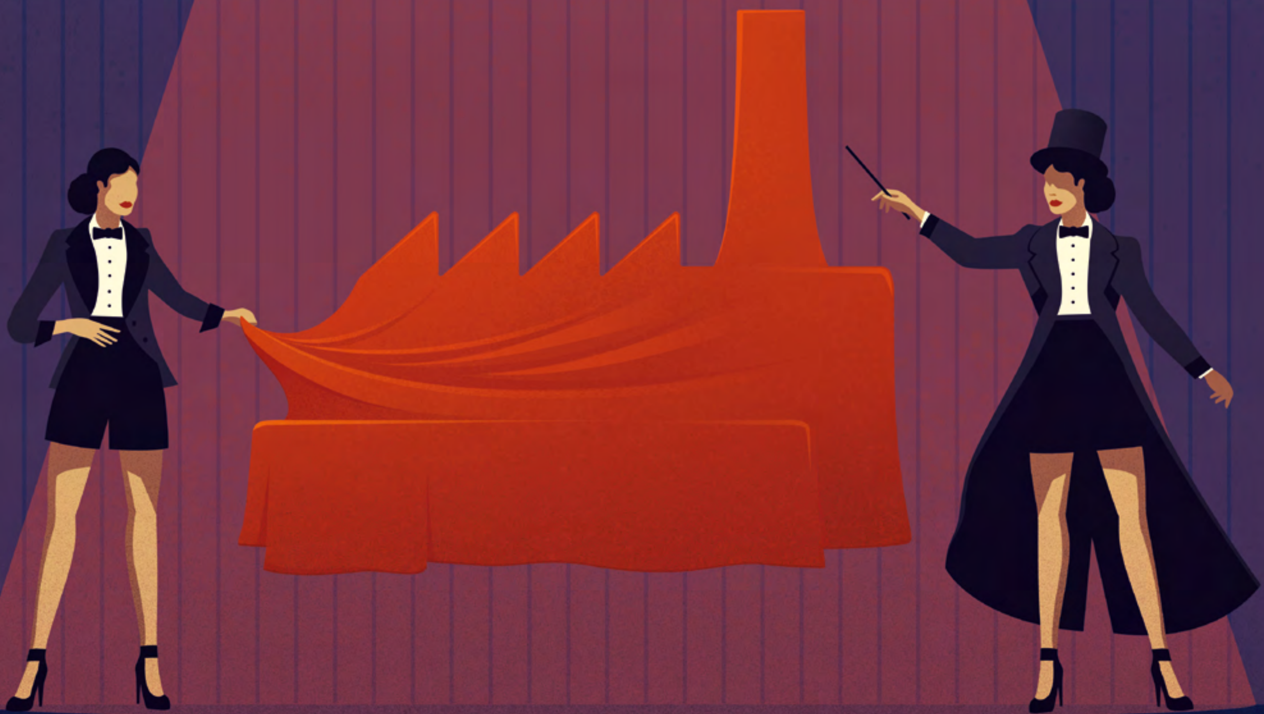
THE VANISHING *PUBLIC COMPANY*

The past decade has seen the number of public companies shrink, while the ranks of businesses owned by private market investors have swelled. What's driving this trend – and does it matter?



After steady growth in the 1980s and 1990s, the number of public companies in the West has plummeted over the last two decades, with peak-to-trough declines of around 30% across many large economies, according to World Bank data. At the same time, assets under management in private markets have soared to US$6.5trn, an increase of 170% in the decade to 2020, according to McKinsey & Company.

But what are the reasons for the sharp decline in the number of public companies? To what extent do cost of capital, the contrasting governance models of private and public ownership, and relative investment performance play a part? And how have changes in the regulation governing public and private markets altered the picture?

Here, three academics who have studied why public markets have lost their shine join forces with three private markets investors to debate why the number of publicly listed companies has declined so dramatically. They also discuss the consequences of there being fewer public companies, why this matters to retail investors unable to access private markets, and how this trend will affect businesses that have historically raised capital through public markets. Chaired by Amy Carroll.

Why are fewer companies listing on public markets?

Roberto Quarta: "I have a foot in both public markets and private equity, and my view is that there is a time for entrepreneurship, a time for companies to be held privately, and a time for companies to go public. There is no doubt, however, that regulations and governance requirements in public markets have become a lot more demanding in the past two decades, so while there may be attractions to public ownership in terms of liquidity, there are a lot of obligations to fulfil as well."

