McGuireWoods

FUND FLOW

EMERGING MANAGER PODCAST

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Today’s Fundraising Environment with Casey Peters of Pacenote Capital

Episode Summary

On this episode of Fund Flow, host Jon Finger is joined by Casey Peters, a managing partner at boutique placement agency Pacenote Capital. They discuss the mandates that formed Pacenote and how maintaining a high touch and selective lens has shaped the company.

Casey founded Pacenote Capital in response to market feedback that there was a desire for value-added through high-performing, young, and hungry sponsors. This was the kicking-off point for his firm.

For Casey and his partners, adding value to relationships went beyond bringing on LPs. He explains how they work to be active with independent sponsors on pre-fund deals. This includes providing coaching on how to view deal attribution and relationship building, along with the functional benefits of applying their expertise to catch errors before the launch of a fund.

“We're boutique — we try to be super hands-on. We have WhatsApp chats with all of our GPs, even our GPs that aren't in market right now. Every day we're talking to each of our GPs. And definitely if we're in market with them, it's all day, eight until eight, just messages firing back and forth. We try to look, feel, and act like we are truly an extension of our GPs, rather than them just being another name on our list,” Casey says.

Throughout this episode, Casey provides insights that emerging managers can use to formulate and improve upon their strategy and pitch. He uses his unique approach with Pacenote to provide tangible examples of why relationships are king and how emerging managers can differentiate themselves in an increasingly competitive marketplace.

Top takeaways from this episode

★ **Video communication is here to stay.** According to Casey, the pandemic has created some lasting changes in the processes for raising a fund, predominantly around video communication. He believes it’s important to have strong Zoom etiquette because the efficiency of video meetings introductions aren’t going away anytime soon.

★ **Fund structures are getting more creative.** In today’s environment, it’s not a one-size fits all deal structure. Some funds have moved away from traditional annual management fees to annual budgets. Other trends include longer-dated funds and the proliferation of GP-led secondaries and continuation funds.

★ **Differentiate yourself as an emerging manager.** It's no surprise that returns are the ultimate indicator of success. If you don't yet have outperformance on the backend, Casey believes that strong communication with LPs is one of the easiest ways to stand out in the market.

Transcript

Voiceover (00:03):

You're listening to Fund Flow, a podcast for emerging managers, offering insights into the journey of new and aspiring fund managers seeking to have access in a crowded market. Tune in as McGuireWoods' partner and host, Jon Finger is joined by guests ranging from first time fund managers to proven emerging managers, experienced LPs poised to back emerging managers, and other key participants in the emerging manager ecosystem. Hear their real world perspectives and gain actionable tips to help inform your strategy and position yourself for a successful fund closing.

Jon Finger (00:38):

Welcome to Fund Flow, a McGuireWoods podcast for emerging managers. I'm Jon Finger, and today I'm very excited to be joined by Casey Peters, managing partner of Pacenote Capital, a boutique placement agent focused on the emerging manager segment of private equity. Casey, thanks so much for taking the time today.

Casey Peters (00:58):

Thanks for having me, Jon. I've been looking forward to this. It's great to hear your voice.

Jon Finger (01:02):

Likewise. Well, tell me a little bit about your history working with emerging managers, other private investment funds, and ultimately how that led you to launch Pacenote Capital.

Casey Peters (01:17):

Definitely Pacenote is my myself and Sam Cannon and Matt Evans. I'll take it a step back. I started my career working for the Bass family, and so I was working for the Basses on their funded hedge funds, and post-GFC had seen this migration of a lot of their third party LPs to more liquid asset classes, and I kept hearing this buzz about private equity. I wanted to move back to the east coast from Fort Worth, and my game plan was to get a banking gig for two or three years, and then try and get an analyst level role at a private equity GP. I give you the context because I had no idea that placement agents existed until I met the now CEO of my now former firm Mercury Capital, which is the old Merrill Lynch private funds group team.

Casey Peters (02:08):

He was like, "This is what a placement agent does. Come work here. It's a more nuanced back doorway for you to get into the industry and cut your teeth, importantly, I'll let you start covering LPs early, in fact, much earlier than most sales folks." So I did that and I jumped in and I would say that I met Sam in 2013. He was running private market sourcing at Global Endowment Management, which is an outsource CIO down in Charlotte. We met in 2013 and a little bit of serendipity he had just started ramping up efforts for GEM focused on lower middle market. Emerging managers, be that independent sponsors or co-mingled Fund Ones. Over the course of the next couple of years while Sam and I talked about this, I kept hearing the same feedback from what I would consider thought leading blue chip limited partners, so university endowments, mission-driven foundations, family offices, et cetera.

