Thinking Ahead Institute

# The evolving role of public and private equity markets

# Asset classes of tomorrow working group

This document has been written by members of the Thinking Ahead Group 2.0 (Liang Yin, Tim Hodgson) following the research and discussion conducted by the Thinking Ahead Institute's asset classes of tomorrow working group. The authors are very grateful to the members of the working group for their input and guidance, but stress that the authors alone are responsible for any errors of omission or commission in this paper.

This paper is part of a series that explores how the investment opportunity set of institutional investors might evolve in the years and decades to come.

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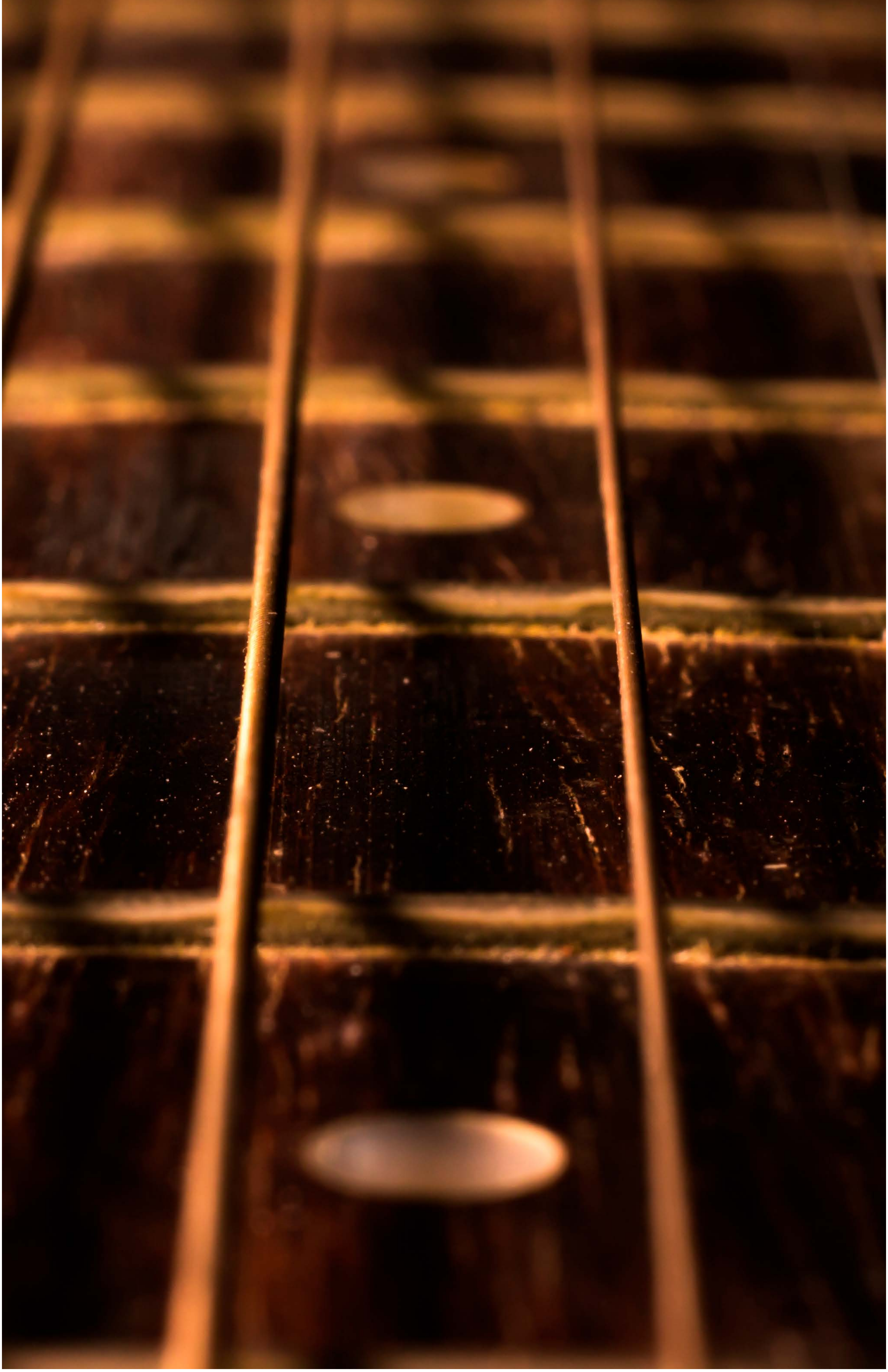


# An initial public offering without offering anything new

On 3 April 2018, the Swedish company behind Spotify, a music streaming service currently used by more than 200 million users worldwide, listed on the New York Stock Exchange. Spotify's public market debut was characterised by two important features that public equity investors ought to take note of.

