"J" curve explained

The purpose of this white paper is to provide our clients with a key insight into how private equity real estate 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 real estate 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 generally 3 years.
- In the early years of a fund, the fund manager is making capital calls to complete investments according to the fund strategy during the investment period. The total acquisition cost of a property includes the agreed purchase price and the costs related to the acquisition, typically, due diligence, valuation, fees, tax, legal costs, real estate transfer tax and notary costs. These costs can amount to more than 10% of the price of the property and are directly booked in the profit and loss as "Fund costs" and therefore have a direct impact on the fund's NAV at the time of acquisition. Over time, the generated cash flows, capex improvements and revaluations will gradually offset these costs and compensate the effect on the NAV. Should the Fund capitalise these acquisition costs at the time of acquisition and "activate" only a portion of the total costs in the Profit and Loss every year spread over the duration of the fund, considering an amortisation of these costs over the years, the J curve would have a much smaller impact on the NAV at the time of acquisition.
- The J-Curve effect is determined by the methodology a private equity manager uses to report the value of their investments. It is important to bear in mind that, in contrast to public equity, private equity investments initially generally have negative returns in the early years of a fund's life when the funds are being invested. 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.
- The stylized illustration below gives a sense of what a typical J-Curve might look like.