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The flattening of the private equity J-curve

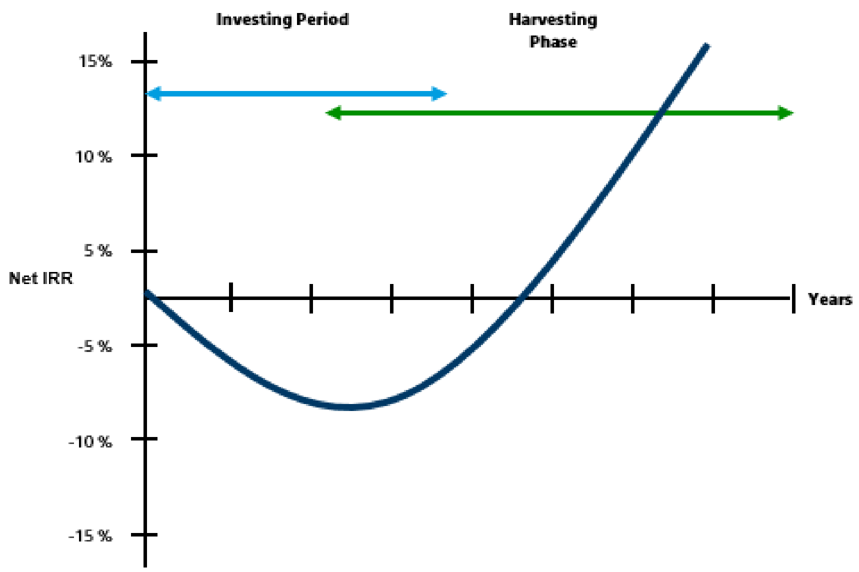
Private market insights

The J-curve

The onset of the COVID-19 pandemic at the beginning of 2020 introduced the world to the epidemiological concept of "flattening the curve." The early indications of the highly contagious virus and its potentially severe impact on patient's respiratory systems led health care professionals and government officials to voice concerned that the demand for intensive care beds and respirators would overwhelm the available supply. By limiting the population's exposure through lockdowns and the implementation of social distancing, officials argued that it was possible to lower, or flatten, the trajectory of the curve that tracks the disease's spread. Another undesirable (although significantly less dire) curve is undergoing significant transformation. The so-called "J-curve", a fundamental aspect of private equity, is also flattening due to numerous factors. The confusion induced by the J-curve for those unfamiliar with private equity might soon be alleviated — not through better education or a broader understanding of the asset class, but by several developments that are leading to the actual demise of the J-curve.

The below graph shows the net of fees internal rate of return (IRR) plotted against the investment period for an individual private equity fund. The curve starts at a zero IRR in year zero. It then drops into negative territory before reversing and trending upward in the fund's later years, thereby forming a shape reminiscent of the letter "J."

The famous "J-Curve"



Source: Mercer. For illustrative purpose only

For those unfamiliar with the asset class, the immediate foray into the negative return region for an individual fund is particularly concerning. The J-curve phenomenon is caused by three aspects endemic to investments in private markets such as private equity:

1. Capital is called over time.
2. There is a lack of market valuation.
3. Fees create a drag on returns.

Most private equity funds have a multiyear investment period over which they source, evaluate, negotiate and ultimately invest in their portfolio companies. Traditionally, an investment is carried at cost for at least several quarters, and the valuation is not changed until later in the company's life. Once a specific fund is activated, management fees are periodically drawn, typically quarterly, independently of the investment pace. As the full amount of capital has not been drawn for that specific fund, and fees are based on committed and not invested capital, therefore the initial fees appear disproportionately large relative to invested capital.

Recent developments

Several recent developments might be leading to the end of, or at least the significant diminishment of the J-curve. Some of these developments are due to private equity fund managers' growing appreciation of IRR's importance to institutional investors. More measures being taken to mitigate the J-curve effect while others are structural changes.

- Despite well-documented issues in applying IRR measures to private equity investments, many institutional investors continue to use IRR as the primary performance and compensation benchmark. Therefore, a practice that is becoming more common is for a fund manager to raise a fund, but not activate it until at least one investment has been made. This is known as warehousing. As fees are measured against an immediate asset base and, all else equal, the time between when the capital is called and the first increase in valuation is shortened which thereby improves the IRR.
- Another mitigating practice that fund managers have been employing more aggressively is using credit lines to smooth out or delay capital calls. Similar to warehousing, using credit lines shortens the time between the capital call and any increase in portfolio company valuation. By using low-interest credit lines, fund managers can substantially improve IRR — and do so at a relatively minimal cost to the fund. In some cases, fund managers have shifted their capital calls by as much as six months. This has been an especially attractive technique for fund managers in the current low-interest-rate environment.
- One structural development that is affecting the J-curve is the adoption of fair-market valuation as specified by global regulation such as the US Financial Accounting Standard Board's Statement 157. As auditors have gained experience with these regulations, it is more common for them to be active in valuation discussions with private equity fund managers, especially for the fund's year-end valuation reports. It is much more common now to see investments written up over shorter periods than previously. The increase in portfolio company valuation can more than offset the drag on returns created by the fees, particularly as IRR is very sensitive to small valuation changes over short time periods.

- A second structural aspect influencing the J-curve is the increasing use of management fee offsets. Private equity funds often receive income from portfolio companies for services rendered, such as participating on the company's board of directors. Investors in private equity became more aware of this practice. They realized that, in effect, part of their investment flowed through the fund into the portfolio company and then directly back to the private equity fund managers. Most funds now either offset the entire income or at least a substantial portion of it. As a result, in these situations the fees called from the private equity fund investors have decreased, thereby diminishing the fee drag and improving IRR.

It is notable that of the four issues discussed above, all are moving in the same direction — to diminish the J-curve effect. For a specific fund, the degree to which each factor affects the J-curve is largely dependent on decisions made by that fund's manager. However, as fund managers compete against their peers and IRR remains a critical benchmark to institutional investors, there are clear incentives to use any available methods to potentially improve competitive positioning. This will almost certainly result in significantly diminishing or, possibly eliminating the J-curve across the industry. If so, there are some relevant implications for institutional investment staff in managing their private equity portfolios:

- For funds that use warehousing and those using credit lines, the impact will be to delay when capital is called, but not decrease the amount called. This could result in fewer, but larger capital calls, which could be beneficial to institutional investors in that it could lower their transaction costs.
- In contrast, funds applying management fee offsets will call a lower absolute level of fees, all else being equal. Thus, institutional investment staff will not have to plan on funding those foregone fees.
- The adoption of fair market valuation can provide institutional investment staff with a more accurate assessment of their private equity portfolio’s actual value. This could be particularly useful in managing portfolio allocations.

An essential difference between the COVID-19 curve and the J-curve is that the COVID-19 curve represents only negative consequences, whereas there are both positive and negative aspects of the J-curve. With the development of a successful COVID-19 vaccine we may minimize or, ideally, even eliminate the disease curve, something beneficial to everyone. With the J-curve we may hope to experience a diminishment of the negative aspects in a fund’s early years Still, investors can certainly hope to continue to enjoy the potential high returns a successful fund can generate in its later years. We may be witnessing the transition from a private equity world of J-curves to one of reverse L-curves which offers the additional benefit that institutional investment staff may no longer have to defend, the perception of negative returns in the early years of a private equity fund investment.

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