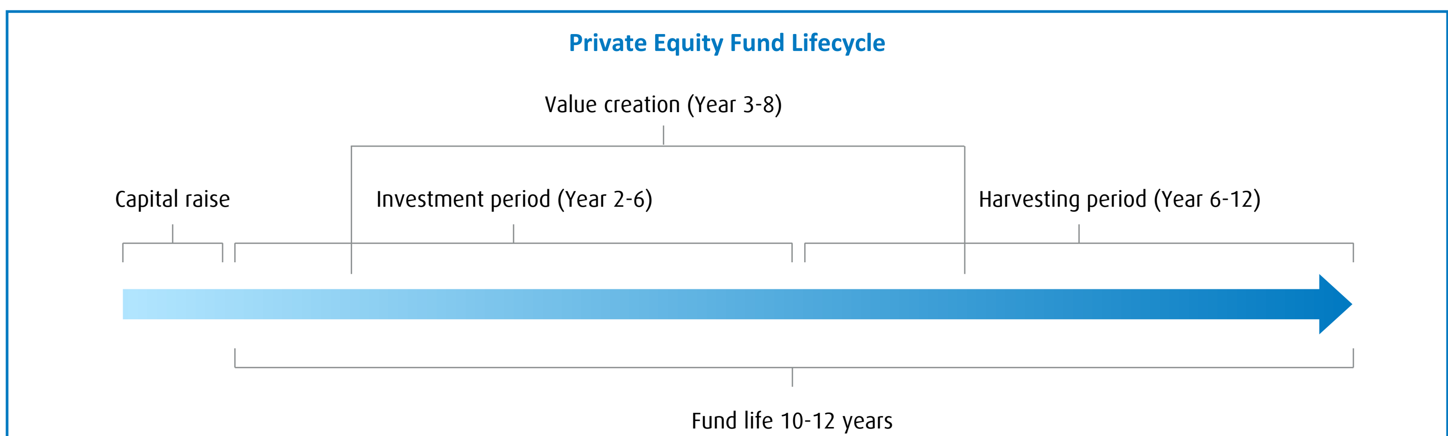
Investing in Private Equity
The Experience

BMO Family Office | November 2022

This publication is Part 2 of a Private Equity series prepared by BMO Family Office, with the aim to raise awareness and understanding on a variety of private equity investments, and how they can be utilized to potentially enhance client portfolios. This article will discuss the life cycle of a traditional private equity fund while focusing on the key differences from investing in public market securities.

As a reminder, most traditional private equity investments have a life cycle of 10-12 years, with the expectation that all invested capital, plus a return is received by the end of the fund's life. How quickly and how much investors can expect to receive is determined by the type of strategy and the performance of the underlying investments. Most private equity funds go through a four-stage lifecycle; capital raise, investment period, value creation, and harvesting period.



Capital Raise

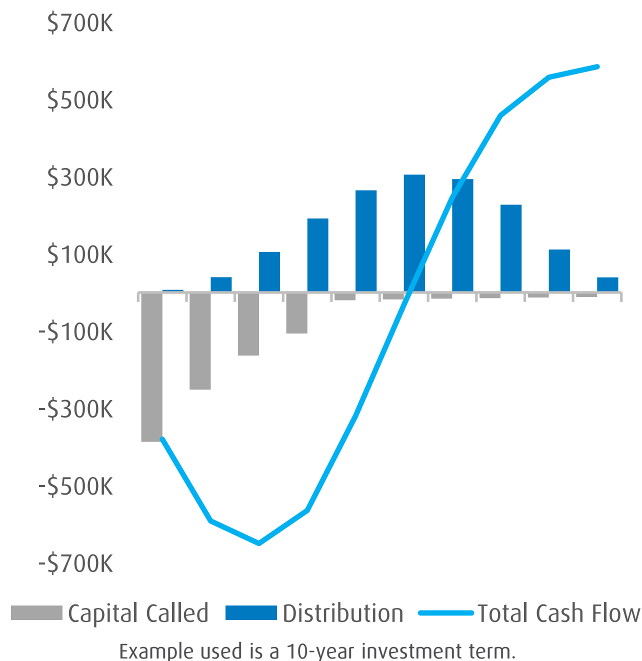
The capital raise period is the pre-investment phase of the private equity fund life cycle. Most private equity funds set a desired amount and a timeframe to raise capital. The targeted capital raise is reflective of how much money the manager believes they can effectively invest. Once the amount and timeframe are determined, the manager must promote interest in their upcoming fund. Uniquely, investors looking to buy into the fund must do so with limited knowledge of what will be in the portfolio, which is known as *blind pool risk*. Potential investors must make their investment decision relying on the manager's pedigree, previous track record, and a multitude of other factors to gain comfort with their investment decision. At BMO, we pride ourselves on seeking to identify high quality managers with above-average return potential for a given risk profile.

