decision to launch this lightly. Numerous case studies informed us of companies' downfalls on the heels of getting away from their core competencies. We've spent the last few years analyzing alignments of interest and whether any part of Pacenote Equity would cannibalize our relationships on the Pacenote Capital side, and while there are a handful of LPs who will now view us as competitors providing equity to independent sponsors, at the end of the day, our core competency isn't fundraising, it's LMM private equity. Ultimately our day-to-day activities won't change in the slightest. We'll still source in the same manner, conduct our diligence and write our IC memos in the same manner, and, arguably most importantly, continue to invest meaningful personal capital in the same manner. The biggest difference is obviously the fact that we are now fiduciaries on behalf of institutions, which we consider an honor. We'll have heightened reporting requirements for our LPs, but our approach to the market will be precisely the same.

As Justin Ishbia, Founder of Shore Capital, explained on the 'Invest Like the Best' podcast, *"I tell our LPs and team members, I will only add a new product if two things are true: 1) we have an unfair advantage with the odds of success tilted in our favor; and 2) the new vertical helps the base business."* **We're confident that the synergies from Pacenote Equity will not only be organic, but powerful for our sourcing engine in ultimately bringing the highest-quality GPs to market for their Fund I raises.**

As we've told our investors, we have no aspirations to be asset managers. We're often asked, *"what's your vision for Pacenote? When are you going to start scaling?"* The answer we've given to-date remains the same, we never intend to scale into more volume of partners or different strategies (or now, with Pacenote Equity, raise large funds). Rather, we simply hope to invest more personal capital each year with sponsors we're excited about and add value for them as true partners (both through our advice and our relationships). Our goal for Pacenote Equity is no different, as evidenced by our large (for us) GP commitment.

In closing, our one request is for anyone who would like to learn more, ask any specific questions or even challenge us on elements we may not have properly accounted for, please reach out to us. We're always trying to get better, and wholeheartedly will appreciate the conversations. We hadn't intended to publicly announce or broadly discuss Pacenote Equity, but on the heels of our Form D filing and the subsequent inbound inquiries (as well as a few articles published without our blessing/wrought with misinformation), we wanted to share the details. So, with any competitive advantages of staying under the radar now fully jettisoned, we're extremely proud to introduce Pacenote Equity. **Pacenote Equity I is a fund with a target/hard cap of $75 million that plans to make 8-10 investments with best-in-class independent sponsors in control-oriented (opportunistically will consider growth equity with 'effective control'), sub-$150 million TEV businesses headquartered in North America (and opportunistically in Europe).**

Themes of Interest

We're constantly on the hunt for exceptionally motivated teams with differentiated strategies and/or approaches. The following are themes we've identified as areas with sustainable market tailwinds and attractive white space for new entrants, particularly in the lower middle market. While we have other areas we are exploring as potential theses, we are most bullish on the below. To the extent you know any groups who fit these themes, we would be grateful for an introduction and excited to speak with them.

As a refresh, we're exclusively focused on 1) equity-oriented strategies (EN: we continue to acknowledge the merits of the private credit asset class given the tightening availability of debt capital and rising cost to finance as such, but don't purport to be experts in the space), 2) in the lower middle market, 3) with sector and/or strategy experts focused on a clearly defined, repeatable competitive moat, and 4) aspirations to build world class firms predicated on sustained outperformance. Said differently, we want partners who want their firms to ultimately be defined by exceptional returns (e.g., we've found that the soundbite *"I want our returns in Fund I and II to be so strong that I can be the largest LP in Fund III"* to be an excellent proxy).

Industrials and Niche Manufacturing

Post-COVID focus on reshoring of manufacturing for many U.S. companies, coupled with new laws aimed at stimulating this resurgence (the Infrastructure Investment and Jobs Act, the CHIPS and Science Act and most recently the Inflation Reduction Act) have fueled an emphasis on the sector not seen in decades. As McKinsey's "Delivering the U.S. Manufacturing Renaissance" report noted, an effective transformation of the U.S. manufacturing sector could boost GDP by $275-$460 billion, while adding 1.5 million jobs by 2030.

