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PACIFIC CURRENT GROUP

FROM OUR CEO

Pacific Current Group (PAC) is one of the very few institutional investors willing to invest at the inception of a new investment management firm. Due to their newness, lack of profitability, and highly uncertain growth trajectory, these investment firms represent high risk to capital providers such as PAC. In theory, of course, this higher risk offers the capital provider greater potential returns.

When we sit down and talk with these aspiring entrepreneurs, we walk through their investment process and business strategy in detail, while also evaluating their key personnel. This helps us get our minds around the size of the opportunity and the extent of the risks. Clearly, we can't fully assess the risks until we know how much capital a new business might need. This leads us to one of the most common hurdles to overcome with these early-stage investments.

One would think that every investment manager that comes to us for capital would have a good sense of how much capital they need and how much ownership they may need to give up to raise the required capital. Surprisingly, this is frequently not the case. Many of the early-stage firms think about their capital needs and how much equity they may need to sell independently of each other – which is a problem.

By looking at these questions separately, investment managers frequently come to us with unrealistic, even non-

sensible, requests. For example, an investment manager might ask us to invest $10m in their company while simultaneously providing us forecasts that suggest the current value of the business is worth less than $10m. In other words, were we to fund the business, PAC's investment would merit more than 100% of the equity, which is not possible and clearly inconsistent with the investment manager's intent behind starting their own firm.

Superficially, it appears that investment managers struggle to do investment math. However, when we dig deeper, we learn that math isn't the problem. The real culprit is that they often have only looked at their situation from a singular perspective. In other words, they have literally never considered what returns a capital provider would receive for investing in their business.

When we run into these unrealistic expectations/requests, we encourage (gently, of course) the managers to look at their business the way a capital provider would. Almost always, this results in firms sharpening their pencils to reduce unnecessary components in their cost structures. It also helps investment firms reconcile the difference between how much equity they would like to give up, and how much they will need to give up for us to fund their new business.

It is our preference that by the time we have our initial conversation, these firms already have a realistic understanding of what it will take for their new business to be successful. Of course, this isn't always practical, as sometimes we are talking with people who are still exploring the merits of launching their own business and are looking to us to help them think through all that's involved in launching a new firm.

In our experience, we find it simpler to negotiate with a manager who understands our perspective and our need to produce returns commensurate with the risk we take. Related to this is our observation that the managers that are overly concerned with the amount of equity they retain generally fare worse, and often fail altogether in their efforts to raise operating capital and launch their businesses.

PAUL GREENWOOD, CEO & CIO

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