Blurring Lines between Private and Public Ownership

Prof. Michelle Lowry

Drexel University, ECGI

Overview

- Decreases in numbers of publicly listed companies
- Increases in private co's
  - Including increases in VC-backed private cos
- What explains the dichotomy?
  - VC-backed co's increasingly get acquired
  - VC-backed co's stay private longer
- Result: Many private cos increasingly resemble public counterparts
  - Sources of capital
  - Corporate governance
  - Methods of growth
- What potential implications does this have?

'Blurring the Lines between Private and Public ownership', Michelle Lowry
Published in Handbook of Corporate Finance, David Denis, ed
Also available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4200794

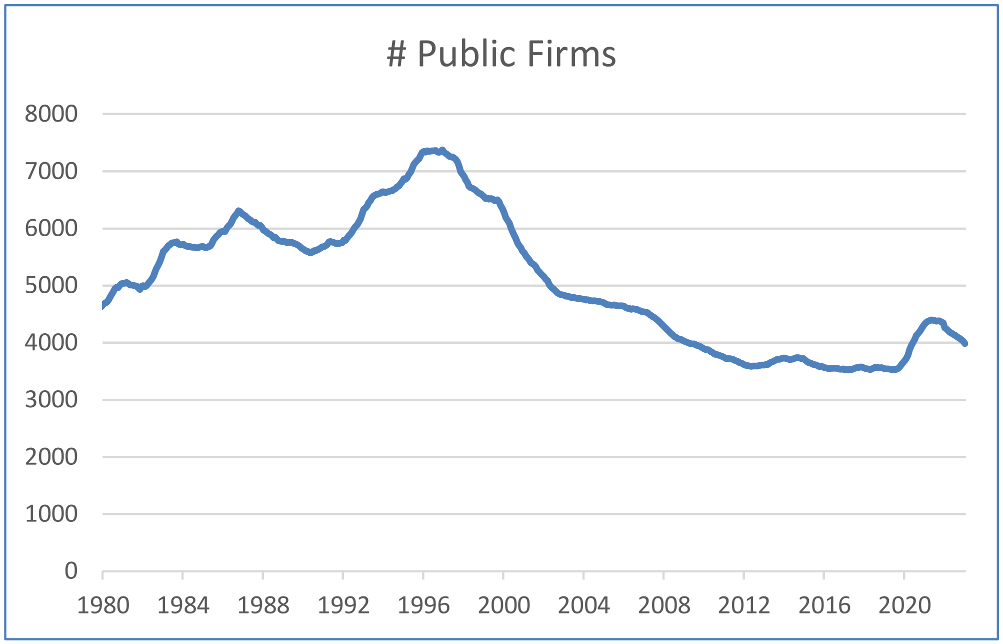
Outline

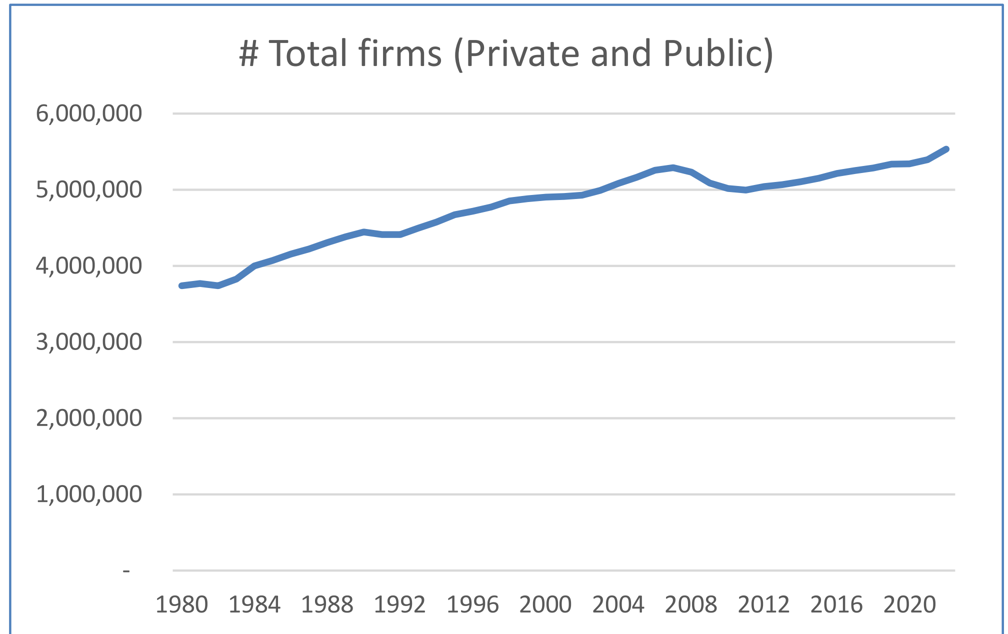
1. Numbers of public vs private co's over time
2. Capital raising
3. Corporate governance
4. Inorganic growth

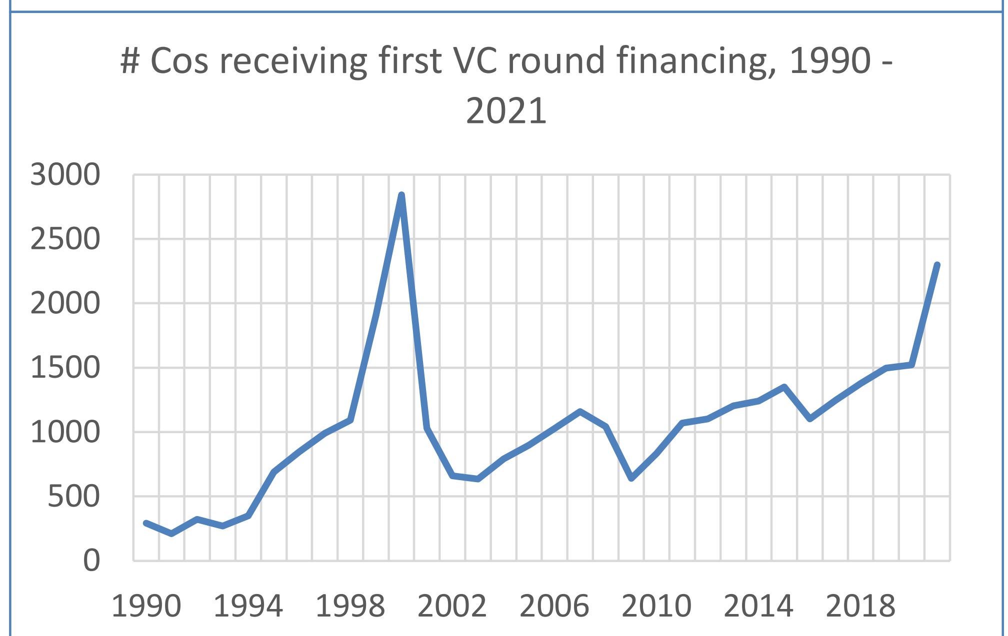
Blurring lines between private and public firms

5. Implications of these types of firms being private

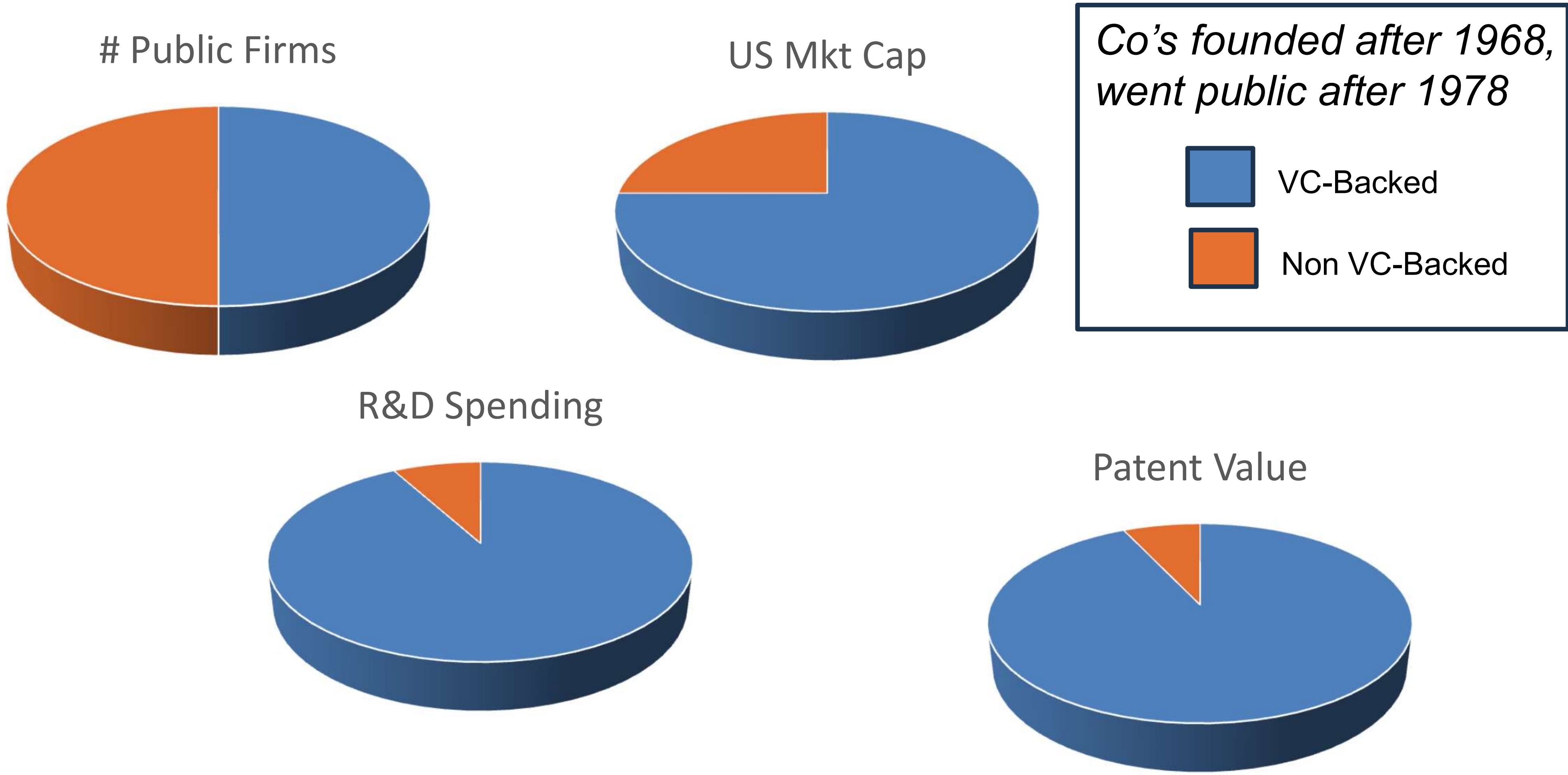
Number of Public Firms: 1980 - 2023







Historically, VC-backed private firms -> public firms



Gornall and Strebulaev (2021), The economic impact of venture capital: evidence from public companies.

Where does this leave us?