We expect 2024 to continue capitalizing on momentum generated from these initiatives along with increased private investment. Geopolitical tensions and a heightened national security focus will further drive companies to move (and improve) their manufacturing operations to the States. While we continue to be excited about the industrial technology ('Industry 4.0') phenomenon we've written about the past two years (old economy businesses benefitting from technological upgrades - manufacturing automation, precision machining, predictive maintenance, digital transformation, etc.), we've broadened our focus to industrials and niche manufacturing at large, with an emphasis not only on a sponsor with technical engineering chops and technological savvy, but also the proven ability to effectively connect with, retain and motivate skilled workforces. As an L2L manufacturing trends piece summarized, *"manufacturers that focus on digital maturity and take proactive steps to retain skilled labor will be better positioned for innovation and sustained growth."*

Aerospace and Defense

After industrials, A&D is where we'll be writing our second white paper of '24. We fully anticipate the demand for A&D products and services to continue to grow in the years to come. On the aerospace side, consumers continue to prioritize experiences over goods, and air travel has proven its resiliency post-COVID stagnation. Globalization will also continue to require air capabilities for international shipping and logistics. Airbus' '23 Global Market Forecast predicts that we'll need 40,850 new passenger and freighter aircrafts over the next 20 years. Beyond aircrafts, certain aerospace subsectors such as drones and space exploration continue to pique our interest as well. Drone Industry Insights' '23 report forecasts that the global drone market will reach $55 billion by 2030, and as the U.S. Chamber of Commerce's "Exploring Economic Opportunity in Space" highlighted, *"to realize a $1 trillion space economy by 2040, we must continue to unleash private enterprise."*

In the defense segment, as the war in Ukraine continued, 2023 also marked an Israel-Hamas war in Gaza, China's continued menacing of Taiwan, and most recently, U.S. strikes on Houthi targets in Yemen in response to their harassment of shipping routes in the Red Sea. Civil wars in Myanmar and Sudan, along with recent violent conflicts in Ecuador and Congo (among other continued clashes elsewhere), further intensified what feels like an inevitable global boiling point. What's more, in the background looms the potential of a third world war between major powers, as each conflict feels more and more interconnected (during the November 2023 Halifax International Security Forum, the acronym CRINK - China, Russia, Iran and North Korea - was the title of the keynote discussion). Further intensifying the increasing quantity of conflicts is the fact that technological advancements of weaponry have made the threat of global war feel both omnipresent, while also unequivocally catastrophic for all involved if it were to be sparked. In the U.S., heightened national security concerns also demand continued technological advancement and economic commitment to buttressing our capabilities.

Supply Chain, Logistics and Route-based Businesses

While the culture of instant gratification and next day delivery did not commence with COVID, the pandemic further intensified this trend while also shining a light on global supply chain pressures. Standards for continued efficiency and logistical perfection are constantly increasing, and, importantly, underpin successful execution in almost every industry. The global supply chain is the backbone (or even circulatory system) of all commerce. While the opportunity for technological innovation, consolidation and collaboration is apparent, we also like the fact that the industry (at least in comparison to others like healthcare, software, consumer, etc.) is relatively nascent when it comes to number of sector-specialist private investors, particularly in the lower middle market.

As globalization and an ever-connected world persist (along with the expectation that everything should be readily accessible), geopolitical events such as those mentioned in the A&D section and ongoing trade tensions make this reality increasingly more difficult to deliver on. Ubiquitous discussions around reshoring all inherently require tailored distribution solutions, with the answer for one industry or specialty wholly distinct from the key considerations of another (e.g., movement of specialty chemicals through the global supply chain necessitate specialization that can't simply be poured over for infrastructure building materials). To us, this signifies a massive TAM.

We feel strongly that this is a specialty that cannot live within a multi-strategy sponsor, but rather needs to be executed by industry experts who understand the complexities of all market participants, and have the experience to look around corners (not dissimilar to our thoughts regarding why, given the technology obsolescence risk, cybersecurity is too specialized to live as part of a broader software investment mandate). Certain subsectors that have piqued our interest are last-mile delivery, specialty freight, predictive supply chain technology and e-commerce fulfillment.

"Electrification Services"

We've written about this theme in our prior two Year in Reviews, and over the course of '23 it has continued to be the most actively inquired about by LPs who share our excitement. We adamantly believe that energy transition and critical infrastructure will be prevailing megatrends in the decade to come. 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 infrastructure hard assets, we are looking for groups 'servicing into' this tailwind who will be needed regardless of who owns the megawattage, who wins the next spectrum auction, the debate between types of alternative energy (wind, solar, hydrogen, biofuel), etc. Datacenter servicing companies lay/maintain fiber optic wiring, testing and maintenance companies ensure safety at high-voltage electrical plants, specialty engineering and design firms assist in the construction of utility-scale energy projects, 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.

