



CAZ INVESTMENTS

Access to Innovative Investing

“The J-Curve Effect”

In January 1982, former United States Secretary of the Treasury William Simon and a group of investors acquired Gibson Greetings, a producer of greeting cards, for \$80 million, of which only \$1 million was rumored to have been contributed by the investors. By mid-1983, just sixteen months after the original deal, Gibson completed a \$290 million IPO and Simon made approximately \$66 million (a 66x return on their original investment). The success of the Gibson Greetings investment attracted the attention of the wider media to the nascent boom in leveraged buyouts and heralded the age of private equity as an asset class.

Most investors do not invest directly in privately held companies, lacking the expertise and resources necessary to structure and monitor the investment. Instead, investors will invest indirectly through a private equity fund. Certain institutional investors have the scale necessary to develop a diversified portfolio of private equity funds themselves, while others will invest through a fund of funds to allow a portfolio more diversification than one a single investor could construct.

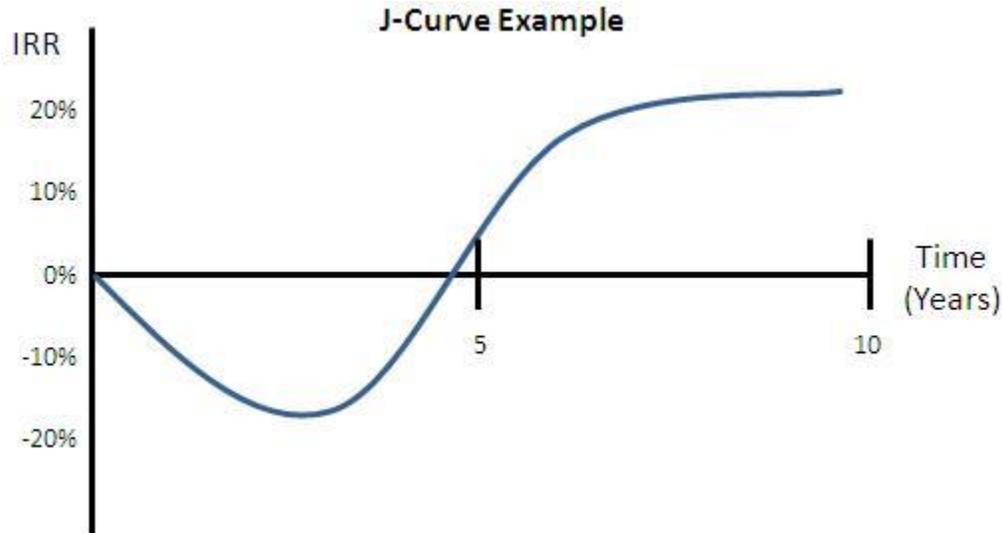
Since its beginnings in the early eighties, private equity has evolved to include a wide range of strategies including venture capital, real estate, infrastructure, and a host of other illiquid vehicles. In addition, the type of investors who can access private equity has grown. In the 1980s, insurers were the major private equity investors. In more recent times, public pension funds, and university and other endowments, have become significant sources of capital. Today, through feeder vehicles high net worth individuals and families can access to this unique and attractive asset class.

The purpose of this white paper is to provide our clients with a key insight into how private equity works and what investors should expect when allocating their capital. Specifically, we will address what is commonly known as “The J-Curve Effect”.

In the early years of a private equity fund, investment returns are virtually always negative. This is something that surprises many people who are new to the asset class. However, it’s a natural by-product of how capital is deployed by private equity managers who are looking to invest the money committed to their funds over a period of anywhere between one to four years. Perhaps the best analogy to use when thinking about this phenomenon is that of the entrepreneur who is starting a new business. Most, if not all, new businesses start with losses in the early years as capital is invested in building out the operations. As a business matures, and as capital investments start to pay off, revenue grows and eventually break-even and then profit is achieved. The exact same pattern is true with a private equity fund investment.

In the early years of a fund, the fund manager is making capital draw-downs to cover expenses, but the investment portfolio has not yet matured enough to build value and offset these costs. As the investments in the fund mature, the fund begins to realize gains and positive cash flows and this explains the J-Curve pattern in returns that is usually seen.

The stylized illustration below gives a sense of what a typical J-Curve might look like. Any investor looking at a negative 16% return in Year 3 might well feel concerned. But, once investments begin to mature, and the fund starts to realize gains, returns turn up sharply. Ultimately, the long term investor in this fund is rewarded with a 20% positive return over a 10 year timeframe. The short term pain is clearly worth the long term gain!



The depth and length of a J-Curve depends on several factors. First, a fund usually consists of different types of transactions: some very successful transactions, those that meet expectations and those that underperform. The latter can usually be identified fairly quickly and are hence written down or written off early on in the fund's life. For the investments meeting or exceeding expectations, it takes a longer time to implement the changes that create value and realize a positive outcome.

Second, the J-Curve is influenced by the level of expenses early on in the fund's life. Since management fees are based on the entire committed capital, while this capital is only gradually invested over the first few years when distributions are usually small, management fees and organizational expenses will have an effect on the shape of the J-Curve.

Third, the J-Curve effect is determined by the methodology a private equity manager uses to report the value of their investments. For example, some managers carry the value of their investments at cost until they're forced to write up the value of those assets at the time of a realization. Other managers utilize mark-to-market valuation where they write-up the value of the asset to reflect the current 'fair value' of that investment. Clearly, the specific methodology used can have a significant impact on the size and depth of the J-Curve effect.

Fourth, the most important factor for the shape of the J-Curve is the timing of the investments and divestments. The more quickly fund managers invest capital, the steeper the J-Curve. The longer it takes to generate distributions, the longer (and usually deeper) the trough of the J-Curve.

Investors should expect a greater return from private equity than from public equity investments due to illiquidity and a long-term commitment. However, it is important to bear in mind that, in contrast to public equity, private equity investments initially have negative returns and accumulated negative net cash flows in the early years of a fund's life. Once one understands the J-Curve effect, this unique characteristic of private equity fund investing becomes less of a concern, and the true benefits of private equity as a return enhancer and asset diversification strategy can begin to be appreciated.

Sources:

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- Buyout Binge. Alexander L. Taylor, TIME magazine, 16 July 1984
- The History of Leveraged Buyouts. 4 December 2006. Trehan, 2006
- Exposed to the J-Curve: Understanding and Managing Private Equity Fund Investments. Ulrich Grabenwarter, 2005

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