First, Spotify's opening market valuation of almost US$30bn was underpinned by US$5bn in annual sales. By any measure, it was already a very large company. At this market value, Spotify was larger than more than half of the companies in the S&P 500 index.

Second, Spotify did not issue any new shares – and therefore did not raise any new capital – during its IPO. None. Zero! In fact, technically, Spotify didn't even have an IPO. They had a direct public offering (DPO), also known as direct listing. The listing simply created a channel for the general public to buy shares of the company from its existing owners.

Traditional wisdom holds that the key function of the public equity market is to match the providers of capital and the users of the capital (such as businesses looking to grow). This process of capital raising serves an important role in the capitalist system. Secondary markets make the process more effective by resolving the time horizon mismatch, providing, simultaneously, sufficient liquidity for investors and a permanent source of capital for businesses. What an ingenious design! But one should not lose sight of the fact that the existence of the secondary market is, first and foremost, to support the capital formation role of the primary market. Spotify's model raised a serious question as to the primary function of the public equity market, which, in this particular case, was only valued for its liquidity provision function.

## The quid pro quo of becoming a public company has changed

All businesses, before reaching cash flow self-sufficiency, require financial capital to grow. For the purpose of this paper, let's focus on the role of equity investors as providers of that financial capital. For much of history, the general public[1] has been viewed by businesses as the most attractive source of equity capital. There's a simple reason for this: collectively, it provides the largest and most diverse pool of capital. Everything else being equal, the general public normally offers the cheapest means of financing.

Of course, the flip side of having access to this large pool of capital is the disclosure and reporting requirements that come with it. Despite this, historically, a majority of companies have aspired to a stock exchange listing: the lure of access to the largest pool of capital has easily outweighed the associated costs. Well, that may be no longer the case. At least not as obviously as it used to be. And there are a number of reasons for this.

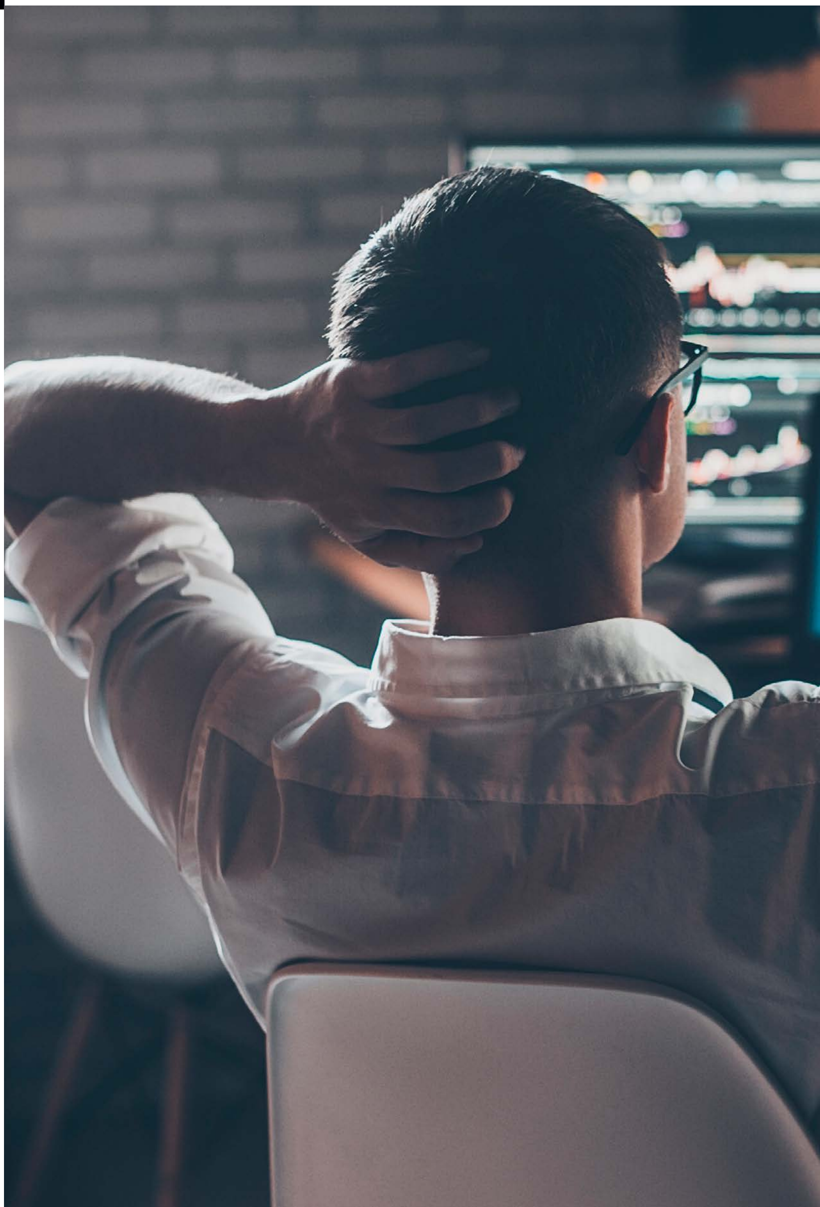
[1] More accurately, wealthy individuals