Casey Peters (03:16):

The resounding feedback when I would pose the question like, "Forget about what mercury has on our platform right now, what would be value add to from a sourcing perspective? The answer typically was, "Look, we have almost fully mature, if not totally mature, private equity portfolio, and the only thing that we're looking to add on the margin here are high-performing, often young and hungrier sponsors where we can get into this a little later where we think the alignment is really strong." So we saw an opportunity in the market because there's a few agents out there that we think really highly of who have worked on some great Fund Ones, but we realized that there wasn't an agent explicitly focused on it, and so that was the birth of Pacenote. So I had worked with Matt, I connected with Sam over the course of 18 and we started building the infrastructure in 2019 around it launched in the fall of.

Casey Peters (04:17):

So what I would say is Cannon didn't have much experience at Mercury working with emerging managers, because at the time the handful of sub 250 million Fund Ones that I sourced opportunistically through my network that I brought to the investment committee, they were shot down with the feedback being, "Look, we have 70 people globally. We can't afford to work on a $125 million Southeastern "U.S. Services-focused group. The floor for potential revenue needs to be higher. So that structural misalignment was my "aha" moment and just there's a need for this in the market. Since we've launched, we've worked with Five-Fund partners. Now, four independent sponsors on pretty fun deals. So feel like we're pretty deeply entrenched in it now, but prior to launching Pacenote, there wasn't a ton of experience actually working with these groups. It was more just hearing from the market that there was a desire for it.

Jon Finger (05:18):

That's great perspective. One of the things that we get asked a lot, and I'm curious as to the candid feedback that you give to your network, what do you tell an emerging manager when they say, "Should I hire a placement agent?"

Casey Peters (05:38):

My partner Sam's party line is, "If you don't need one, you definitely shouldn't hire one," but the reality is we try to approach the way we work with our partners, much different than, I think, most other agents. Different GPs I had worked with prior to Pacenote, it felt very finite. You'd kick off, and then when the fun closes, that's the extent of the relationship and maybe work on the next vintage. There was nothing on the interim. When we launched Pacenote, the idea was find partners that we want to back, and importantly, we won't work on any funds or direct deals with independent sponsors unless the four of us are writing personal checks into the opportunity, and it's not fee waiver deferrals. It's actually us writing stroking checks on day one.

Casey Peters (06:35):

So we think that that alignment is a good ballast in terms of keeping us honest and not working on too much and just only our highest conviction ideas. When we're getting into it with a sponsor that we think we're excited about and doing our diligence, we try to help them see that our approach is different, and obviously, the quality of our relationships with the LP universe is one important factor, but there are definitely groups who come from really pedigree GPs, and this is more the exception than the rule, but they have formal attribution, track record's exceptional.

Casey Peters (07:14):

We've seen plenty of groups over the last four years who have gone out and raised a successful Fund 1 without an agent. But I would think that the feedback we would give is, if you talk to most of our sophisticated LP relationships, they would say that there's real value in an agent, even if you're going to be oversubscribed, just anecdotally, there's one Fund One that we know that was oversubscribed that didn't have an agent, and they ended up rubbing a few LPs the wrong way, just how they managed the end of the process and just communication and capacity and all that. So I think there's real value in what placement agents bring, but can definitely understand why over time, there's a little bit of a negative stigma with working with one.

Jon Finger (08:01):

Understood. You touched on it a little bit and something that I think really sets you and the team apart from, from other agents is maybe talk to the audience about your value proposition to emerging managers and really beyond the differentiation of Pacenote, how do you add value to your relationships beyond just bringing LPs on? I don't mean it like that's not hard work, but in addition to bringing on the limited partners?

Casey Peters (08:32):

Totally. It's a great question. Despite the fact that while I was at my prior firm, we didn't really engage on many lower middle market Fund Ones, even though I had brought a bunch to investment committee. Importantly, my partner, Sam, who I've mentioned, spent a ton of time engaging and working with independent sponsors and Fund Ones while he was at Global Endowment Management, and he really started that effort for them in 2013. Over the course of the last seven-and-a-half years, he was there and they worked with a couple of dozen independent sponsors, and they really became a thought leader in working with these groups, proactively spinning teams out of GPs and anchoring their Fund One, they were the sole LP in certain Fund Ones and were really active with independent sponsors on pre-fund deals. Sam was really the engine that drove that.