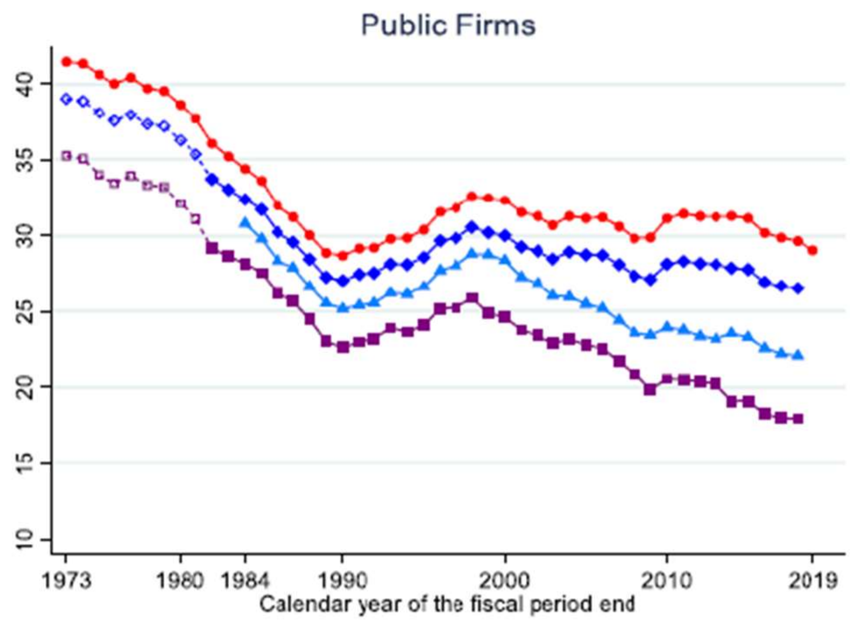
- VC-backed companies are a key source of
  - Growth
  - Innovation
  - Value

- Fewer of these companies are going public
  - Some are getting acquired
  - Many are simply staying private longer and longer

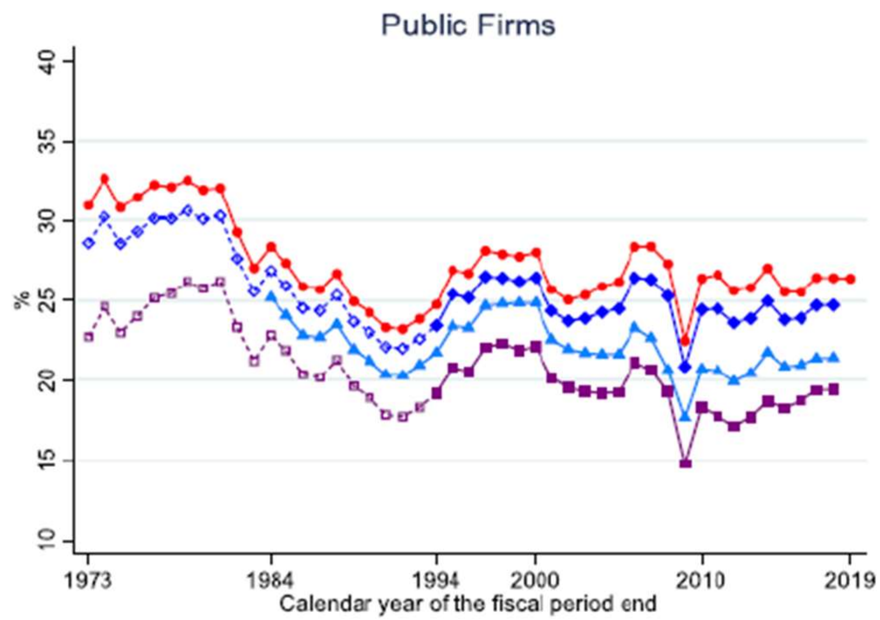
- What do these ‘still private companies’ look like?
  - They are larger and older
  - How different are they than their public counterparts?
  - What implications does this have?

The waning economic importance of public firms

Panel A: Employees as a percentage total nonfarm payroll employment (1973–2019)



Panel B: Value added as a percentage of U.S. nominal GDP (1973–2019)



Schlingemann and Stulz (2022), Have exchange-listed firms become less important for the economy? Journal of Financial Economics

LOTS of attention on why fewer public firms

WSJ OPINION

Where Have All the Public Companies Gone?

THE WALL STREET JOURNAL.

Fewer Listed Companies: Is That Good or Bad for Stock Markets?

The New York Times

The Stock Market Is Shrinking. That's a Problem for Everyone.

FINANCIAL TIMES

US has fewer listed public companies than China

LOTS of attention on why fewer public firms

PRIVATE OR PUBLIC EQUITY?
THE EVOLVING ENTREPRENEURIAL FINANCE LANDSCAPE

Michael Ewens
Joan Farre-Mensa

Where Have All the IPOs Gone?

Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu*

Public versus Private Equity

René M. Stulz

Dissecting the Listing Gap: Mergers, Private Equity, or Regulation?*

Gabriele Lattanzio
William L. Megginson
Ali Sanati

The Deregulation of the Private Equity Markets and the Decline in IPOs

Michael Ewens
California Institute of Technology

Joan Farre-Mensa
University of Illinois at Chicago

The Disappearing IPO Puzzle: New Insights from Proprietary U.S. Census Data on Private Firms *

Thomas Chemmanur
Jie (Jack) He
Xiao (Shaun) Ren
Tao Shu

The U.S. listing gap☆

Craig Doidge[a], G. Andrew Karolyi[b], René M. Stulz[c,d,e,*]

Why do firms choose to stay private?

1. Increasing availability of capital to private firms
2. Confidentiality concerns for young, high R&D co's
3. Public firms' greater sensitivity to product mkt competition
4. Increased regulatory requirements of public firms

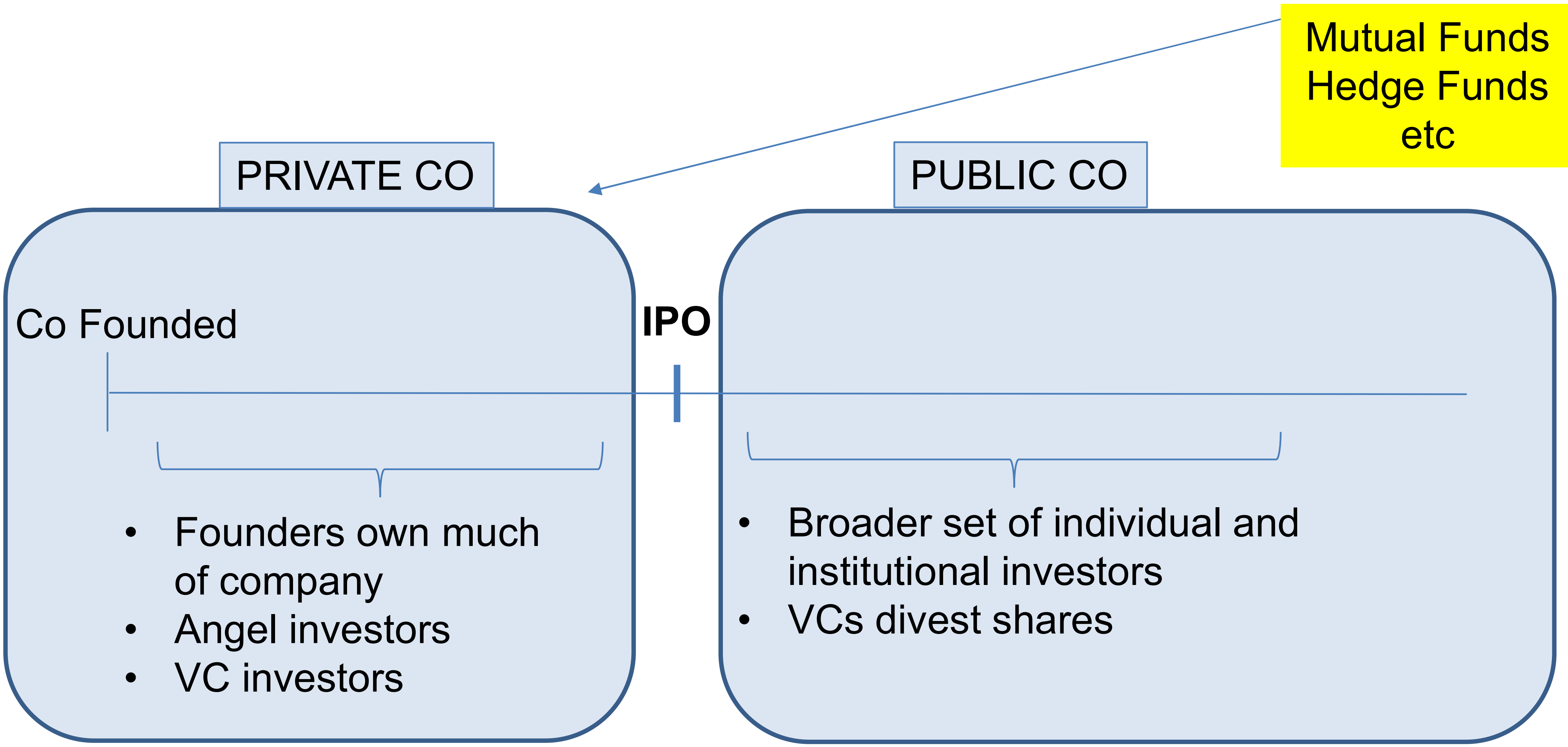
Ewens and Farre-Mensa (2020, 2022), Chemmanur, He, Ren, Shu (2022); Stulz (2020); Doidge Karolyi and Stulz (2017), Gao, Ritter and Zhu (2013); Ewens, Xiao and Xu (2022)

Outline

1. Numbers of public vs private co's over time
2. Capital raising
3. Corporate governance
4. Inorganic growth
5. Implications of these types of firms being private

Blurring lines between private and public firms

Private vs Public Companies – sources of capital

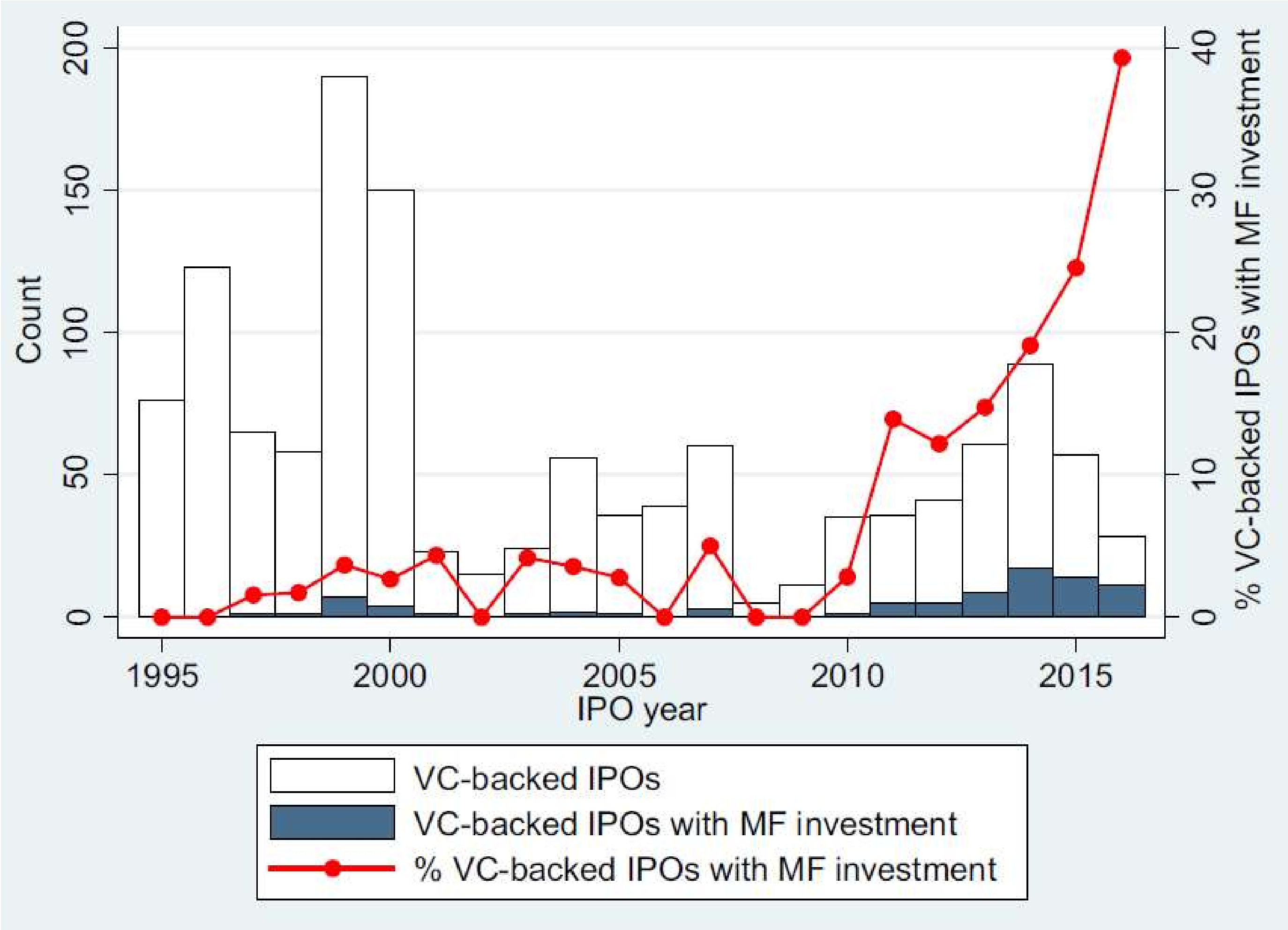


Typical characterization of financing, by private vs public cos

This characterization is overly simplified / somewhat outdated

Private firms raising capital from investors who traditionally focused on public firms

