



PRIVATE SECURITY INVESTING INSIGHTS

# Understanding The J-Curve

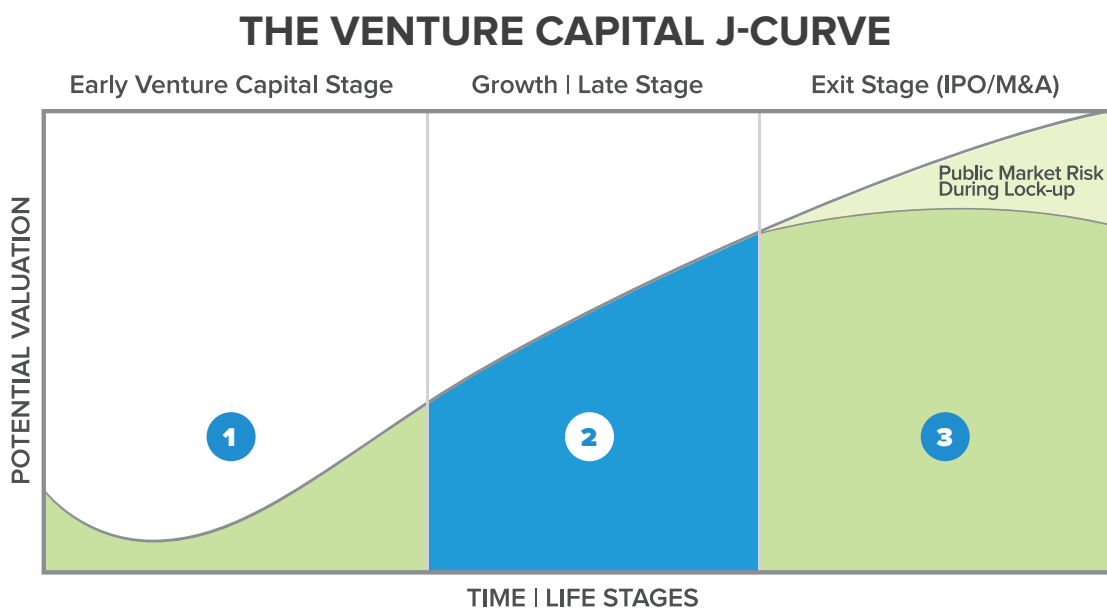
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# Understanding The J-Curve

*Investing in private companies can offer a number of benefits to investors including access to an asset class that has a low degree of correlation to the broader markets, diversification and the potential for sizable returns. As companies stay private longer, a greater portion of their appreciation is frequently occurring during the private stage of their life cycle.*

The J-Curve is a graphic representation of the relationship between a private company's valuation and its life-stage or "term". The J-curve is not a representation of the performance of a private company; rather it shows an average trend or pattern often experienced by a portfolio of private companies from inception and initial funding through becoming public or being acquired.

The J-Curve is commonly broken into 3 stages – the **Early Venture Capital Stage**, the **Growth/Late Stage** and the **Exit Stage**. These stages are designed to define where a company is in its life cycle and suggest common valuations to time ratios. There are four primary issues that impact the J-Curve shape – returns, drawdown rate, accounting methodology and duration.



*This chart is for illustrative purposes only and does not represent an actual investment*

## 1 Early Stage

This stage is recognized as the time when a company is in its "start-up" phase, focused on R&D, infrastructure creation and securing early rounds of capital, usually from venture capital investors.

The early venture capital stage is known for being "pre/early-product and pre/low-revenue." Often early-stage venture capitalists invest in a person or a group of people that have an idea with little to no structure around it. They pursue big and disruptive ideas germinated by "serial entrepreneurs" who have previously founded several successful companies. During this early-stage, companies typically launch a product, build basic infrastructure and refine their business model with the goal of eventually generating revenue from their first customers.

### **Common Characteristics of early-stage companies include:**

- Initial product and market development (R&D)
- Infrastructure development
- Early customer traction
- Rapid “cash burn” rate
- High failure rates of 30%-50%

Investing in early stage private companies typically carries a much higher degree of risk, but in exchange it offers the greatest degree of return potential, given the investor has committed capital at or near a company’s inception. Many early-stage venture investors take control of a significant percentage of the company’s equity. If the company is successful, the payouts can be large and can compensate for losses generated from investing in failed companies.

When investing in private companies, future top performing companies typically show a negative return in the early years. The curve seen in the early stage is sometimes referred to as the “valley of tears” because the start-up costs are significant and often outweigh the company’s valuation. Write-downs are likely to occur in early stage companies.

## **2 Late-Stage**

This stage is recognized as the time when private companies mature and transition into generating positive EBITDA. It is sometimes referred to as the growth-stage. They typically have revenue streams of \$75M or more with rapid annual growth rates. Late stage companies are focused on marketing and sales and their cash flow becomes more consistent and dependable. Capital investments are made to foster further growth and development through new products and technologies. Venture capital investors still invest in late-stage companies, but the profile of the VC firm is often different than early-stage venture investors. The risks in this stage are mainly centered on execution, market size and scalability of technology. The likelihood of a late-stage company failing decreases significantly, as the customer base and product line grows.

### **As compared to early stage companies, late stage company characteristics include:**

- Revenue levels of \$75 million or more with growth rates of 30%-100% per annum
- Increased product development and concept stabilization
- Execution risk
- Minimal failure rates but write-down rates of 15%-25%
- Closer to exit – within 3 to 4 years

Valuations of later stage companies are more connected to fundamentals of the business and they continue to grow as the company executes against its annual revenue goals. Investing in late stage companies can generate solid return multiples, but not the extreme return multiples that are characteristics of early stage investing. Given the significantly reduced failure rates and lower write-down rates, however, investing in late-staged companies on a risk-adjusted basis is often more attractive for many investors.

### 3 Exit Stage

At this stage the value of a private company is monetized through either going public or being acquired by another company. Annual revenue has typically hit \$200M or more but its growth rate has slowed to 10-15% per year. If the company's exit strategy is to go public, then it faces significant legal, filing and administrative fees, which can significantly impact EBITDA. For this reason, acquisitions are generally preferable. Approximately 80% of all exits are done through acquisitions versus IPOs.

After a liquidity event the pre-IPO stockholders are typically subject to a "lock-up", or a period of time when they cannot sell their shares. The IPO lock-up commonly lasts for 180 days. Additionally, after a merger or an acquisition, hold-backs are negotiated, often tied to milestones, and can last a year or longer. Lock-ups and hold-backs obviously create risk for the stockholder, driven predominantly by the volatility associated with public exchanges.

**As compared to early and late stage companies, exit stage companies maintain the following characteristics:**

- Revenue levels of \$200M or more with average annual growth rates of 10-15%
- Focus on extending market share
- Exit expenses and legal complexities
- Lock-up risks resulting from the combination of illiquidity and general market volatility

After going public, the company quickly assumes a different investment profile and is focused on growing market share and meeting street expectation of revenue and profits.

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