Casey Peters (09:27):

So our experience collectively as a team from those different sponsors that Sam had worked with we find to be really helpful with different groups that we're speaking with. So party line is that we want to be early, like oftentimes you offers up an introduction, but they say it's a year or two years away, you say, "That's perfect," because we have, and Sam had built this at GEM. It's his, So You Want to Launch Your Own Firm, that's what it's actually titled, playbook. We have a list of all different third-party service providers, how we would force rank them based on our experiences, how you should think about deal attribution and your relationships with operating partners and CEOs of portfolio companies. So there's a lot of guidance that can be helpful well in advance of a GP actually pulling the rip cord and leaving their current shop to stand something up on their own.

Casey Peters (10:28):

Then I would say we spended a unique amount of time prior to "launching" into the market with our GPs, and particularly in this Zoom world that we're living in now where we don't think the days of 150 in-person meetings over the course of three months is going to be the first wave of fundraising. It's a lot of first conversations over Zoom and we can touch on this more, but it's more competitive by far than we've ever seen for LP dollars currently, and it's that way for the last 18 months, two years. So the way we describe it to our partners is, "You need to engender emotional conviction from this LP," over a virtual interaction in a 60-minute window when they have a ton of stuff going on throughout the rest of their day, and so that's not easy to do.

Casey Peters (11:27):

So we do a good amount of coaching just on presentation style, delivery of what makes the strategy uniquely compelling, et cetera. Then functionally, there's a lot that I would say my partner, Sam, adds a ton of value, and given that he comes from the LP side and that ranges from say which GP, but we caught a mistake in a cashflow file that one of our GP's fund admin had built out. We were able to catch that before we launched and update the cash flow files, et cetera. Then on the back end, we've had Sam's expertise prove to be really valuable when we're sifting through different LPs that are interested in an independent sponsor deal.

Casey Peters (12:17):

As you know probably better than anyone, the range of economics can vary pretty dramatically, so having Sam's experience and we are able to guide our partner in this instance and say, "Hey, this is where we think you can push this LP to in terms of what you want for carry and monitoring fees, et cetera," and ended up being a great outcome. We're a boutique, and we try to be super hands-on. We have WhatsApp chats with all of our GPs, even our GPs that aren't in market right now. Pretty much every day we're talking to each of our GPs, and definitely if we're in market with them, it's all day, 8:00 until 8:00 just messages firing back and forth. So we try to look and feel and act like we're truly an extension of our GPs rather than them just being another name on our list of 10 or 15 or 20 things that we're working on at any point in time.

Jon Finger (13:20):

That's great. Clearly, one of the things that really sets you apart is that high touch. You talked about it's not a large team at Pacenote. You're very selective around your mandates. What do you look for in an emerging manager candidate to decide that it's one Pacenote wants to work with?

Casey Peters (13:45):

Yeah. You and I have talked about this before. That's the million dollar question. We've been fortunate that since we've launched we've had a bunch of really successful outcomes. It feels like the market receptivity to what we're doing has been really strong. We've met a ton of new LPs that are interested in the types of opportunities, so we're lucky from that standpoint, but time will tell, if in five years the fund performance of our groups isn't there and then it's tough too, for us to feel good about preaching our message and our thesis to the market. So we spend a ton of time underwriting groups, and so that we try to keep the top of the funnel really broad. We're pretty rigorous in how we log all the GPs we're meeting with. Sam's an animal in DealCloud.

Casey Peters (14:39):

We're probably speaking with 10 to 15 or 20 new sponsors per week, and there's a really wide spectrum of quality of sponsors as you know, and that could be experience, age, perception as to, there's some groups that have just heard about this independent sponsor phenomenon and think it's easy to go undersource of deal, underwrite it at the same time it's raising equity. It's not for the faint of heart, but our top criteria and on our scorecard that we use as the four of us are voting at investment committee is, is the GP a killer. Maybe that can come off crass, I guess, and "killers" can come in all different shapes and sizes.