Once the manager hits their target raise, they will typically close the fund for investment. If an investor does not allocate to the strategy before the final close, they will be unable to allocate to this fund. In addition, if an investor would like to invest with the manager in the future they will have to wait for their next fund, also know as *vintage*.

Investment Period

The close of the fund marks the beginning of the investment phase which is roughly the 2–6-year period of the lifecycle and at which time the manager deploys the capital its investors have committed to the fund. The manager does not invest all the capital immediately, but instead uses the total commitment as a "budget" to deploy capital over the investment period. As most private investments have limited liquidity options (i.e., listing in the public market, strategic sale to another company, etc.), the manager must be very confident that they are investing in quality businesses. Therefore, the manager will take their time deploying capital in an effort to minimize the chance of losses and strive to maximize investor gains. During this period, investors will have a number of what are referred to as *capital calls*. These occur when the private equity manager requires money to fund an investment. Capital calls are of varying sizes depending on the amount of funding required for any specific investment.

J-Curve Illustration of Investing $1MM



Example used is a 10-year investment term.

It is important to note that, typically, during the investment period the fund charges fees on the full amount of committed capital regardless of how much has been invested. This is because the manager is spending resources to find investments for the entire fund commitment and; therefore, charges fees on the full amount. This is what is known as the *J-Curve*, as fees are comparatively high to the amount invested and investments are not yet generating cash flow to offset the fees. This creates negative "paper" performance in the early years of a fund's life cycle. This negative performance tends to reverse itself as capital is deployed and investment values increase and the fund enters the value creation phase. While this initially can be concerning, it is important to note that this is a normal phenomenon. Patience is required if investors want to maximize the full benefits of true private equity investing.

Value Creation

As funds are deployed during the investment phase, the value creation period begins. Value creation in private equity is similar to that of public markets with some differences. We outline two key differences below.

Investment horizon – As private equity investors have a 10-year (give or take) investment horizon, managers tend to take a longer-term view on changes to the company. This is unlike the public markets, where shorter holding periods force companies to be scrutinized quarterly basis (at a minimum), and often more regularly. This consistent pressure can push public companies to focus on meeting their short-term growth goals rather than maximizing long-term growth objectives.

Larger ownership stakes – Results in investment managers typically having considerable influence and control over the portfolio companies in which they invest. This high level of oversight helps the manager shape the company in a way that they believe will maximize the harvest value for their investors.

Harvesting Period

The value creation period comes to an end for each investment once the harvesting period begins. The harvesting period is the phase of the private equity lifecycle when investors begin to receive distributions from their investment. For a typical private equity fund, there will be multiple investments. As a result, as each portfolio company is harvested, investors will receive their capital back, plus any returns, after accounting for the performance fee, which is also known as *carried interest*. This feature is why traditional private equity funds are known as self-liquidating. While investors cannot sell these investments at their discretion, the manager returns the investor's capital and gains throughout the life of the fund. This structure creates liquidity during the fund's life, coupled with the unique challenge that the investor does not control the magnitude or timing of the cash flows.

Broadly, the expectation is that investors have received all their capital back prior to the end of the harvesting period. This means that in the final few years of the fund's life it should be returning mostly gains to investors of the fund. Many investors are intimidated by the long investment period of private equity, however, understanding that an investor's capital is being returned during the life of the fund means their whole investment is not locked in for the entire term.

Conclusion

It is important to remember that the timing of these lifecycle phases varies depending on the underlying investments made by the fund. Certain funds begin returning capital to investors in years 3 and 4, whereas other funds may begin returning capital later in the fund's life. In addition, there can also be overlap between the phases as some portfolio investments will be in the process of being harvested, whilst others will still be in the value creation phase.

Successful private equity allocations are built over time through consistent commitments to multiple funds. Investors are encouraged to build a strategy for any investment in private equity to ensure it provides the best opportunity to maximize returns and minimize overall risk.

If you have an interest in discussing private equity solutions as a potential opportunity for your portfolio, please reach out to your BMO Private Wealth professional.

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Arthur Diochon has over a decade of experience in the investment industry across all asset classes. As BMO's Head of Alternative Research, he is responsible for providing insight, support and research on the Alternative asset class. These responsibilities include alternative portfolio construction for UHNW clients, maintenance of the Firm's recommended list and available products.

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