# The rise of the intangible economy and the abundance of private capital

And of course the perception of public markets as increasingly short-term focused does not do it any favours in winning over businesses. Indeed, some companies have delisted for this reason. Added to that is the substantial cost of an IPO (around 5% in the US[3]) as well as rising ongoing costs of being a listed company, driven by increasing regulatory requirements. As a consequence, particularly in markets like the US and UK, we have seen a significant decline in the rate of public listing. In the US, between 1980 and 2000, an average of 310 operating companies listed per year; this number dropped to 99 per year between 2001 and 2011[4]. The number of firms listed on the US equity market has dropped to just above 4000 today from a peak of over 8000 in the late 1990s[5].

Today's *knowledge-based* business models tend to be asset light. New start-ups no longer have to build manufacturing capability or large-scale computing power or even build a back office because all these functions can be outsourced. Because of this low hurdle, businesses at the start-up stage are more susceptible to imitators and competitors which makes the disclosure requirements of the public market less appealing.

The economic backdrop is that corporate investment is increasingly in intangible assets. It now exceeds investment in tangible assets in the US and the UK[2]. Investment in intangible assets is treated under today's accounting standards as an expense, therefore acting as a drag on earnings. A business that invests heavily in intangible assets might struggle to "sell" the constantly 'depressed' earnings to the public.



[2] "Capitalism without capital – the rise of the intangible economy", Jonathan Haskel and Stian Westlake, 2018

[3] "Where Have All the IPOs Gone?", Ritter et al, 2013

[4] Same as above

[5] World Bank data

Of course, this is just one side of the equation. Yes, becoming a public company is less desirable than before but, at the end of the day, businesses still need capital. So where else are they finding it? The answer is in the private space. The size of the private equity industry has grown more than six fold from the beginning of the 21st century to a level of well over US$3tn[6]. Spotify didn't need to raise any capital because it had raised all the capital it needed – over US$2.7bn –before its public listing.

## Granted, direct listing is still an exception rather than the rule. But consider[7]:

**Google**
raised over **US$1.9bn in new capital** in its 2004 IPO. Prior to that, it had raised **$25m of private capital** (a public-to-private fund raising ratio of 76 to 1).

**Facebook**
raised over **US$16bn in new capital** in its 2012 IPO. Prior to that, it had raised **US$2.4bn of private capital** (a ratio of 6.7 to 1).

Fast forward to 2019,
**Uber**
issued **US$8.1bn worth of new shares,** having already raised more than **US$22bn in the private space** (a ratio of 0.37 to 1).