Sports, Media and Entertainment Services

As mentioned above, post-COVID consumer trends have placed much higher emphasis on memories over material objects. A Business piece entitled, "Experience Over Goods: the Millennial Shift in Spending" outlines the movement in today's consumer preferences towards the things we've seen and done and places we've been, and away from our possessions. Consumption of content, whether live or digitally streamed, has become king, and sports, media and entertainment ("SME") all play meaningful roles in this ever-growing landscape.

We've witnessed a very public proliferation of private equity ownership in sports over a relatively short timeline (from 2019-2021, every major U.S. sports league, except the NFL, amended their rules to allow for private equity minority ownership of teams). The [Sports Business Journal](#) reported in September that the NFL formed a subcommittee to evaluate potentially changing their ownership policies, a signal most constituents believe is an inevitable first step towards near-term approval allowing for PE investment in their teams as well.

Much like we don't want to be investors in the actual power supplies or hard asset infrastructure, we don't have interest in owning minority shares in large sports franchises (as one investor we think highly of described, "*that's effectively beta exposure, with little means of driving value other than relying upon the sports sector's continued growth*"). Rather, we're excited to find a partner investing in companies servicing into these tailwinds. Engineering companies designing and maintaining high-tech stadiums, businesses innovating around the fan/'talent' experience, crucial services needed by all teams that will prevail regardless of who wins a championship. In the media space, one sponsor we've spent time with is consolidating post-production special effects studios which we found to be innovative.

Agriculture/Horticulture and Food/Water Sustainability

If this theme feels like a working title, it's because it is. While we've excitedly searched for a partner in the agriculture space, what we've found is that on one end of the spectrum, large scale crop production frequently fits better in yield-oriented investment strategies. On the other extreme, the most impressive agtech investors we've spent time with operate as early-stage venture investors (both with respect to their company ownership stakes and approach to highly diversified portfolio construction), whereas our core competency and preference is with control-oriented investors who are comfortable owning concentrated portfolios.

That said, we continue to be interested in the space. According to the [World Resource Institute](#), one-third of all food produced globally is lost or wasted between farm and fork, more than 1 billion tons, costing the global economy more than $1 trillion every year. Yet globally one in 10 people remain malnourished, and food loss/waste drives 8-10% of total global greenhouse gas emissions. To us, those metrics certainly equate to an opportunity.

Most recently we've refined our search to focus on horticulture. Horticulture is typically carried out in closed environments on small scales and deals with the development of advanced techniques that can be used to improve quality of end products and increase production efficiency. In our opinion, smaller scales with a focus on technological enhancements, coupled with the need for specific skill sets and training, make this subsector ripe (pun intended) for repeatable value-creation. While there isn't a long list of comparables who have traded recently (Berkshire-owned Fast Growing Trees is one example), and certain technological innovations have yet to prove that their costs can consistently compete with traditional methods, we do believe there is white space for increased efficiency across the entire value chain, and synergies of scale to be had that make the industry investable for private equity.

Residential Services

While our bar for acquisitive roll-up strategies has gotten meaningfully higher with rising interest rates, one services niche continues to pique our interest. In addition to its high degree of fragmentation, the essential residential services market is unique in that homeowners can't afford to defer these projects (leaking roofs, basement flooding, foundation repair, etc. are all mission critical). Anecdotally, despite the commercial real estate slowdown, in our respective cities we continue to observe high numbers of home renovation projects. We've also seen interesting data from sponsors regarding the sheer number of existing homes with roofs and/or foundations reaching 'end of life' (against tightening lending criteria, often requiring these remedied prior to mortgage approval). Furthermore, the increasing frequency of catastrophic climate events only intensifies the demand for these non-discretionary services.

Given the lack of any clearcut market leaders, we believe there is significant white space for numerous scaled platforms to succeed (and for the most sophisticated operators/investors to outperform the sector's growth). We've seen numerous interesting roofing consolidation opportunities over the course of 'H2, as well as other non-deferrable services such as gutter repair, but the sub-specialties we're most intrigued by are foundation repair and flood/mold remediation. As always (in our opinion), the strategy is best executed at the micro-cap level where sponsors can sell to sponsors upmarket who can't afford to spend time on small initial equity investments but are willing to pay premium valuations for a larger, more mature enterprise.

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