Study: J-curve can predict returns

The performance of a vintage year can be linked to a specific J-curve, fresh research has found.
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Investors will be able to have an idea of how their underlying funds are performing after a little more than two years into the fund's life by analysing its vintage year's J-curve, fresh research has shown.

Cyril Demaria of the University of Sankt-Gallen in Switzerland conducted the research, analysing J-curves and performance from funds in the US and Europe, Middle East and Africa (EMEA).

Most private equity funds are subjected to a J-curve, meaning that vehicles experience negative returns for the first few years as the investment portfolio has yet to mature, before performance picks up.

For US venture capital and EMEA venture capital, the study focused on the vintage years between 1981 and 2001, looking at 1,265 funds and 789 respectively. For US leveraged buyouts and EMEA leveraged buyouts, the study researched the period between 1984 to 2001, looking at 626 and 471 funds respectively.

Demaria divided vintage years into a few categories including: good vintages, not so good vintages, mediocre vintage and very good vintages, calculating an average J-curve for each of them.

These average J-curves allow investors to get a rough idea of how their funds are performing. "Below two years of existence of the fund we cannot make predictions, but between two and five we can exclude certain categories of returns," Demaria told *Private Equity International*.

"Once you have identified the category you can sometimes see changes from one category to the next between three and five years. After five years, we can have enough confidence that the returns will remain in the same category," he said.

The results are "a major finding", according to Demaria. "If the returns aren't looking good, LPs can already try to set capital aside and factor this in," he added.

He added the findings were important as regulations like Solvency II and Basel III are forcing many LPs to reassess their exposure to private equity because the illiquidity of the asset class is seen as a potential danger.

"Private equity will never be as liquid as other asset classes. This is why solvency ratios are so harsh for it. Illiquidity has been seen as a source of risk, but's it's a feature of the asset class. If we consider it as a dimension of the investment, you can use the J-curve potentially as an indicator," he said.

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>
> *Cyril Demaria*

The tools can easily be taken up by existing LPs, according to Demaria. Large LPs, which have their own cash-flow insights, can aggregate these J-curves themselves and can benchmark their existing funds, he said.
"The ones that don't have such histories of cash-flows can use existing data from data providers like Thomson or Cambridge Associates to calculate [them]," he added. "If the critical mass takes up the model, it could lead to a different dynamic in the secondaries market."

The model has its limitations however. The J-curves are calculated per vintage year, not per individual fund. When you have a border-line vintage year, the results may be blurred, Demaria admitted. "Funds that were raised on the 1 January may not be investing in the same conditions as funds that were raised on 31 December of that same year," he said.

Additionally, the model is unable to distinguish between different investment strategies or factor in certain scenarios that might affect valuations and returns. "If dividend recaps have happened, it might blur the picture a bit for LBO funds, especially in the US. Also, if the manager's incentives are different from the typical model and GPs are encouraged to invest their capital quicker, then that might impact the J-curve and therefore the analysis," he said.

While the model has its limitations, it could help to get some distance from internal rate of returns (IRRs), which may not always give an accurate picture of performance, Demaria said. "We criticise IRRs rightfully but [continue to use them] because of the lack of a better tool. None of these tools are perfect; [this J-curve analysis is] just an additional tool in the arsenal of the LPs, which might prove useful."