Casey Peters (15:29):

Effectively, we want someone who is 100% invested in the success of their new firm, and especially important the performance of their early deals and early funds and they're willing to work as hard as they can to get there. So that's when we meet with groups, it's usually a gut feel thing where we'll get off a call and Sam and I will debrief, and it'll just be like, "Yeah, there's something there," and a lot of times you just know that there's not, given how high our bar is. So there's a lot more nuance to it and specific criteria, but for what it's worth our top criteria is, "Do we get off of a call and say we need to drop everything and try and work with this group, we want to be partners for 10, 15 years?"

Jon Finger (16:21):

Excellent. In thinking about the current environment, maybe talk a little bit about how do LPSs currently view spin out from established blue chip private equity funds and how are they viewing independent sponsors making the move to raising a committed first time fund?

Casey Peters (16:45):

Yeah. So I'll take the first part of that question and maybe give a little bit of just macro LP landscape color. We wrote about it in our year-end review last year, but there's been a few contributing factors to the proverbial denominator effect, where as a result in Q1 of this year, we had a lot of LPs saying to us, "Hey, we've spoken for everything in our 2022 budget already. We're looking out to 2023," and that's a combination of existing managers are coming back to market more quickly than expected, or then typically in the past the cycle was three to five years. Now, you're seeing groups coming back and raising their subsequent vintage in 12, 18 months. Growth of fund size, it's our party line is we want to work with groups who want to make their money in the carry as opposed to ballooning AUM and clipping 2% on it.

Casey Peters (17:50):

If you can do, it's a really lucrative model, but we just happen to think that more judicious fund size will give us a higher likelihood of hitting our net three times bogey, but growth of fund size, and then the proliferation of the venture capital universe. If you're fortunate to be in some of the blue chip SandTell GPs, they have seven or eight different offerings, and if you want to be in one, you have to be in all. I won't name the GP, but there's LPs that have half of their annual commitment. If this group comes back and all of their different vehicle are raising the next vintage. What that's resulted in is a lot of capital out the door, the last 24 months, and folks that frankly are a bit exhausted on the LP side with just the volume of groups coming back to market and new GPs. So with that backdrop, it's gotten really competitive to raise LP capital for new vehicles.

Casey Peters (18:56):

We happen to think that where we play with newer groups, Fund One, and we have a sub criteria in that killer category that says, "Is the success and performance of Fund One critical to the success of the GPs ultimate career?" Basically, you want groups where they literally have to get it right on Fund One with their performance, if they don't want to go back and work at another GP. So we think that, and this is what we're hearing, one of the benefits, as a sidebar of working on one, maybe two things at a time is that we can spend most of our time away from sourcing, just having general catch-ups with our LPs and sharing notes. That's just a different tenor of a relationship than needing to press 10, 15 thing GPs at any one time. So we're hearing this from LPs, but we do think that there will be, over the next couple years, almost definitionally, there has to be a reset for these LPs.

Casey Peters (20:05):

If they have, call it 16 GPs and their private equity roster, they're used to four coming back a year and now eight to 12 are coming back every year, it's just not sustainable. So one thing that we've tried to key in on is we ask LPs, "How are you thinking about your existing GP re-up decisions and your re-up underwriting?" Because the party line used to be we're backing Fund One so that we have capacity and Fund Two. We can't afford to miss the boat on all the A+ Fund Ones because they'll be oversubscribed Fund Two. So LPs like to show that they're loyal, that they're long term, and so rarely would you see groups barring a GP divorce or something catastrophic, you'll usually see LPs defaulting to re-upping into Fund Two with their new relationships. We're seeing that the bar for re-ups is much higher.

Casey Peters (21:06):

As a result, we know some endowment LPs who it was typically 70 to 80% re-up and now it's sub 50%. We think that looking ahead, the demand for investing with newer groups where fund size is judicious and alignment's really good, we'll be there. There's a long list of super high quality GPs that are in the middle market or large cap or mega cap that we think highly of, and they frankly won't have any issues raising capital TA won't have any issues raising whatever they want to raise, even coming back 18 months after the last vehicle. But we think that there's a glut in the, call it 500 to a million to 2 billion fund size of groups who performance hasn't been that strong. I think that there will be a lot of attrition for LPs, at least specifically in the ENF and family office world with those groups. So I guess the punchline is more competitive than it's ever been, but I don't think that the demand for backing new groups is something that's going to change over the next couple of years.