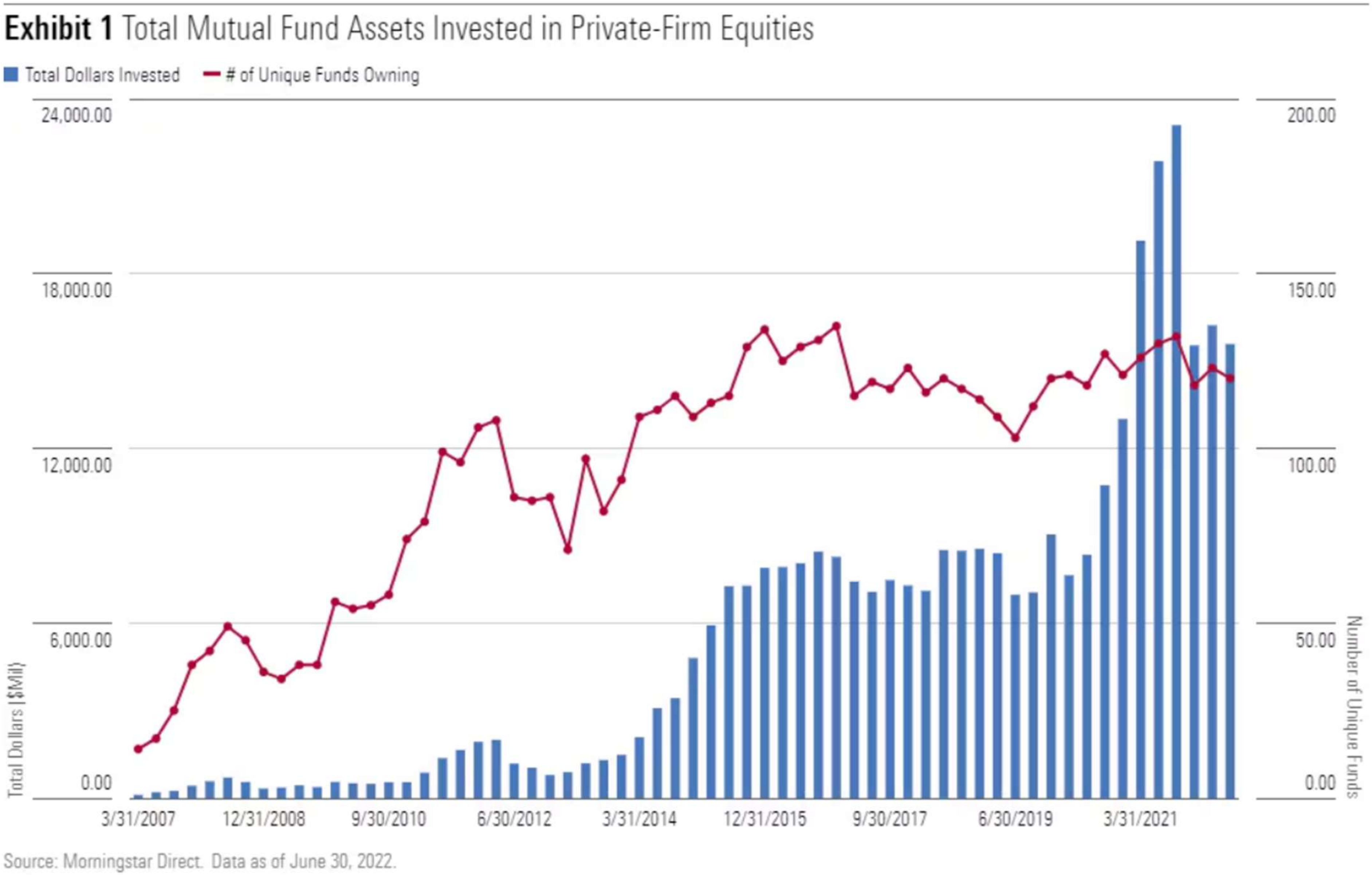
- Increasingly common for mutual funds to invest in private firms



As of 2017, nearly 40% of VC-backed IPOs had mutual fund investment prior to going public

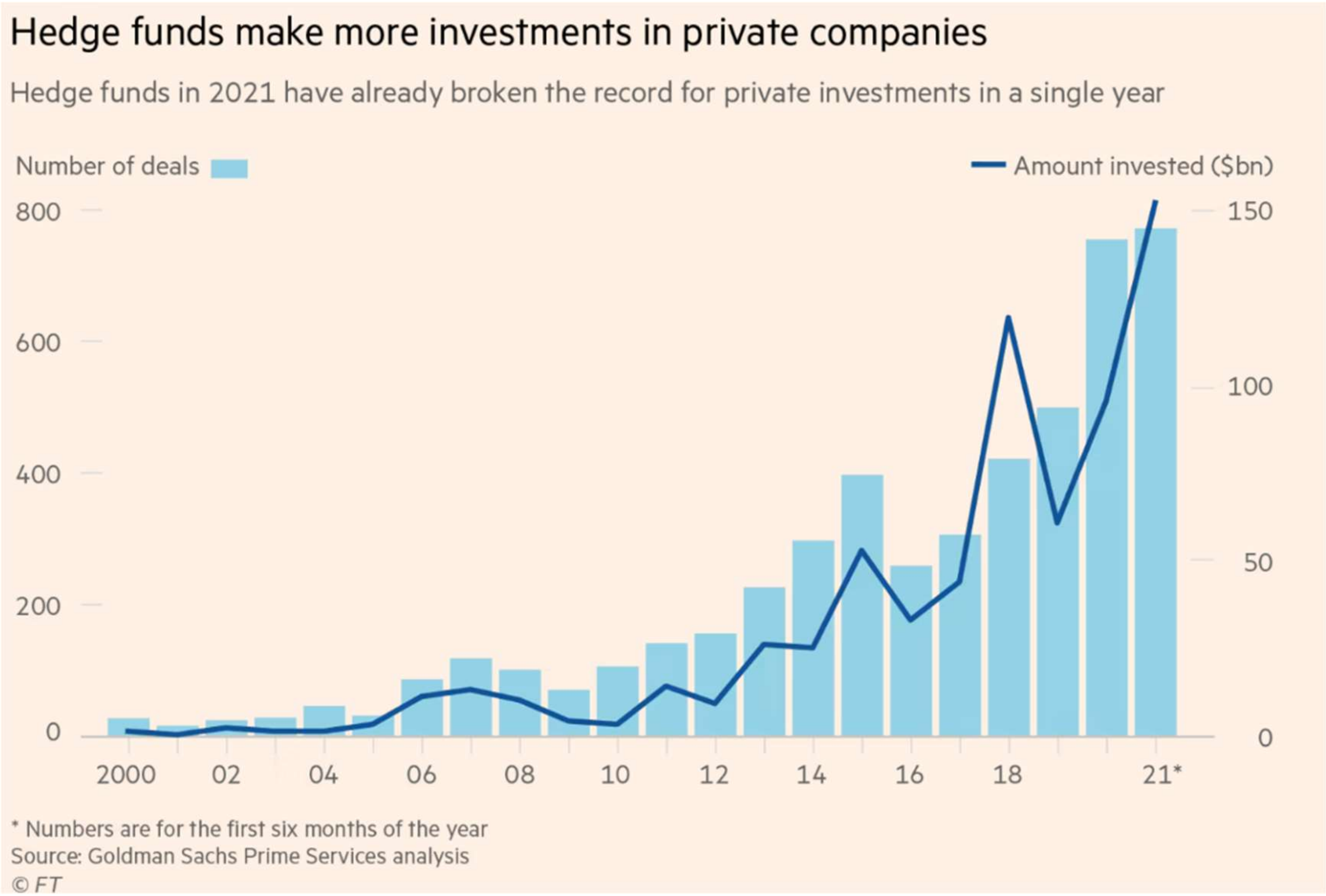
Kwon, Lowry, Qian (2020), Mutual fund investments in private firms, Journal of Financial Economics

Private firms raising capital from investors who traditionally focused on public firms



Private firms raising capital from investors who traditionally focused on public firms

- Hedge funds also invest in private firms



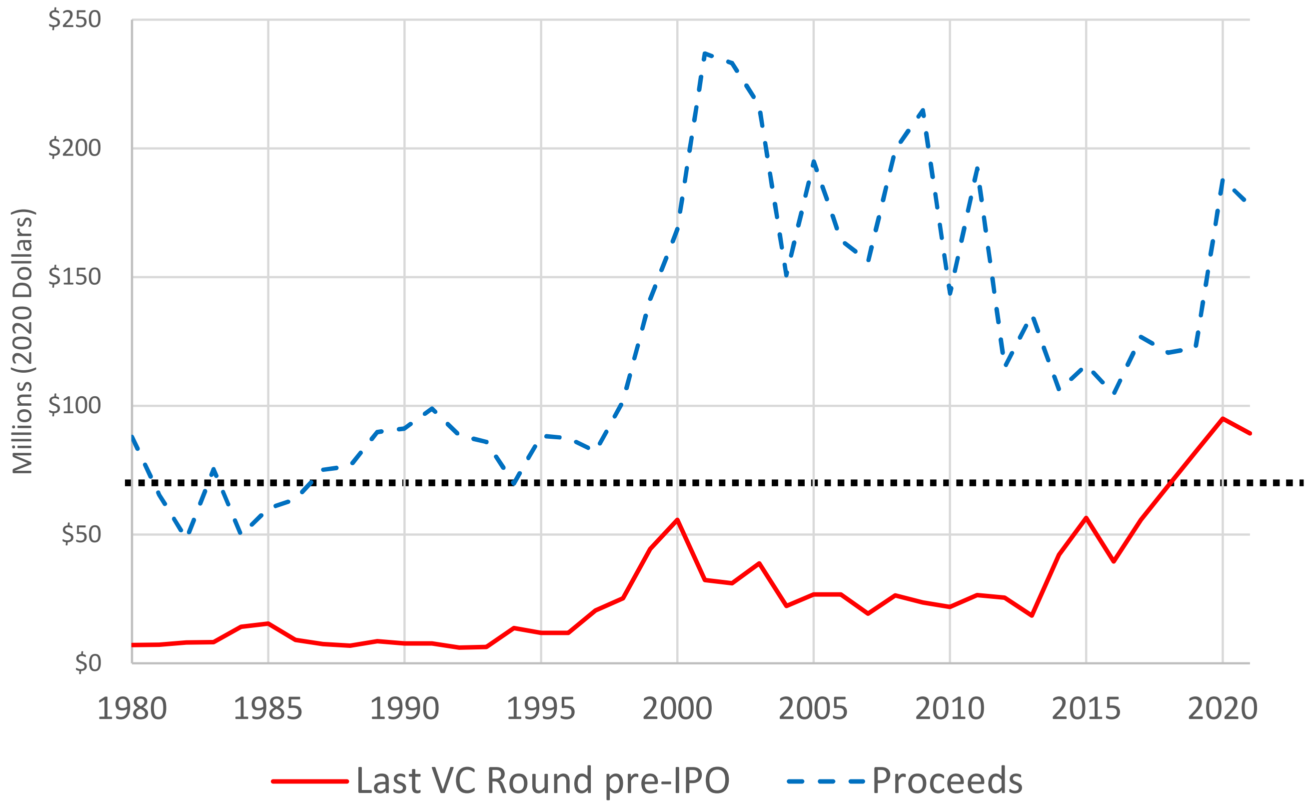
See also Aragon, Li and Lindsay (2023), Exploration or Exploitation: Hedge Funds in Venture Capital

Effects of increasing MF and HF invts in private firms

- As mutual funds and hedge funds have increasingly invested in private firms
  - These private firms have found it easier to raise more capital

- The size of pre-IPO Venture Capital backed financing rounds
  - Has increased dramatically