[6] "Capital formation", CFA Institute, 2018

[7] "What is the point of the equity market?", Schroders, 2018 and other publically available data

# What does this mean for investors?

When businesses can find sufficient capital outside the public market, going public stops being a need. It becomes a choice. It appears that more and more companies are in no rush to join the public company family. For many founders and early investors, it may only make sense to do so when they reach a scale so large that only the public market provides enough liquidity to allow many of them to cash out at the same time.

Just like Spotify.

Public market investors are therefore now accessing companies at a later stage of their development than in the past, if they are able to access them at all. When these companies list, they emerge as mature and large companies, highlighted by the case of Spotify and others like it[8]. This delay could lead public market investors to miss out on a significant period of growth.

On the other hand, public markets are increasingly dominated by huge, maturing business (they are fewer and bigger) that generate more cash than they can spend on future growth opportunities. From a business lifecycle perspective, they might not present the most rewarding investment opportunities. When a company's market share is already very large, the limit to growth is no longer just a theoretical concept.

## Think about your total equity exposure and ways of accessing private equity

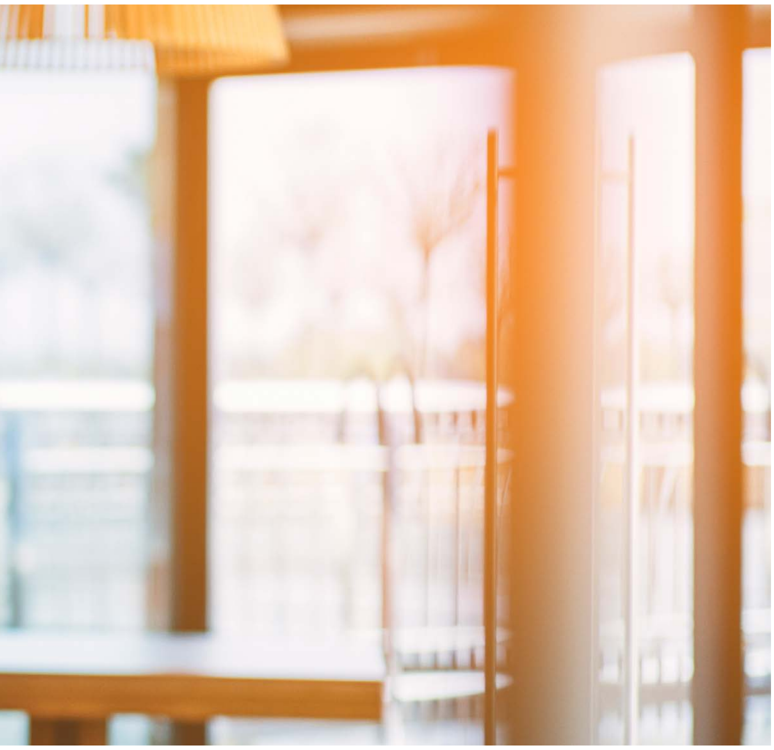
[8] "The Incredible Shrinking Universe of Stocks", Mauboussin et al, Credit Suisse, 2017

[9] "Private equity races to spend record $2.5tn cash pile", ft.com

Our key message to investors is that if you have an equity investment programme built predominantly around public market exposure, you can benefit from extending the opportunity set to cover the entire business spectrum, both public and private.

There are legitimate concerns regarding the current state of private equity investment, notably the signs of overheating at the larger end of the buyout segment in particular.[9]

The question of timing should form part of any discussions about making a private equity allocation. Overpaying can lock in a bad investment, regardless of how sound the underlying investment thesis is. But that is not a reason to ignore private equity totally.