Jon Finger (22:27):

Yeah. That's great. Great perspective, Casey, really appreciate that. One of the things you identified, actually, I think it was in your annual report, which is just a fabulous narrative on what's going on in the environment, but, sure. Thank you. So you identified and you've touched on a couple of times the idea of incentive alignment for LPs when it comes to committing to an early vintage fund, what are some of these incentives that GPs should really have front of mind when developing their strategy or their pitch in order to present it as most attractive to the LP community?

Casey Peters ([23:11]):

Yeah. It's a long list and it's an important question. I would say number one, and a lot of subsequent points are covered by this is, what's the economic alignment? How much of your personal capital are you willing to bet on yourself? Because at the end of the day, that's a big part as to why these really sharp LPs want to back newer groups because they know it's make or break and that they're going to be working 24/7 to make sure that their Fund One portfolio companies are exceptional outcomes. Whereas, if you in AUM and performance can be average or above average, then there's human nature to take your foot off the gas a little bit. So it's economic alignment, but there's no hard-and-fast rules, like 2% GP commitment was, and I guess still is the off- the-shelf what LPs expect to see in a deal or fund. We tell sponsors that that's our floor and we'd love to see it closer to 5% if possible.

Casey Peters ([24:28]):

We worked with one GP in particular who knows 10% of their own fund, and LPs love that. You're saying that your personal capital, the best use of it, in your opinion, is investing with yourself. The flip side to that is a lot of newer groups haven't had meaningful carry events yet, and so the good thing is these LPs are fully aware of that. Our second GP care equity, Pete was young when we launched Fund One, he was in his early 30s and walked away from a lot of carry and two deals at his prior shop where he generated an incredible amount of value. So there wasn't a ton of liquidity to personally invest, but the question we ask is, "What percentage of your liquid net worth are you willing," and this is on the fund front, "to invest is your GP commitment and Fund One?" If someone's willing to take out a second mortgage on their house to bet on themselves, that's usually a good sign. There's some nuance to it, but I think that the alignment is paramount, and that goes for GP partnership too.

Casey Peters ([25:45]):

I think that while the buzz about emerging managers and Fund One and the lower middle market, pretty much everyone's hip to it now. It's not a novel idea, but the reality is there are a lot of not great outcomes that you don't see in the rags. You see all the successes about fundraising and great deal outcomes, but you probably could do a whole podcast series on horror stories of partnerships dissolving, et cetera, and so alignment is really important among the GP team as well. We have a couple of different rules. I won't share some of them, but things that we look for and tells to us as to, "All right, this is true cohesion. They're in this forever. They really care about each other," as opposed to, "Hey, this team got cobbled together to try and go out and raise a fund." So I think the economic alignment is sort of what takes the cake at the end of the day in the LP's eyes.

Jon Finger ([26:51]):

That's great. Thank you. You touched on this earlier and I think it's a very relevant conversation, how did you see the process and framework for raising a fund change during the pandemic? How do you think, what lasting changes do you see, hopefully knock on wood, continuing to come out of the pandemic in the future-

Casey Peters ([27:15]):

Yeah.

Jon Finger ([27:16]):

... for what that process is going to look like?

Casey Peters ([27:18]):

Yeah. The obvious one is just the growth of video communication. While I'm the first to admit that pre-COVID, I would say, to people there's no replicating in person time, especially when you're trying to get an LP to move and spend the time to commit to a new relationship. Now it's, like I mentioned before, we are telling sponsors, "You should really sharpen your Zoom etiquette and not be looking at things on your second screen and really engaging," because what you lose is that skin-to-skin interaction that you used to get in LP's offices for the first meeting. But obviously, the counterbalance to that is you can be super efficient. We've had month kickoffs for our GPs where we're doing 40 to 50 meetings in a month, and that just wasn't possible if you were flying to different cities across the country to see people.

Casey Peters (28:21):

So I think that the biggest thing is just the use of Zoom. It's funny where we've heard it may be one of our half topics for the 2022 letter, but folks have gotten Zoomed out a little bit, the monotony of the Zoom train all day, and so we've been mixing in just good old-fashioned audio calls with just LP catch-ups. It's a little different when we were first meeting a GP and people find that refreshing. So I think that go forward, I mentioned this before, the first interactions GP/LP will be over Zoom most of the time. I don't view that changing. It's just a much more efficient way for the LPs to filter their top of the funnel. The key is making sure that what I said before, you're engendering that emotional conviction where they want to spend more time.