Size of last VC round versus IPO proceeds



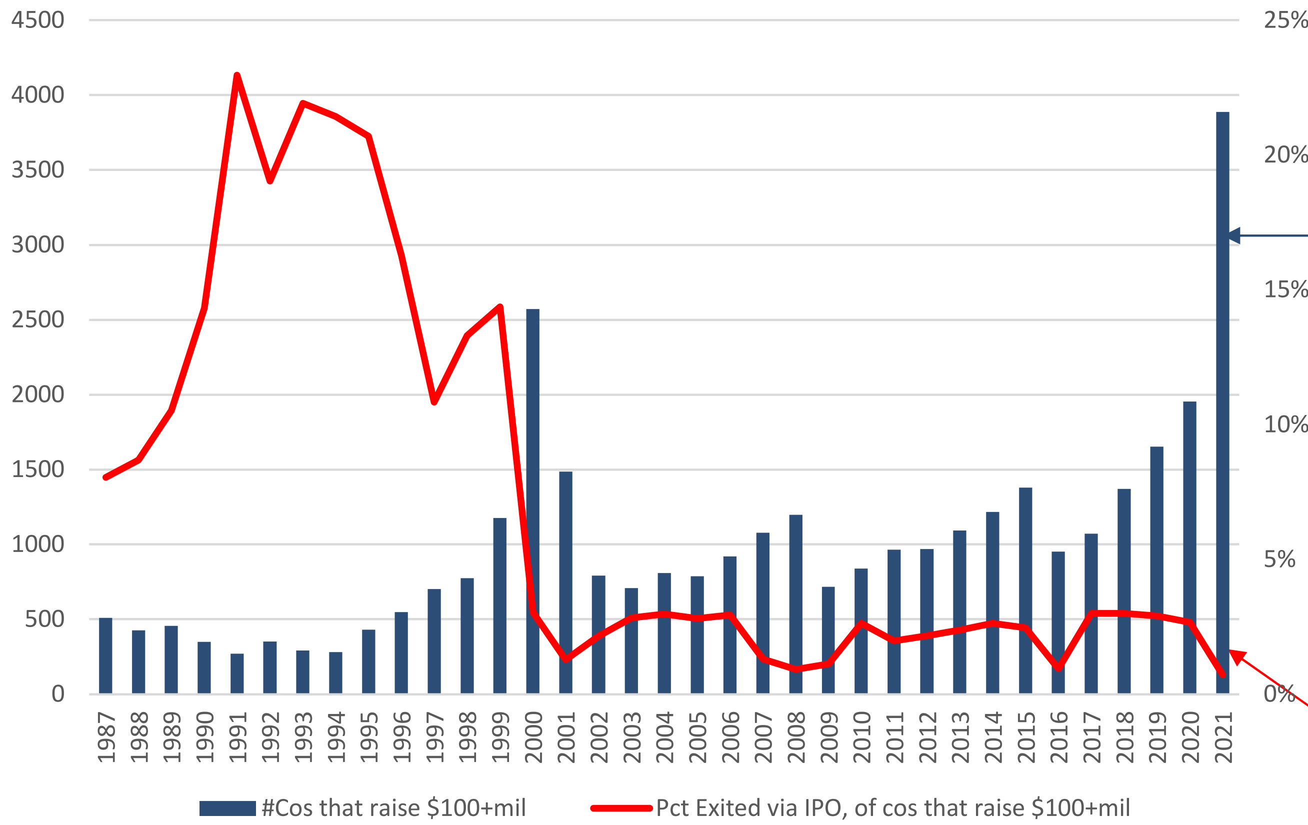
These alternative sources of capital have contributed to private co's raising more money (without going public)

Median size of last pre-IPO VC round today
>
Median proceeds raised in IPOs through mid 90s

Many firm types that were public in earlier years
Are now private

Co's are raising a lot of $ - but not going public

Another perspective: Firms are raising increasing amounts of money
But they are still not going public



Increasing # of private co's are raising > $100 mil within 7 years

But decreasing % of these co's are going public (within 7 yrs)

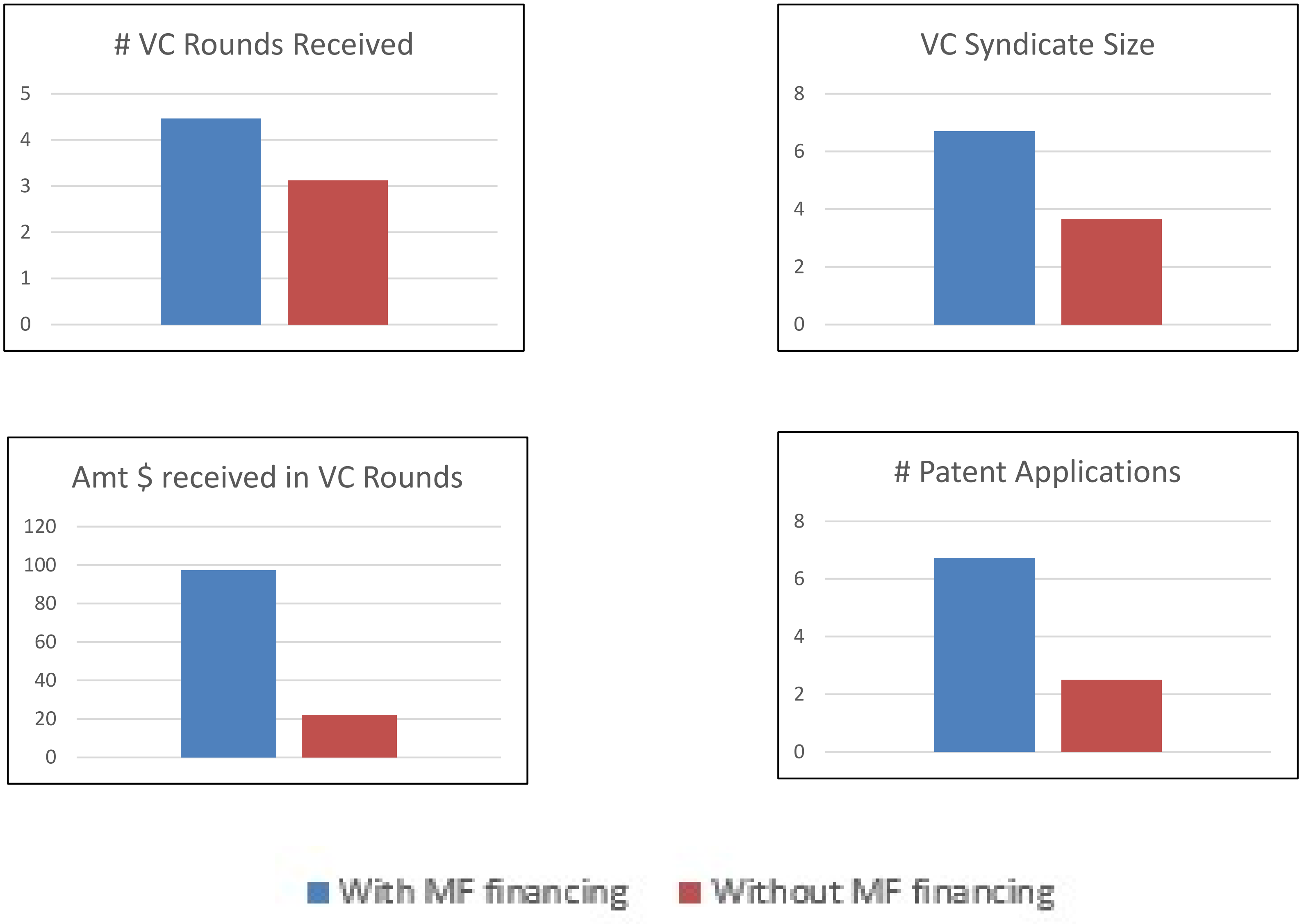
Updated version of stats in Ewens and Farre Mensa (2020)

Why are MFs, HFs, etc investing in private firms? A chicken and egg view of things

- The availability of more capital to private firms
  - Enables firms to stay private longer
  - Enables firms to grow and mature more, prior to going public

- The fact that companies grow and mature more, prior to going public
  - Increases the willingness of non-traditional investors to invest

Types of companies in which mutual funds invest



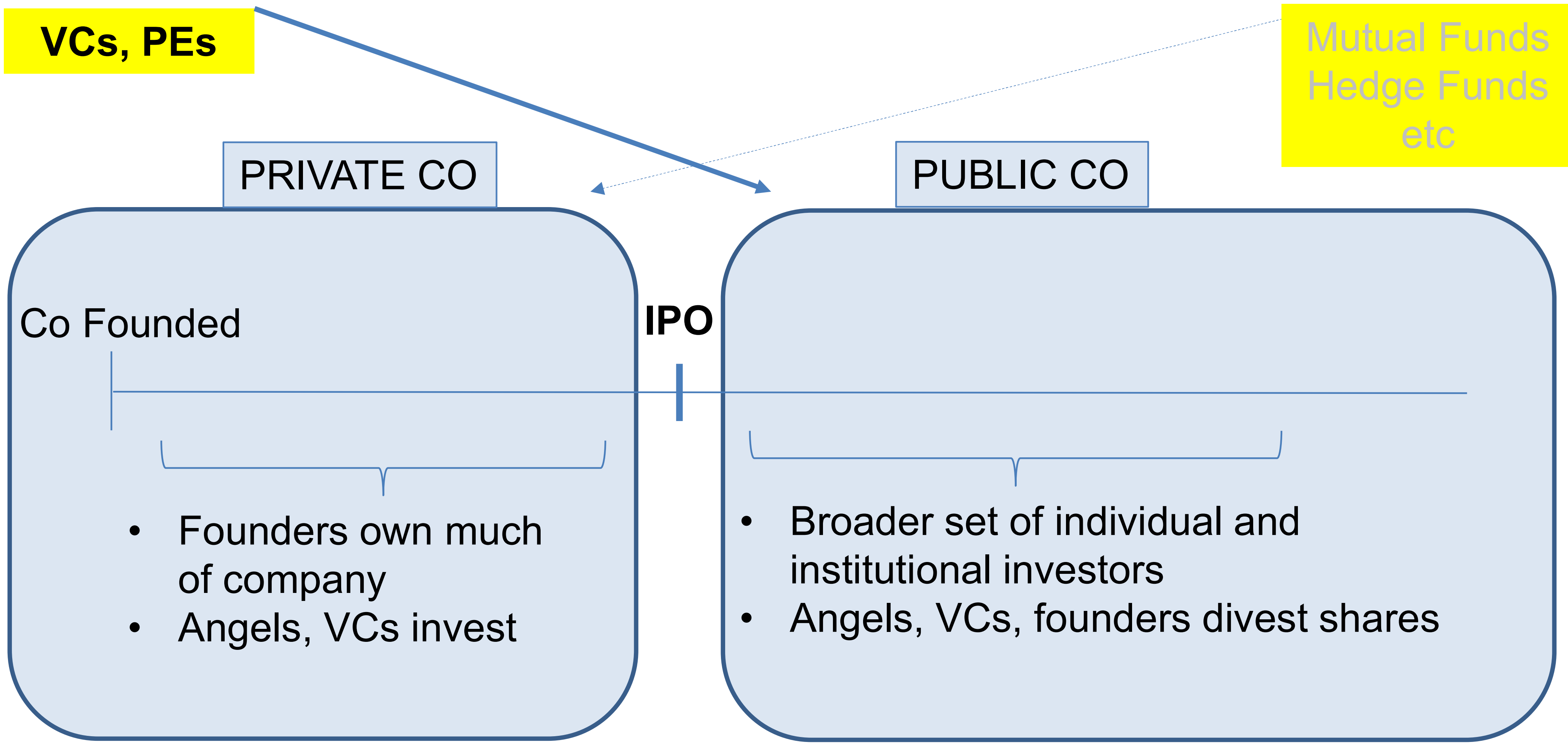
Kwon, Lowry, Qian (2020)