David Layton: "I agree that it is about the cost of regulation and compliance. Both investors and entrepreneurs have grown weary of the corporate governance changes required in order to go public. In an attempt to address the implicit tension between managers and owners, there have been successive waves of laws. But the combination of regulations, proxy advisers and so-called best practice codes, combined with the short-term nature of public markets, has diluted a board's decision-making capabilities, stifling the entrepreneurial spirit of many companies. We call these things governance correctness. That has become so entrenched, it is a real inhibitor.

"The other major factor, of course, is the maturation of private markets. I don't think it's a coincidence that from 2000 to 2019, the number of public companies fell significantly, while private markets' assets under management grew to almost US$7trn."

Gregory Brown
Gregory is professor of finance and director of the Frank Hawkins Kenan Institute of Private Enterprise, University of North Carolina. He is also the founder and research director of the Institute for Private Capital. He previously served as director of research for Amundi Smith Breeden and worked at the Board of Governors of the Federal Reserve System.

Thomas Chemmanur
Thomas is professor of finance and Hillenbrand Distinguished Fellow at the Boston College Carroll School of Management. He was previously associate professor of finance at the Graduate School of Business, Columbia University, and has also taught at Massachusetts Institute of Technology, New York University, and Duke University.

Joan Farre-Mensa
Joan is an associate professor in the department of finance at The University of Illinois at Chicago, having previously worked at Northeastern University and Harvard Business School. He is particularly interested in understanding how a firm's listing status affects its financing environment and policies.

Gregory, your research posits that there is a cost/benefit framework in which investors and management teams balance the benefits of a lower cost of capital in public markets with the governance advantages of PE. What are those governance advantages?

Gregory Brown: "Public company ownership structures are diffused. Even the biggest institutional investors, such as Vanguard and BlackRock, may hold just 5% [of a company]. And those investors will own stakes in thousands of companies, so their ability to undertake good governance and monitoring of management is extremely limited. The other disadvantage of public ownership is the 'free rider' problem. Even if you spend a lot of time and effort trying to influence a company, you get just a small fraction of the benefit.

"WHEN COMPANIES HAVE IMPORTANT STRATEGIC CHOICES TO MAKE, IT IS FAR EASIER TO DO THAT IN A PRIVATE SETTING"

Gregory Brown
University of North Carolina

"The notion that public boards and public owners are going to be well positioned to undertake difficult decisions is therefore quite a stretch. When companies have important strategic choices to make, it is far easier to do that in a private setting, where you have just one or, at most, a handful of controlling shareholders."

David Layton: "I think PE's advantage is the ability to focus on those things that will have real impact. You could argue that in the past this focus has been applied one dimensionally to returns. But I think the industry is maturing and firms are now taking broader stakeholder needs into account. That is far more easily achieved when the board, management team, and entire company are aligned with a single set of objectives, rather than being pulled in 10 different directions.

"I would also say: do not underestimate private capital's ability to look into the future. Private market solutions are increasingly long term. Quarterly reporting is restrictive. Public markets get tired of long-term stories in a way that private capital doesn't."

David Layton

David is co-chief executive officer of listed private markets investor Partners Group. He is also head of the PE business department and a member of the global investment committee. Layton was previously head of Partners Group's PE business in the Americas.

Anne Glover

Anne co-founded Amadeus Capital Partners alongside Hermann Hauser in 1997. She started out in the US at Cummins Engine Company and was then at Bain & Company, before returning to the UK to join Apax Partners. She was also chief operating officer of investee company Virtuality Group, after it listed on the London Stock Exchange.

Roberto Quarta

Roberto is chairman of Clayton, Dubilier & Rice Europe, having played a particularly important role in the firm's investments in SPIE and Rexel. Quarta is also chairman of listed companies WPP and Smith & Nephew, and served as chief executive officer of BBA Group from 1993 to 2001, before taking over as chairman.

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David Layton
Partners Group

Roberto Quarta: "With the PE model, the management team and investors are on the same side of the table. That allows for a direct conversation in real time. In a public company, there might be thousands of investors, as Gregory says. Anyone looking to make a significant move usually sounds out their top 20 investors to get a sense of support, but it's very different to having that close rapport. Then there is a real regulatory burden with public ownership and potential compensation issues in some markets, too. That is particularly true in the UK, and can cause real problems with attracting and retaining talent."