## There are a number of current options for accessing private equity. None is perfect. For example:

1. Rely on the companies in an existing public equity portfolio to acquire young and growing private companies via acquisitions:
   - **Pros:** no need to build any private equity expertise; access to potential strategic synergy
   - **Cons:** don't get to decide what to buy and at what price; potential agency issue (empire-building); doesn't work in markets where there are not many listed companies to start with

2. Invest in private equity / venture capital funds (directly or via fund of funds):
   - **Pros:** oversight of better informed and more motivated owners potentially leads to operational improvement
   - **Cons:** expensive management fees plus carry; the playbook of leverage, operational improvement and resale after a few years only works for a small proportion of the private business world; time horizon misalignment (GPs' five to seven years vs asset owners' multiple decades)

3. Co-invest: a private equity fund (GP) invites a fund investor (LP) to co-invest in a specific company:
   - **Pros:** much reduced (or even zero) fee; a stronger relationship between investors and managers
   - **Cons:** high governance requirement; adverse selection

4. Direct investment: asset owners bypass specialised private equity funds completely and invest directly in private equity:
   - **Pros:** better time-horizon alignment; in theory it covers the entire private business universe
   - **Cons:** governance hurdle hard to overcome even for some of the largest and most sophisticated asset owners.

# Think ahead

This might surprise many, but according to one study the total value of unlisted companies in the world is well over US$100tn, larger than the total value of all listed companies. It dwarfs the current size of the private equity industry (c US$3tn)[10].

It is plausible that over the years and decades to come, investors will up their participation in private investments, driven by the forces discussed in this paper. It is also plausible that the private equity investment model undergoes a structural shift, away from the current playbook, to allow for wider participation.

Will a "passive" direct investing model emerge? Under such a model, owners supply capital directly, with no leverage and no desire to replace the entire management team, with the intention to own the assets indefinitely instead of looking for an exit within a pre-set period (think Berkshire Hathaway).

If the governance and human capital problems are too difficult for a single asset owner to overcome, perhaps this could be achieved by forming a platform where asset owners can collectively keep the private equity talent busy and reasonably rewarded and where investment ideas can be shared and co-created?

The private markets of tomorrow may well differ from those of today. Technology may well drive evolution in this space. Crowdfunding platforms already exist to connect businesses and investors in the unlisted space. Will they evolve to become the new private "stock exchanges"? How about the impact of blockchain and its facilitation of fractional ownership?

But whatever the nature of the private markets of tomorrow, it looks likely to be a bigger part of the institutional landscape than it is today.

[10] The Global Capital Stock: Finding a Proxy for the Unobservable Global Market Portfolio", Gregory Gadzinski, Markus Schuller and Andrea Vacchino, The Journal of Portfolio Management, 2018

## Limitations of reliance – Thinking Ahead Group 2.0

This document has been written by members of the Thinking Ahead Group 2.0. Their role is to identify and develop new investment thinking and opportunities not naturally covered under mainstream research. They seek to encourage new ways of seeing the investment environment in ways that add value to our clients. The contents of individual documents are therefore more likely to be the opinions of the respective authors rather than representing the formal view of the firm.

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## About the Thinking Ahead Institute

The Thinking Ahead Institute seeks collaboration and change in the investment industry for the benefit of savers. It was established in January 2015 by Tim Hodgson and Roger Urwin, who have dedicated large parts of their careers to advocating and implementing positive investment industry change. It is a global not-for-profit research and innovation group made up of engaged institutional asset owners, asset managers and service providers committed to changing and improving the investment industry. Currently it has over 40 members around the world and is an outgrowth of Willis Towers Watson Investments' Thinking Ahead Group, which was established in 2002.

The Institute aims to:

- Build on the value and power of thought leadership to create positive change in the investment industry
- Find and connect people from all corners of the investment world and harnesses their ideas
- Work to bring those ideas to life for the benefit of the end saver.

It does this by identifying tomorrow's problems and investment solutions through:

- A dynamic and collaborative research agenda that encourages strong member participation through dedicated working groups
- A global programme of events including seminars and key topic meetings, webinars and social events
- One-to-one meetings between Institute member organisations and senior representatives of the Thinking Ahead Group.

These solutions fall into three overlapping areas:

- Better investment strategies
- Better organisational effectiveness
- Enhanced societal legitimacy.

The Institute has a governance board comprising both Institute members and Thinking Ahead Group representatives. For member subscription rates and any other details please contact:

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## About the Thinking Ahead Institute

The Thinking Ahead Institute seeks to bring together the world's major investment organisations to be at the forefront of improving the industry for the benefit of the end saver. Arising out of Willis Towers Watson's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners, investment managers and service providers. Currently it has over 40 members with combined responsibility for over US$12 trillion.

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