Summary to this point

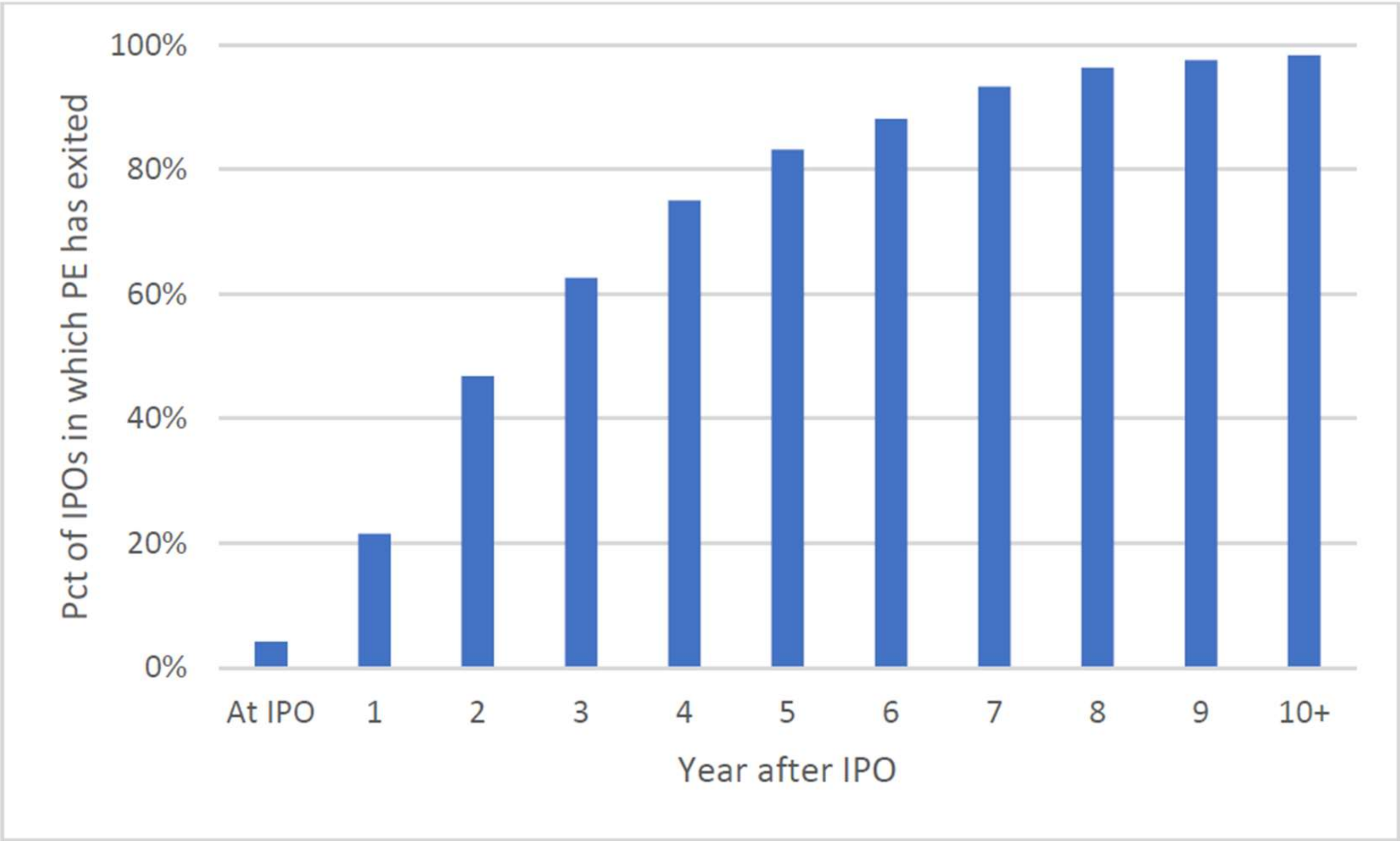
- Many firms today that are private
  - Are larger and have raised more money than public co's in 1990s
  - Moreover, many of these private firms also have relatively disperse investor bases
    - Mutual funds, hedge funds, etc.

- Along many dimensions
  - Late-stage private firms are similar to public firms
  - (or at least more similar than they were in 1990s)

Part 1:
Private vs Public Companies – sources of capital



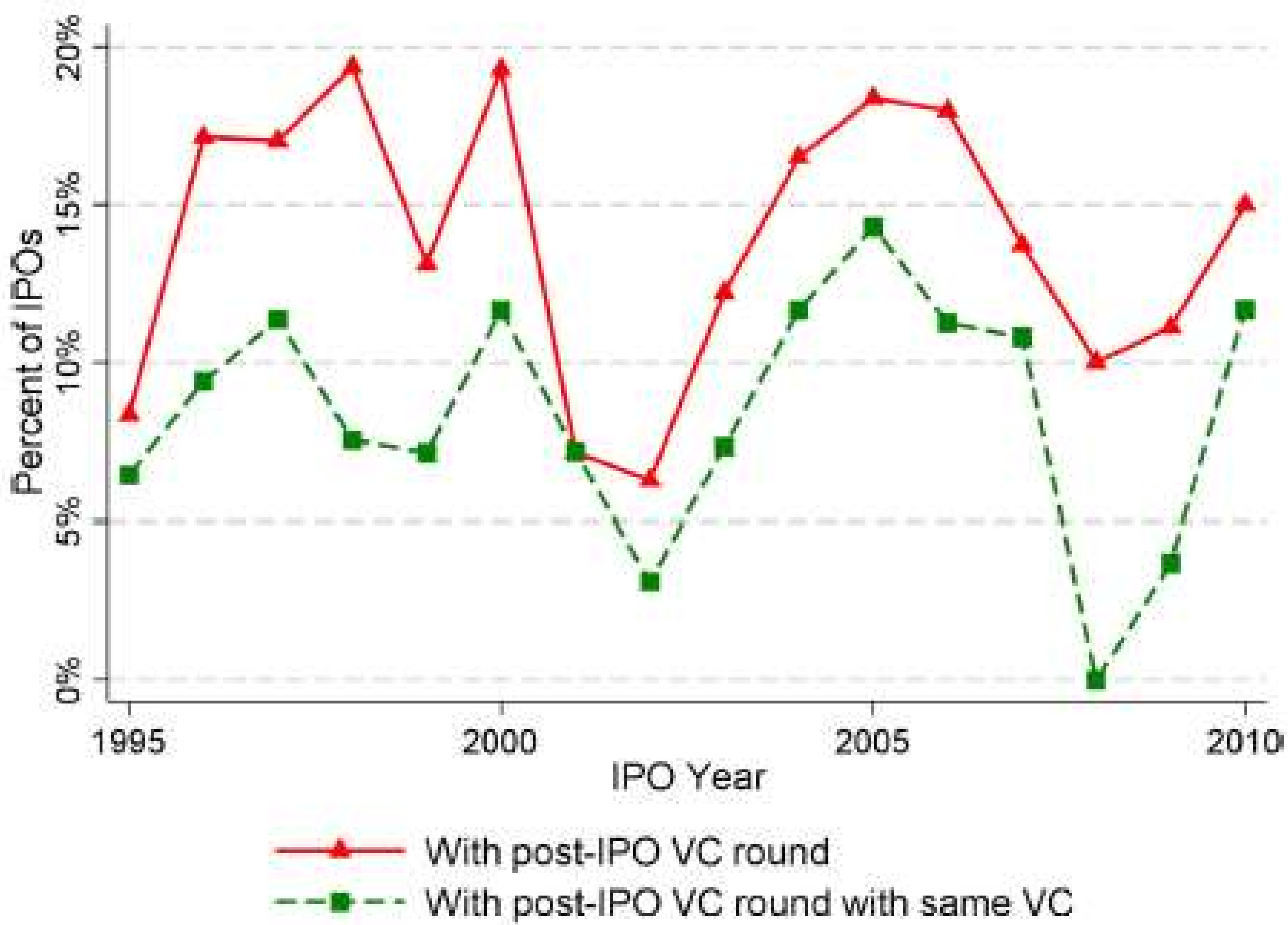
Pre-IPO Investors – holding on for a long time



In ¼ of PE-back IPO firms:
Pre-IPO PE investors still hold ~30% (on average) of shares 6 years after IPO

Jones, Jenkinson and Rauch (2022), Long good-byes: How do Private Equity Funds Manage Sell-Downs after Initial Public Offerings

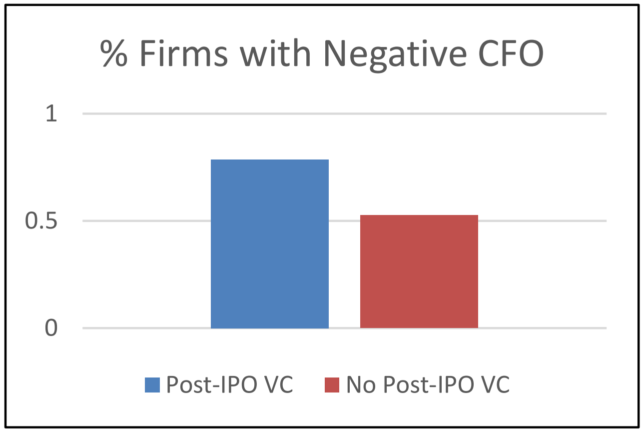
Pre-IPO Investors – investing MORE after the firms go public

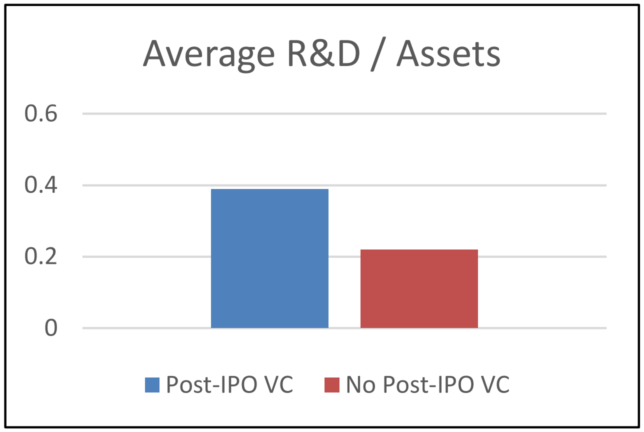


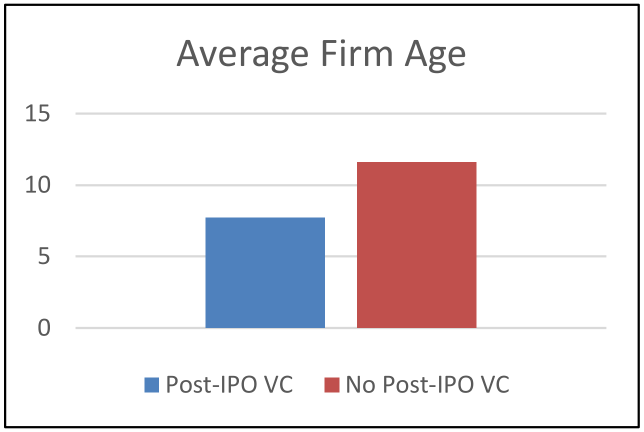
Sample of VC-backed IPOs: VCs invest additional money after IPO in 15 - 20% of cases

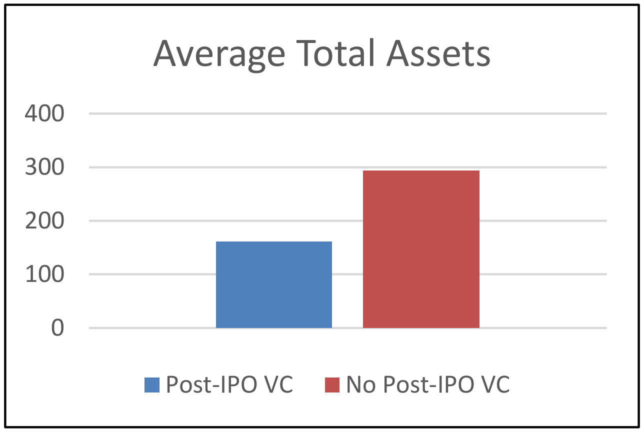
Iliev and Lowry (2020), Venturing Beyond the IPO: Financing of Newly Public Firms by Venture Capitalists

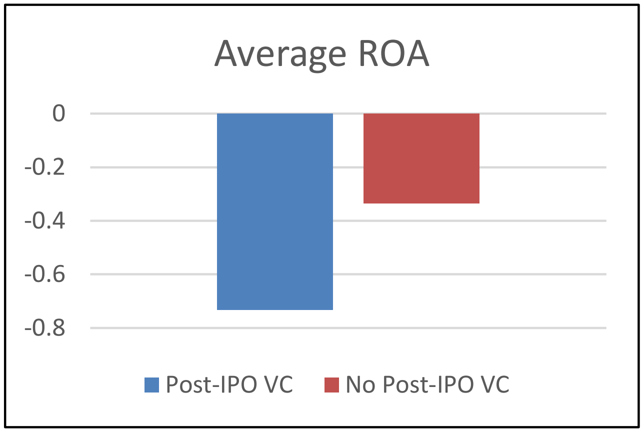
Types of public firms in which VCs invest