Jon Finger (29:18):

Makes sense. What are some trends that you and the team have seen in fund structures in the recent past, and are there different trends that you've seen with a true first time fund versus vintage two, three and beyond?

Casey Peters (29:39):

Yeah. So our first partner rally day, I viewed a thing for making the introduction way back when. They wanted to do something structurally innovative on their Fund One. They agreed with us that they wanted to signal to the LP community, "Hey, we're not leaving the lower middle market. We're staying at our fund size." So in lieu of a typical 2% annual management fee, the way we helped them whiteboard this structured it is, it's an annual budget that's ratified by the L pack. They have full transparency into where the dollars are going and the managing partners there have kept their salaries, and it's good structural alignment. What they got in return was two supercharged carry tiers over different ratchets, and so we've seen different within 10-year fund life structures, folks think about pulling different levers. Then frankly, we've had some sponsors say, "Hey, I don't want to do anything too cute on the fund structure. I want the investment merits to stand for themselves and I want my first fund just to be plain vanilla, two and 20."

Casey Peters (30:58):

So we've seen a few different things in the 10-year life. What I would think is most interesting, and we definitely have heard it a lot, experienced it a lot with sponsors that we've spent time with and probably will write about it at the end of the year, but these longer dated fund structures. So evergreen vehicles 20-year fund life holding companies, and it's interesting, we've had just in the past six to eight weeks, two different sponsors who fall into the very young and very hungry category who came to us and they spent a ton of time studying the tax efficiencies of a holding company structure versus a fund structure. There's a few groups who have done it really well out there. Our feedback generally, at least for now is, if you want to go out and raise a fund, it's already an unbelievably high bar to get new LPs there, to then call it a 20-year fund life or have some nuance around the structure. It's just another hoop that they have to jump through.

Casey Peters (32:07):

So that's on the fund front, but I guess I maybe should have said this earlier. We tell folks all the time, dancer isn't always go raise a fund. There's plenty of independent sponsors. I know you guys are close with them at McGuireWoods that have been serial independent sponsors and have developed a stable of really reliable equity partners that are there, and they can go out and hunt for yields as if they have committed capital. So that's a really eloquent outcome if you can get it, and obviously, then your carries not crossed across deals. So there's a little bit more flexibility if are just focused on, "Hey, I want to do a great deal every year or 18 months, two years" We approach that a little differently like, "All right. This is the LP universe who are looking for those types of partnerships," but I'd say the main trend this year is longer dated funds. We've seen this proliferation of GP-led secondaries and continuation funds, and it's definitely something that people are talking about quite a bit.

Jon Finger (33:20):

Yeah, no doubt about that. I echo those sentiments, and I think you touched it on a little bit, but one of the things that I've noticed more activity within recently, it's just this creativity and flexibility in the sense that we've certainly seen plenty of independent sponsors become emerging managers, but we've also seen fund managers decide, "You know what? We want to operate more like independent sponsors," and also the transitory nature. We've seen groups go back to a fund structure. So I just think it's in today's environment, and recently it's not a one size fits all for 20 years. Definitely.

Casey Peters (34:03):

Yep.

Jon Finger (34:03):

There's definitely some fluidity there that I think is great for the market. It's great for among other things, it addresses the short term challenges with re-ups potentially-

Casey Peters (34:14):

Totally.

Jon Finger (34:14):

... to maybe say, "Okay, I'm going to go off the board for a little bit," but you touched a little bit earlier on some of the dynamics with fundraising currently, but maybe talk a little bit we're now in environment where you and I knew for the past, however many years interest rates were basically zero. So we have rising interest rates. We have rampant inflation. We have potential if we're not already there, we're in a recession, I guess, as it relates to the more macro environment, what do you see in store for the rest of the year and '23 for emerging managers looking to raise funds?

Casey Peters (34:57):

I think that all of the factors you touched on will have different types of effects on LPs and their broader portfolios. We spend all of our time on the illiquid private equity. We'll do a little bit of venture, but these LPs usually have public markets portfolios. That's another version of the denominator effect when public markets, especially tech stocks with groups that are over-allocated to VC can have meaningful effects on how LPs are approaching how much capital they're going to out a 12-month window. We that that overall, the current macro and markets environment is going to bounce along for the next few months as people navigate rate changes and what that means for inflation and maybe too candid, but to us internally, public markets just don't even feel real, just the amount of volatility and sentiment that drives these whip lashes from day to day.