Do you think we are seeing a delay to the point at which companies are listing, or are more companies just avoiding public markets altogether?

Gregory Brown: "We are definitely seeing both. We see cases where companies are staying private longer. The average time from the first round of venture funding to initial public offering has increased significantly. But we are also seeing an increase in companies that never go public. They either remain private companies or go straight into strategic acquisitions."

David Layton: "I would say that more companies are staying private altogether. This isn't a delay; it's about a structural shift in behaviour and I think it's fuelled by a private markets industry that is broader, more substantial and able to solve more problems than ever before."

When can it start to make sense for companies to list? In what circumstances does the lower cost of capital in public markets win out?

Gregory Brown: "From an investor standpoint, the biggest advantage of public ownership is liquidity. If they want to trade out, they can do so in a nanosecond. And when a business reaches a certain size, it can definitely make sense. There are no trillion-dollar private companies. Access to cheaper

capital is a real draw. And when the company's strategy is relatively easy to understand, information asymmetry is low. By far the most corporate value is held on public markets after all, so clearly there are some benefits."

Anne Glover: "I think the lower cost of capital argument is a bit spurious. In addition to the governance benefits, in private capital it is possible to create a leverage structure that optimises what is needed for a company's specific situation. This is in contrast to public markets, where you can clearly raise debt, but it is all intermediated by ratings agencies and bond issuances.

"The whole capital structure in public markets only makes sense for very large companies. Listed markets are incredibly important for those multinationals – being able to issue corporate bonds during the coronavirus crisis has been essential to their survival. But that is only relevant to a certain market capitalisation and above."

So is it just about size?

Roberto Quarta: "I think size is critical. In my experience, when you get to a certain size it becomes far more difficult to sell in a private setting and an IPO almost becomes inevitable."

Anne Glover: "I don't think it's just about size. It's about predictability. The public markets don't like unpredictable performance. Three strikes and you are out. If you disappoint three times, you are a stock that no one will touch, even if there are valid reasons for why you have disappointed – perhaps a drug trial has failed or a particular currency has gone haywire. It doesn't matter. Public markets don't like volatility."

David, your firm – Partners Group – is a public company, but your role is to extol the virtues of private ownership to management teams. How do you balance the two?

David Layton: "Despite having listed our management company, we have continued to apply a corporate governance philosophy that prioritises entrepreneurial growth. In any case, I absolutely believe that public markets can provide opportunities for businesses – to increase their profile, for example, or to provide an important channel for succession planning. We took one of our portfolio companies, VAT, public in 2016 and we continued to govern it with an entrepreneurial spirit even as it transitioned onto the public markets. That was the right move for that company at that time, and we would do it again.

"ACCESS TO LATE-STAGE VENTURE CAPITAL IS SO MUCH GREATER NOW, SO THESE UNICORNS DON'T NEED TO GO PUBLIC AND INCUR ALL THE COSTS ASSOCIATED WITH THAT"

Thomas Chemmanur
Boston College Carroll School of Management

"In the past, companies would have wanted to go public to achieve an attractive valuation, or because they didn't have other means with which to access capital. Yet today, private markets players are willing to pay prices on a par with public markets because they have confidence in their ability to drive value."

So how much of the increase in private capital AUM is about deregulation – and how does that square with the superior governance and resulting outperformance we've just discussed?

Joan Farre-Mensa: "Deregulation plays a significant role. Our argument is that a US federal law passed in 1996 – the year when IPOs peaked in the US – made it easier for private firms to raise capital across multiple states by unifying the states' regulatory environments. We think that was so significant because we observed a sharp increase in the ability of late-stage start-ups – traditional IPO candidates – to raise large amounts of private capital from investors at that time. Slow-changing factors, such as private firms' potential superior governance, would not have resulted in such immediate changes."

Thomas Chemmanur: "We also found support for the more abundant PE financing hypothesis, which we also believe was driven by deregulation and the end of the US blue sky laws [state-by-state laws against securities fraud]. Access to late-stage venture capital is so much greater now, so these unicorns don't need to go public and incur all the costs associated with that."