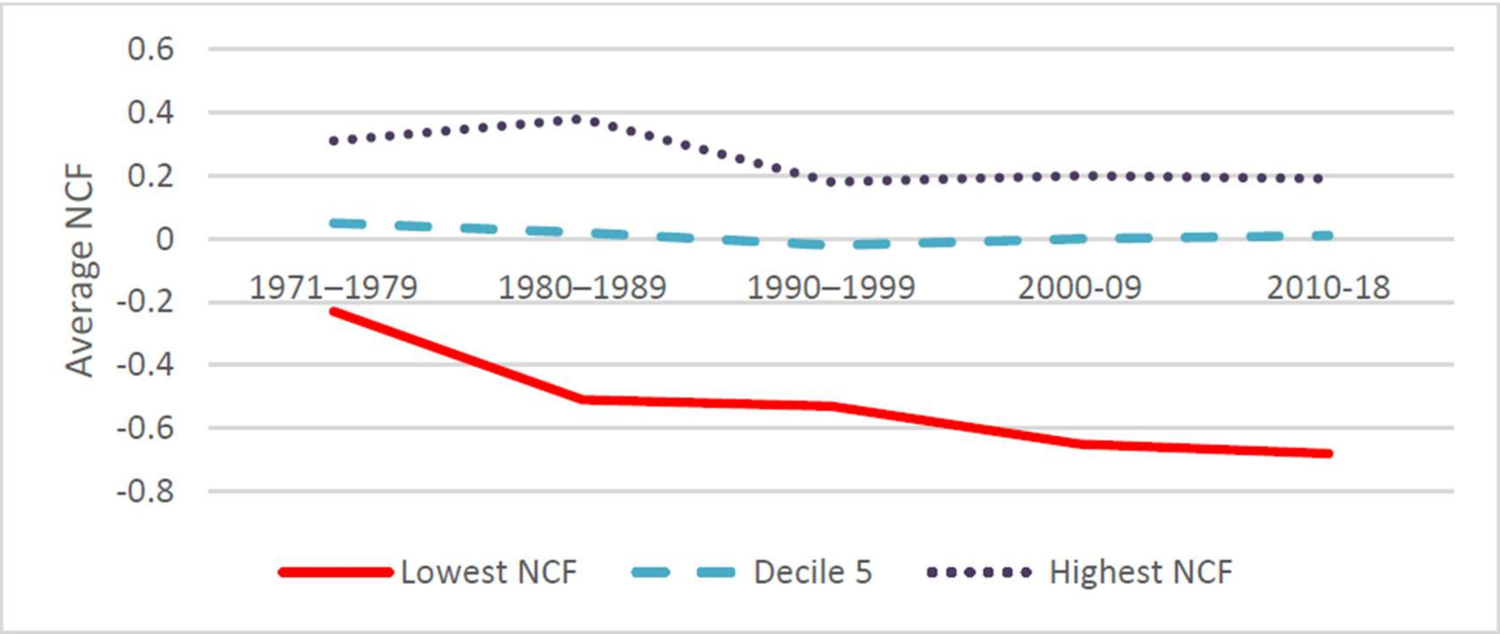


Just as MFs invest in private firms that were 'more similar' to public firms, VCs invest in public firms that are 'more similar' to private firms

Iliev and Lowry (2020)

More generally, looking across public firms

Panel A: Average NCF across each NCF decile



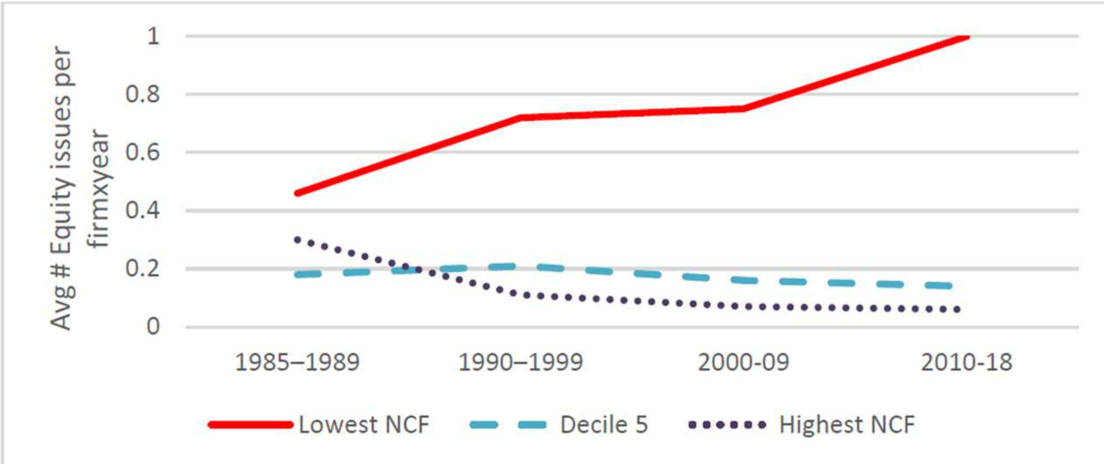
Public firms increasingly characterized by high negative Net Cash Flows,

Harder to assess ‘true value’ of such firms

Denis and McKeon (2021), Persistent negative cash flows, staged financing, and the stockpiling of cash balances. Journal of Financial Economics

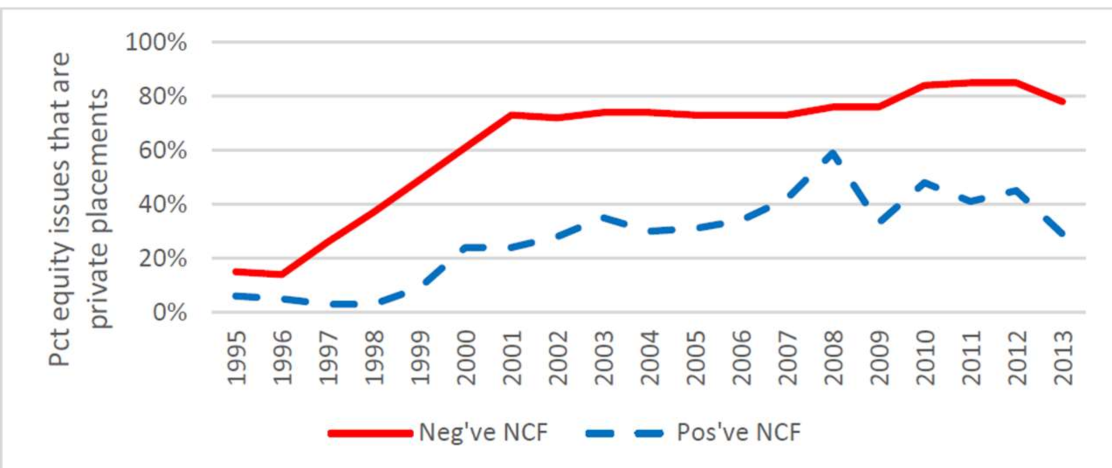
More generally, looking across public firms

Panel B: Average number equity offerings per firm year, across each NCF decile



These firms with negative NCFs are increasingly raising equity

Panel C: Percent equity issues that are private placements



BUT … these equity offerings are increasingly private placements

Summary of evidence to this point

- Mutual funds (who typically invest in public firms)
  - Increasingly investing in private firms

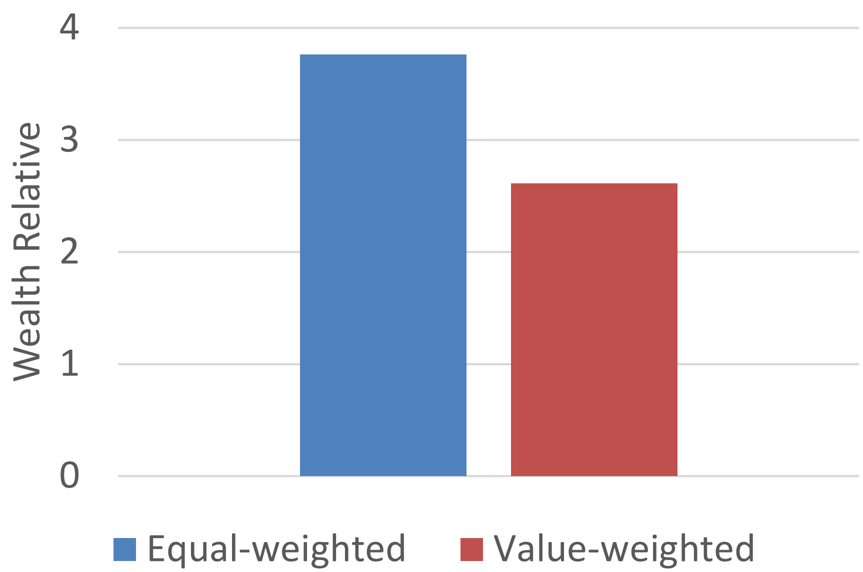
- Venture capitalists (who typically focus on private firms)
  - Also invest in firms after they go public

- Public firms increasingly characterized by firms w negative NCFs
  - These firms increasingly raise equity in form of private placements

- What motivates such investments?? - a look at investors' returns

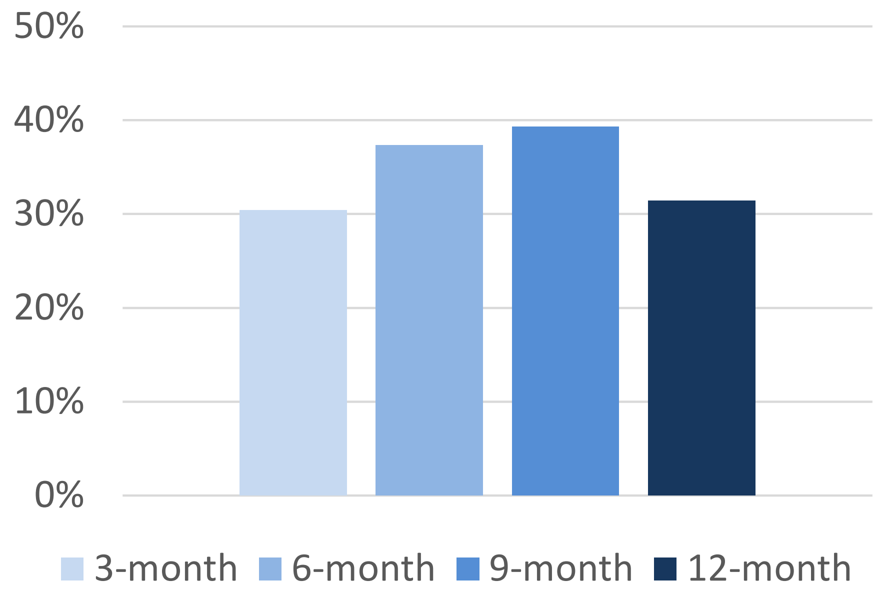
Do the intermediaries benefit, from investing in different classes of firms?

MFs' returns to investing in private firms



Mutual Funds earn 2.5 – 3.7 times as much in their private firm investments, as in a market-wide index

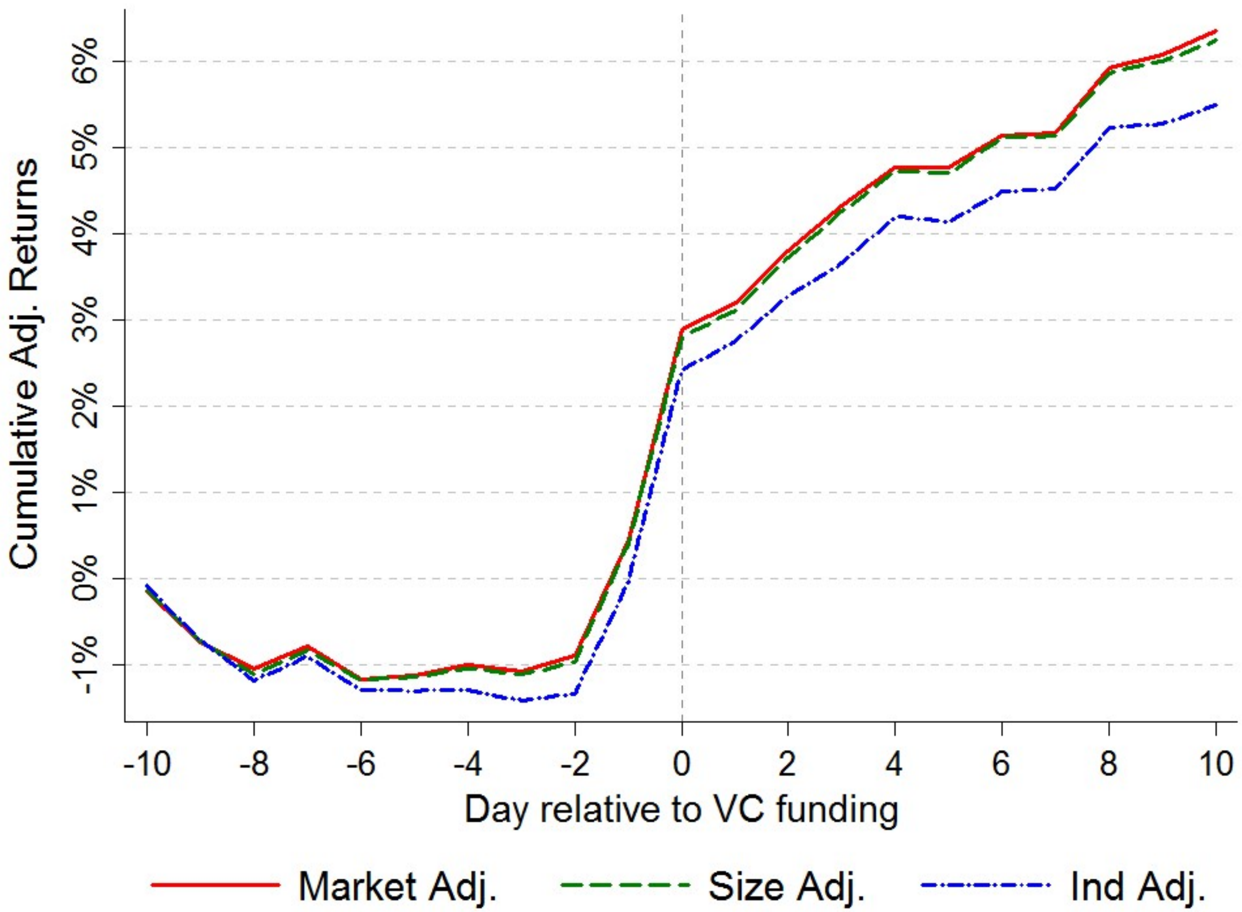
VCs' returns to investing in public firms



Venture capitalists earn 30 – 40% abnormal returns, over the 3 – 12 months following an investment in a public firm

Do the underlying firms (and their investors) benefit?