Casey Peters (36:04):

I think a lot of LPs are great at this. They try to be more long term in what they're looking for and understanding that a commitment to a new fund is a long-dated investment. But I think that we've been telling independent sponsors, it usually happens at the back end of a fundraiser, a deal raise where they'll go tap on their network, former bosses, colleagues, friends, and scrap together 10 to 15, 20 personal investors, and that usually happens at the end. One piece of advice we've been giving sponsors is, "Go do that now." Early in and we know that you're already working extremely hard, hunting for deals or underwriting a live deal, and also raising equity. Like I said, it's not for the faint of heart, but we think that if you can say, "Hey, I have, call it 20 million circled from two of my former bosses, and same with my co-founder," and that's just a signal.

Casey Peters (37:12):

One question that we always ask on every single reference call is, "Well, are you going to invest?" Not, "Would you invest?" Or, how strong you think they are, but will you be investing with this person or with this group? To us, that's the ultimate sign of someone's conviction, and whether they think something is top-notch. To bring it full circle, we think that market uncertainty will be here for the duration of this calendar year, and we're wrapping up two funds at the end of June. We're in market with two different independent sponsors, so we have a lot going on. We'll have one of our GPs back to market in the fall. We're not in a rush unless we get super, super long a group. There's few that are excited, but launching a new fund in the back half of this year, is going to be a tall task, I think.

Jon Finger (38:15):

For sure. Maybe drilling back down on more of the micro level and some of those dynamics, in your experience, can you share what you have seen with certain emerging managers who have really done the best job differentiating themselves in today's market?

Casey Peters (38:37):

Yeah. I think that obviously the ultimate returns are super important, but that's years away from what you can do when you're meet first meeting groups or commencing a new relationship. So our advice to our GPs is over-communicate. LPs don't want to have to call you when they've heard that something bad is going on. That dialogue should be ongoing. Frankly, we've spoken with some sponsors and we ask the type of LPs that they want, and the answer is, "Well, I don't really care. I just want to raise the capital. I don't care who it comes from." We don't love that answer, I guess is what I would say, because we want groups who are really motivated by, "All right, who am I investing on behalf of? Is there a mission there?" That's inherently why endowments, foundations, family, offices are great fits for these types of groups.

Casey Peters (39:39):

So I think that transparency and communication will connect LPs relationships of ours, to other LPs and GPs, to other GPs just for best practices in terms of quarterly reporting or annual meeting prioritization and making it feel like it's not just a waste of time. So I think other than out-performance on the back end, communication's really important. I think that the groups that have differentiated themselves in the emerging lower middle market over the past few years have a easily identifiable, distinct thing or handful of things that they do differently. It's, this is our approach to post close value add, or this is our highly thesis-driven sub segment in a market where we're hunting, and we think we're early.

Casey Peters (40:40):

Gone are the days of just being able to be a generalist and go out there and raise a big fund. So I think that groups who have some unique attribute or attributes about them, those are what have passed muster for these LPs and there's GPs out there that we just know are really, really strong. Our client comes to mind where they have a great LP base. Our GPs built something really special. They're doing really interesting deals and they can communicate exactly what they're doing. Turn/River on the software side is another one. Those are a handful of things that I think groups can think about specifics to differentiate themselves.

Jon Finger (41:25):

So we always say learn from your failures, I don't mean yours, Casey, I mean emerging managers. What are some of those failures that you've seen with emerging managers within the process, and what can other emerging managers learn from that?

Casey Peters (41:46):

Yeah. Even at Pacenote, it hasn't been all successes and definitely not personally, to your point, that's where you learn the most. I would say, and we fortunately haven't experienced this at Pacenote, but the number one risk for not just Fund Ones, but all "emerging" managers is partnership risk. There's just, you see a lot of groups who we'll see it on LinkedIn a number two at a GP we were talking to 18 months ago is taking another role right now. That can be a function of a lot of different things, and so we're not passing judgment on it, but we spend a disproportionate amount of time understanding the man co-ownership splits, carry splits, expectations or future fund size growth and carry split changes. The biggest failures we've seen have just been on the team partnership staying together.