Gregory Brown: "There is no doubt that regulatory changes in the US and elsewhere did make it easier to

raise private capital. But just because you can do something doesn't mean it makes sense. There has to be an economic rationale behind it as well. And the evidence is that capital is going into venture and buyout funds because the returns have been superior."

Anne Glover: "Actually, I would invert the argument altogether. Deregulation is not material here. In the US, the Sarbanes-Oxley Act has added $1m to $2m annually to the cost of going public. No small company can withstand that. And in Europe, MiFID II has reduced sell-side research dramatically, while the Combined Code [in the UK] has made being the non-executive director of a small public company an extremely unenticing prospect. We have regulated our way against attracting talent to the boards of public companies. So, I would say that it is increased regulation that has kept companies private, rather than deregulation."

Thomas's paper suggests that the quality threshold for public companies has increased since 2000. Do you think that is the case, and how relevant might that be to this debate?

Thomas Chemmanur: "We found a greater sensitivity to product market competition in firms going public since 2000 – only stronger firms with better business models have chosen to list since then. The evidence we have to support this is firms that have gone public since 2000 have had greater total factor productivity on average, compared with those that went public previously."

Anne Glover: "Quality is an interesting term, though. Start-ups can be high quality but might have losses. And if you are looking at quality in terms of simple measures of productivity, such as revenue per employee, that is misleading. Google and Microsoft have incredibly high revenue per employee and therefore incredibly high profitability. But a start-up or growth company may not. The whole point is that you are investing in the creation of wealth, and that is not the same thing as productivity. Productivity is a function of scale and misses innovation completely."

"WE HAVE REGULATED OUR WAY AGAINST ATTRACTING TALENT TO THE BOARDS OF PUBLIC COMPANIES... IT IS INCREASED REGULATION THAT HAS KEPT COMPANIES PRIVATE, RATHER THAN DEREGULATION"

Anne Glover
Amadeus Capital Partners

Joan Farre-Mensa: "Some commentators are claiming the opposite: they argue that by trying to incentivise more companies to go public – by reducing disclosure requirements for smaller listed companies, for example – we could be degrading the protections that public offerings provide. Indeed, commissioner Allison Herren Lee of the Securities and Exchange Commission recently argued that, if we stay on this path, we may see a continued decline in both the quantity and quality of public offerings, to the detriment of all investors."

Gregory Brown: "Has the threshold for going public increased, or are these companies better positioned to remain private? It is hard to say for certain, but I do think there is evidence to refute the quality threshold claims. What about special purpose acquisition companies [SPACs]? People are just throwing money into the market for what is essentially a blind investment. That's not low quality; it's completely unknown quality. And if you look at some of the Chinese companies that have been able to raise substantial sums of money in the US, despite inferior transparency, that doesn't support this hypothesis either."

How does the rise in SPACs inform this debate?

Anne Glover: "Originally, public markets were used to form capital – to do IPOs. Today, 99% of trading is in the secondary market. That's what has led us to this fascinating phenomenon of the SPAC. Capital raising is now so difficult, even in the US, that backable teams are raising capital and then going on the hunt for acquisitions. It is just a way of short-cutting the whole IPO process, which has become extremely painful."

Can you foresee anything that would slow or change the direction of this trend from public to private ownership?

Anne Glover: "More appropriate regulation of public markets. I am spending a lot of my time on exactly this point because, even if only 10% of our companies go public, it is of massive benefit to underlying investors when high-potential businesses list and to the domestic economy where they list, because it keeps that company and that leadership at home."

Thomas Chemmanur: "Regulation is certainly one answer. The JOBS Act – or Jumpstart Our Business Startups Act – in the US, was designed to do just that, by relieving the regulatory and transparency burden of going public for smaller companies. The evidence of success, however, is mixed. The alternative is to reduce the cost of going public, possibly in the form of the direct listings we have seen from the likes of Spotify and Slack."

Joan Farre-Mensa: "If disclosure requirements and other regulations that apply to public companies were extended to private companies, that could make all the difference. For example, if the Sarbanes-Oxley Act were to be applied to private companies, that could reduce the appeal of remaining private. So, anything that makes private companies look more like public companies could eventually slow the trend."