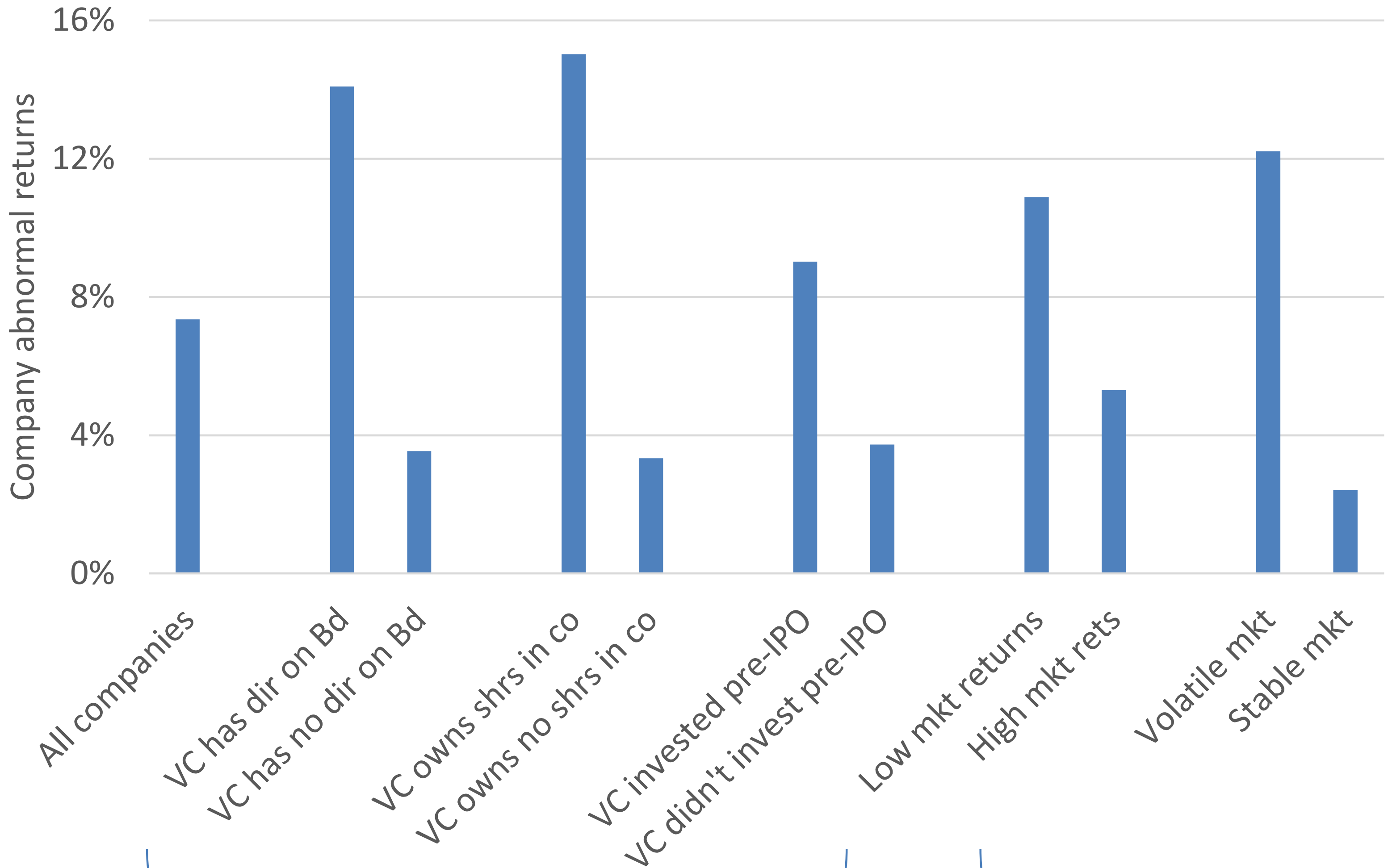
Daily returns around Post-IPO VC Financing dates



Public firms who receive VC investments:

Earn 3 – 6% Abnormal returns in days around announcement of these financings

Do the underlying firms (and their investors) benefit? In what cases do they benefit the most?

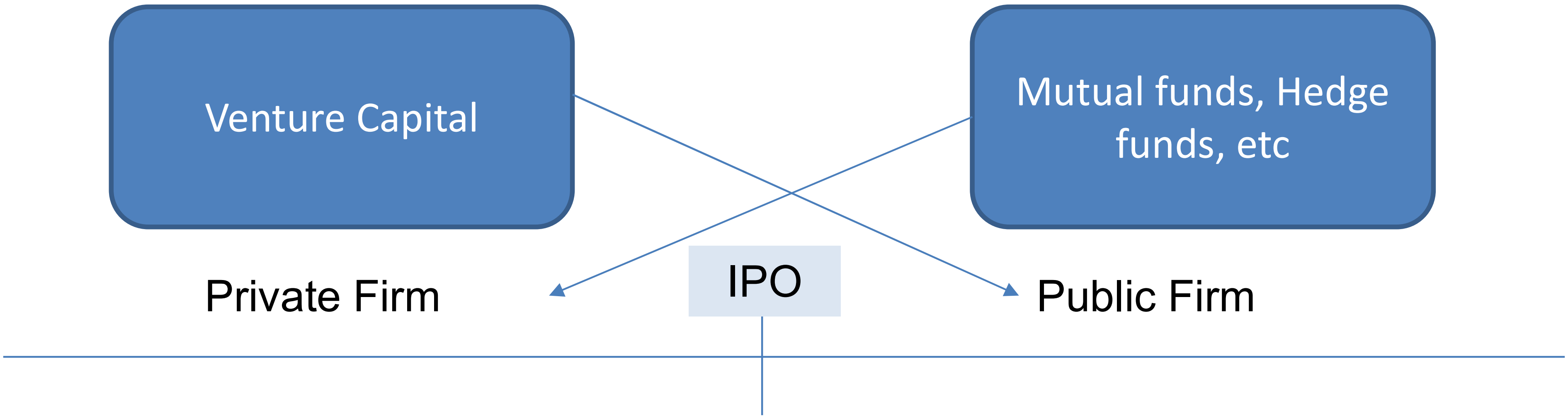


When investor (VC) has greater info advantage

When more uncertainty about firm value

Consistent with many public firms representing firms that are harder to value, e.g., co's with negative net cash flows

The blurring lines between private and public status: Sources of capital



Key statistics

1. Almost 40% of VC backed IPOs had mutual fund investment prior to going public (2017)
2. Many private VC-backed firms had hedge fund investment while still private
3. MFs benefit from these invts
4. Underlying firms benefit as well

Key statistics

1. >15% of VC-backed IPOs receive additional VC funding after going public
2. VCs benefit from these invts
3. Underlying firms benefit as well

Outline

1. Numbers of public vs private co's over time
2. Capital raising
3. Corporate governance
4. Inorganic growth
5. Implications of these types of firms being private

Blurring lines between private and public firms

How different are public vs private firms? Traditional Framework

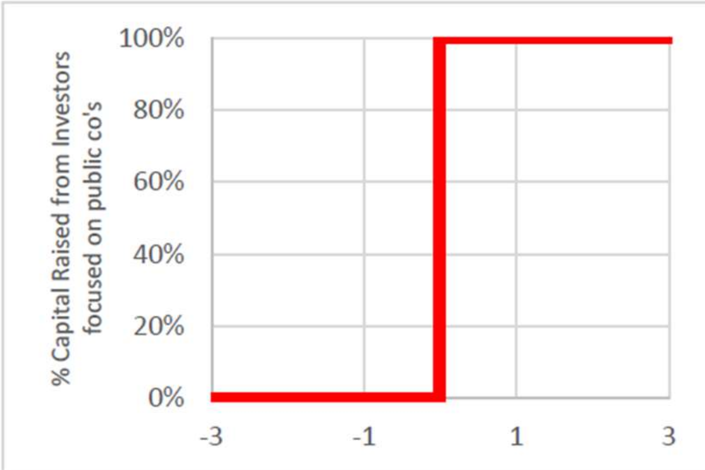
Private Firm	IPO	Public Firm

Different Governance structures?

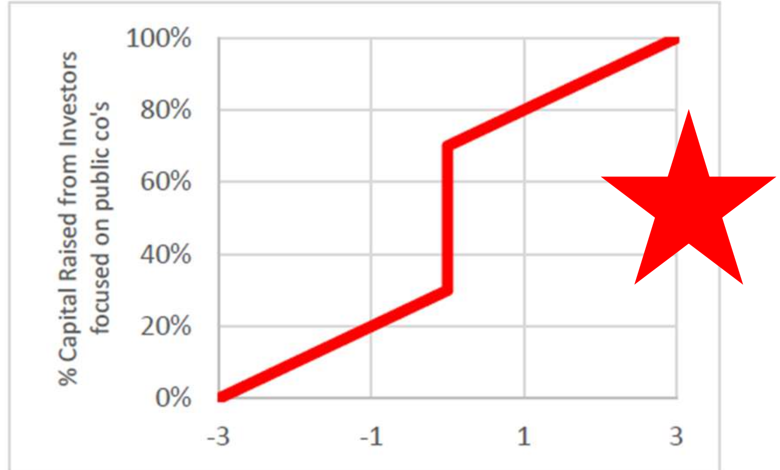
Private Firm	Public Firm
Close control -> little emphasis on formal gov'ce	Regulations + External investor pressure -> distinct governance structures