Jon Finger (42:50):

Sure. I always say you don't know what you don't know and there's instances, I think, where first time fund managers go through the process, and this is some of the things we talk about on other episodes here, but what do you think emerging managers, first-time fund managers overlook in preparing for the process of raising a fund?

Casey Peters (43:17):

I think that one element that we try to drill home is, "Look, you might think that in your prior life when you're doing fundraising meetings or whatever you were having good conversations or you were connecting, whatever you think your bar is or whatever you think a good connection is, you need to really ... " and this is not easy. If we have three, four meetings a day for a couple of weeks when we first kick off, it's exhausting and just it takes a lot of mental energy, but we're saying be really invested in the conversation and the relationship and understand what drives them, who they're investing on behalf of. I think that just goes a long way in terms of these LPs are really sharp and they can feel when someone cares and is invested in that particular conversation, or if they're just mailing in and giving the party line and these groups are really shrewd.

Casey Peters (44:20):

So I think that that's one thing that we've seen some groups overlook, and it's an extension of what I had alluded to before, just this idea of, "Hey, I just want to raise the capital. It doesn't really matter who it's from." That's one thing. Then I'd say the second thing is being able to really effectively communicate what you're doing post- close, and this is specific to buyout, is really important because it's five, 10 years ago, just having a couple of operating partners on the slide deck would do the trick, today people are really hip to, "Okay, well, how are they compensated? How do you think about specialties within what you're doing post close?" So being able to this falls into the effectively communicate your strategy in particular, the post close value add is something that we think LPs are particularly keen on.

Jon Finger (45:19):

So in closing, Casey, this may be difficult and perfectly fine if you want to reemphasize something you touched on earlier, but in thinking about the one piece of advice you would give an emerging manager, and also the one piece of advice you would give to a limited partner looking to engage with an emerging manager, what is most critical in your mind?

Casey Peters (45:48):

I'll take the first part and split it into two. If you're-

Jon Finger (45:54):

Crafty.

Casey Peters (45:55):

Yeah. If you're thinking about in, "Hey, a year or a couple of years I want to launch my own firm and I have that entrepreneurial bug," our advice would be, be really consistent in the types of deals you do stay on strategy. It's great if all five of the deals that you led, the operating partner and the CEO of the portico are all saying the same thing about you and the feedback's really consistent. So consistency of strategy, how you comport yourself is the best advice we give folks who are a couple of years away, and they're more just in the just ideation phase. For groups that have formally launched their own firm, and let's just say, want to go raise a fund, I guess the number one piece of advice I would give is, and this can take a lot of different shades, but effectively communicate that you want to build real relationships, end of the day, the LPs have full portfolios. They have hundreds, if not thousands of different GPs coming across their desk every year.

Casey Peters (47:05):

It's really easy to pass on something. If it feels like you're not going to have a meaningful relationship and it's going to be two way. That'd be advice I'd give folks on the GP side. For LPs. I think that they know it even better than us, but we're seeing, and this stems from our bogey stepping back. Everyone says that every GP Target's 3X plus, but one LP had said to me, "Hey, in my 20 plus years, doing this less than 5% have delivered a 3X net and less than 1% have delivered a 3X net on subsequent vintages. So that last category is what we're benchmarking ourselves against, and so we just happen to think that there's a higher likelihood of turning a 3X at an appropriate fund size.

Casey Peters (48:04):

I've had this debate with LP some close enough with where I can challenge some of the thoughts that they have, but there's a lot of Fund Ones who have gone out and raised a billion dollars, a billion plus right out of the gates. We just have a hard time believing that it's really hard to turn a billion 3X as opposed to $150 million fund and hence the merits of the lower middle market. But I think that we're seeing a lot of LPs doing this, there's a preference for, and I had one the other day say, "We're looking for the same thing. We always have young hungry groups, lower middle market and now we're adding on those filter. We want groups who have a hard time fundraising for whatever reason, so we know that there's not going to launch and raise a $507 million fund. So that's just a little insight into some recent LP conversations and how people are thinking about the world. But I don't think they need our advice too much on what they're looking for on the LP side.

Jon Finger (49:10):

Well, fantastic. That's great. Casey, thanks so much for sharing your expertise today and thank you to our listeners for joining us on this episode of Fund Flow.

Casey Peters (49:22):

Thanks, Jon. I really enjoyed it.

Voiceover (49:25):

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