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Joan Farre-Mensa
The University of Illinois at Chicago

David Layton: "But I think the phenomenon of governance correctness has become so entrenched it is likely to persist for the foreseeable future. If private markets fail to meet broadening needs for environmental, social and governance considerations and stakeholder impact, that could possibly slow the trend. But in fact we are seeing real progress on that front, and as long as that continues, I think the shift towards private ownership will persist."

Finally, does it matter that there are fewer public companies if PE has the capital and skills to build strong businesses?

Gregory Brown: "Personally, I think it's fine. The economy is evolving, and it is not clear to me that small companies, where almost all of the decline in public ownership has taken place, are better served by public markets. So, economically, we could be better off with more private companies. Certainly, there is productivity research to suggest that this is the case.

"One challenge we do face, however, is who has access to those private investments. At the moment, PE is available only to institutional investors and the very wealthy, and it seems unfair to tell ordinary citizens that they cannot have access to the highest-returning investments."

David Layton: "I agree. If a larger and larger share of the economy – and increasingly the most compelling, best-governed, and best-returning situations – is owned in the private markets, then I think society has to wrestle with the lack of access that ordinary people currently have to those investment opportunities."

Anne Glover: "But PE is not a long-term holder of businesses. It is very good at transitions – restructurings or high growth spurts. It is not good at long-term sustained planning.

"For example, companies like BP and Shell that operate in climate-sensitive sectors are having to plan far into the future. Yes, they need to deliver short-term performance, but scenario planning needs to be long term.

"I think for some of the big problems we are facing in the world today, public ownership is the right answer."

Joan Farre-Mensa: "Society is putting a lot of effort into making sure public companies behave in a certain way. Take, for instance, the recent board diversity requirements passed in California. If more and more of the economy remains in private markets, those regulations will apply to a smaller and smaller set of companies – not necessarily a good or a bad outcome, just a matter of fact.

I also agree about this issue of investor access. Not only are more companies now unlisted, making it hard for retail investors to invest directly, but more pension plans are now defined contribution, which, unlike defined benefit plans, rarely allocate assets to PE."

Roberto Quarta: "I think having a healthy public market matters because, ultimately, PE has to exit. We are transitional owners, as Anne says. We buy businesses, make them better and then exit in some form. That will typically involve the public markets at some stage.

"Of course, that listed company may then be taken private once again, for all sorts of reasons. Then we see the story come full circle and we begin again."

"HAVING A HEALTHY PUBLIC MARKET MATTERS BECAUSE, ULTIMATELY, PE HAS TO EXIT. WE ARE TRANSITIONAL OWNERS"

Roberto Quarta
Clayton, Dubilier & Rice

THE RESEARCH

Three separate academic research papers attempt to explain the dramatic shift away from public company ownership structures in favour of private markets.

In *Public or Private? Determining the Optimal Ownership Structure*, Gregory Brown and Sarah Kenyon (University of North Carolina, Frank Hawkins Kenan Institute of Private Enterprise) and Andrea Carnelli (Pantheon) argue that there is a cost-benefit framework in which companies trade off the governance benefits of private equity ownership with the potential for a lower cost of capital in public markets when deciding on an ownership structure.

The authors note that public markets offer a large pool of capital and extensive risk sharing but can be expensive to access, inherently short-term in outlook, and can suffer from misalignment between management and shareholders. PE may not have the same depth and risk-sharing capabilities, say the authors, but it offers strong alignment that can overcome the governance issues of diffuse public markets.

The paper finds that companies pursuing complex strategies or requiring a long-term investment horizon benefit most from private ownership and argues that governance engineering by PE sponsors can explain the rise of private markets to the detriment of public ones.

Deregulation of Private Equity Markets and Decline in IPOs, by Joan Farre-Mensa (The University of Illinois at Chicago) and Michael Ewens (California Institute of Technology), takes a different approach. The paper explores how the deregulation of securities laws in the US, and in particular the National Securities Markets Improvement Act of 1996, increased the supply of private capital to late-stage start-ups, giving entrepreneurs more bargaining power and enabling companies to remain private for longer.

Meanwhile, *The Disappearing IPO Puzzle*, by Thomas Chemmanur (Boston College Carroll School of Management), Jie He and Xiao Ren (both of the Terry College of Business, University of Georgia), and Tao Shu (Chinese University of Hong Kong), investigates the decline in US IPOs since 2000. They find that abundant PE funding is keeping companies private, while also suggesting that the quality threshold has been raised for public companies since the year 2000.