How different are public vs private firms?
Two alternative frameworks

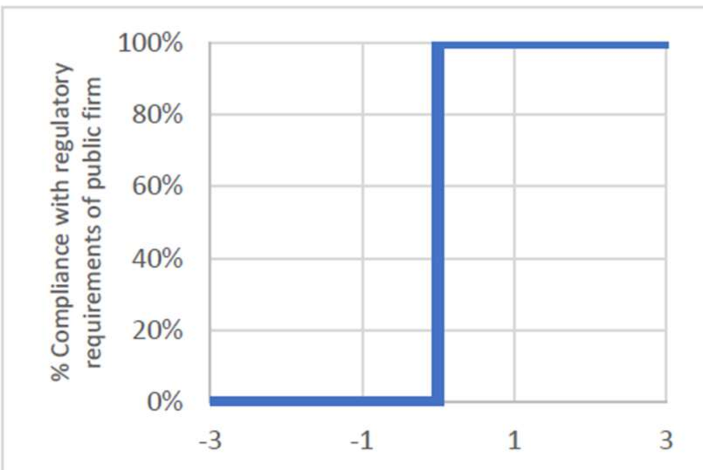
Panel A1: Sources of capital, Case 1



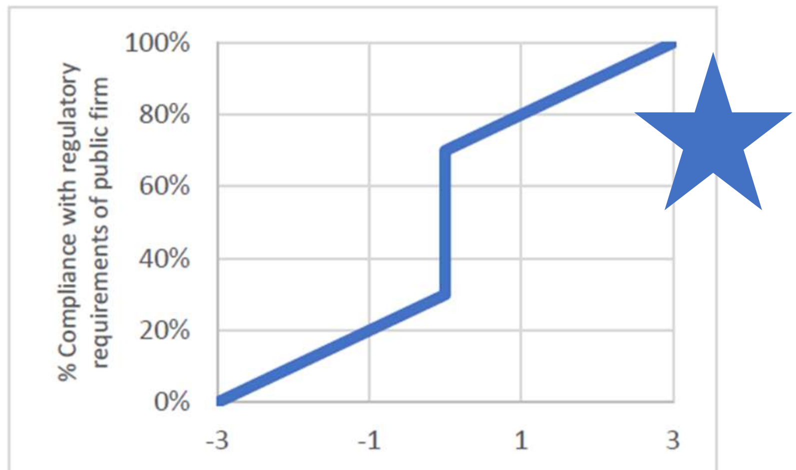
Panel A2: Sources of capital, Case 2



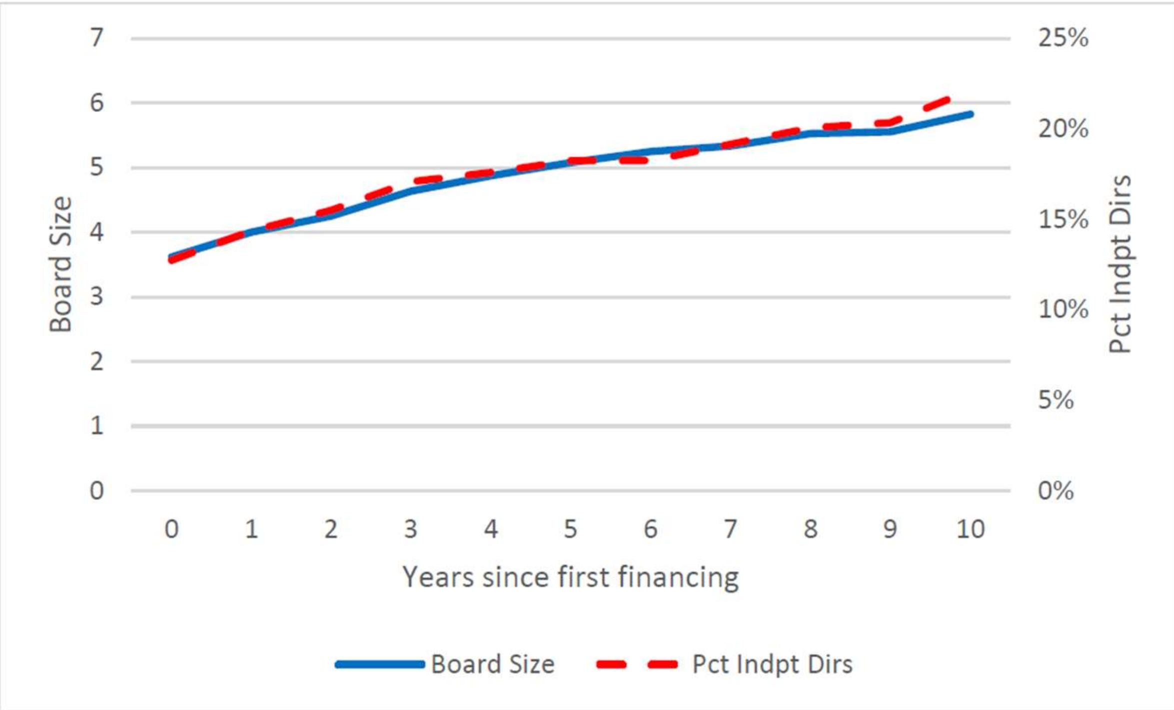
Panel B1: Governance, Case 1



Panel B2: Governance, Case 2



Evolution of governance over the life cycle
Looking at private firms



Avg Board size increases
- 4.7 to 7

Avg Board independence increases
- 17% to 31%

At first financing round
- 37% of firms have 1+ indpt dirs.

At fourth financing round
- 65% of firms have 1+ indpt dirs

As private firms mature, they are are adopting governance structures more similar to those of public firms

Ewens and Malenko (2024), Board dynamics over the startup lifecycle

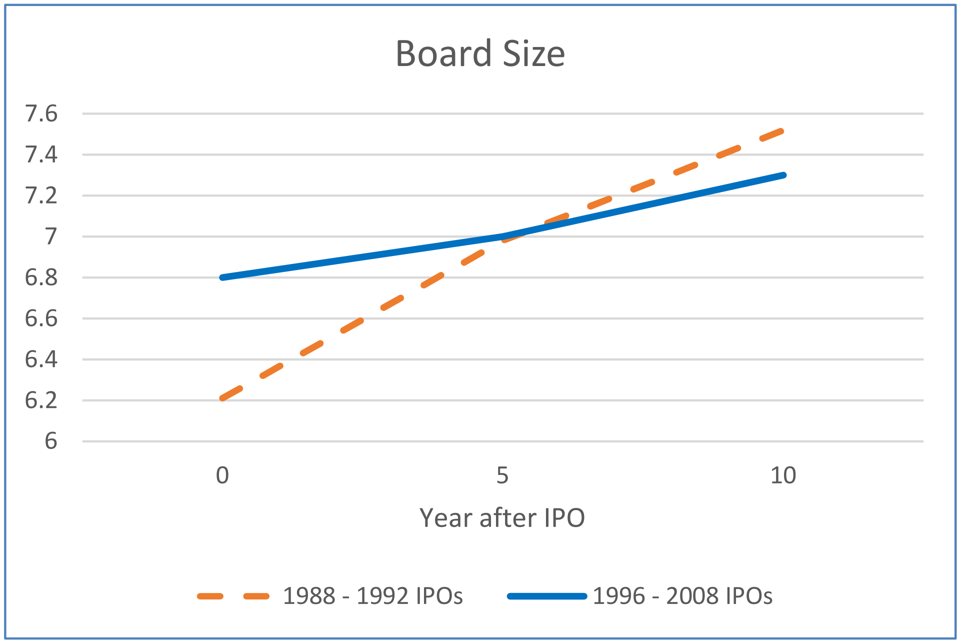
Evolution of governance over the life cycle
Looking at private firms

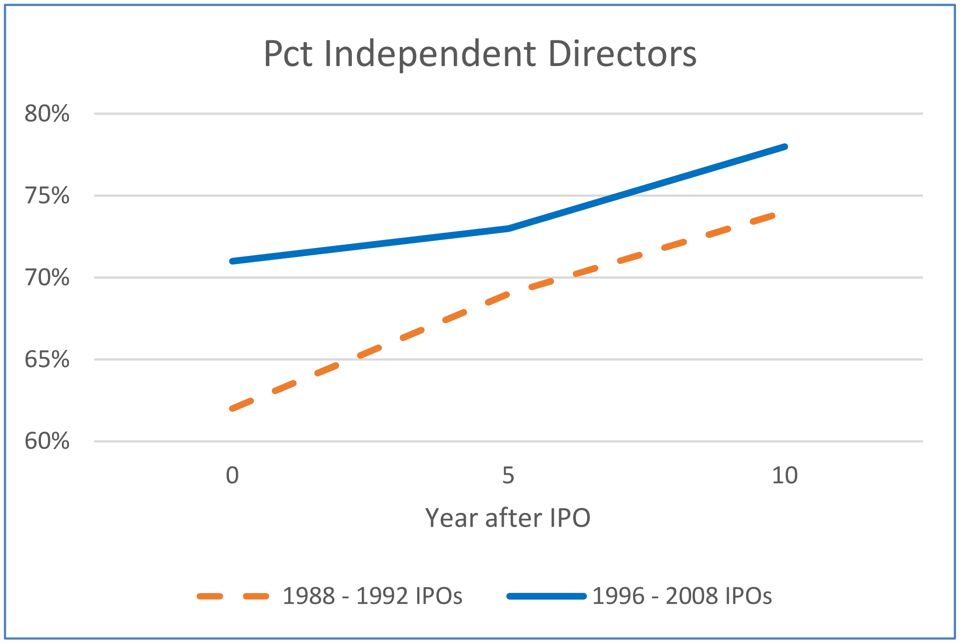
- How much of private firms' changes in governance
  - Increasing Board sizes
  - Increasing Board independence

- Is driven by fact that private firms of today ≠ private firms of 1990s
  - Firms stay private longer, mature more
  - Firms have more disperse shareholders

- Compare evolution of firm's governance AFTER the IPO
  - Across firms that went public 1988 – 1992
  - Across firms that went public 1996 – 2009

Post-IPO Evolution of Governance
IPOs in 1988-92 vs 1996-2008





In more recent period, IPO firms' governance structures are closer to those of mature firms

The firms are maturing more *prior* to going public

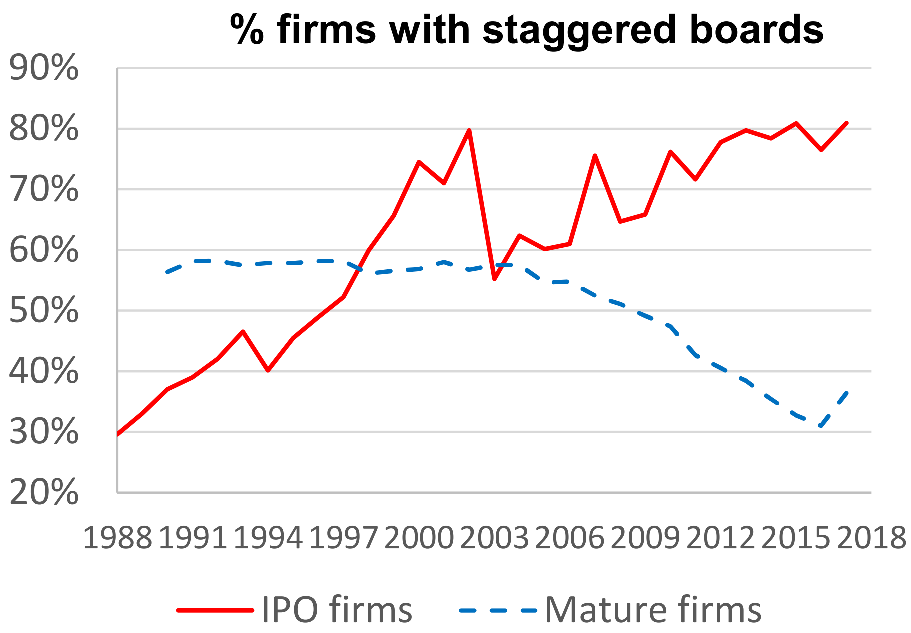
Thus, rate of change in years after IPO is slower (for more recent IPOs)

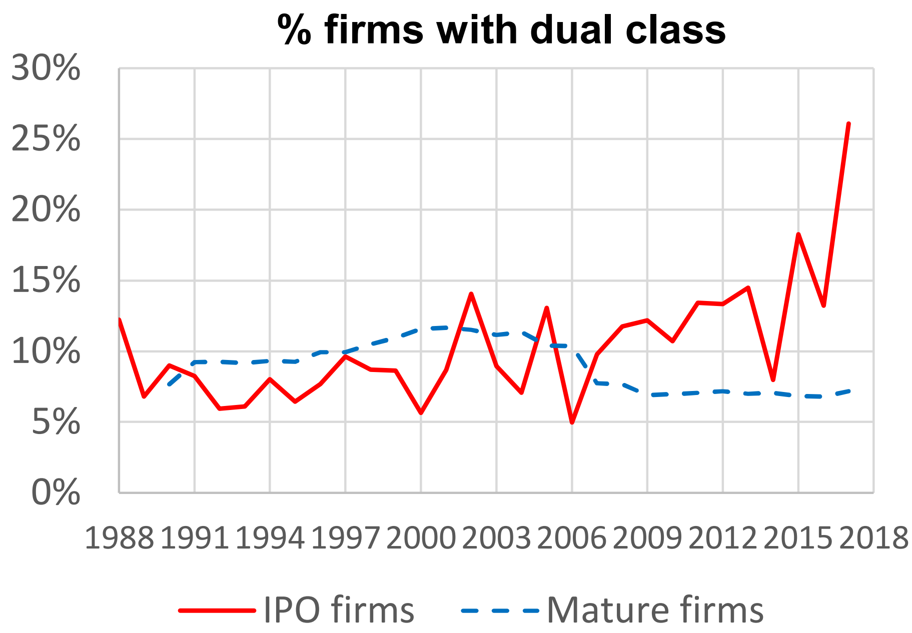
Looking at takeover and takeover defenses

- Governance device of last resort = a takeover
- Private firm: a small number of people typically have control
  - Founder
  - Early investors such as VCs
- When a firm goes public, this typically changes
  - Many new investors
  - Ownership percentage of founder and early investors decreases
  - Founder and early investors no longer have control
- Has this distinction changed?
  - Ownership is already more disperse prior to going public
  - Do founders / early investors try to maintain more control, post-IPO

Looking at takeover and takeover defenses

- Founders / early investors can maintain control via
  - >50% ownership
  - Sufficiently high-powered takeover defenses





In more recent periods, founders and early investors are maintaining control AFTER firm goes public, through takeover defenses

Is this maintaining of control 'good'?

- Classified Boards
  - Smooth transition from private to public status
  - Give founders 'some' additional control
    - But not 'absolute' control

Not value-decreasing

- Dual class share structures
  - When control held by founder / insiders

Value-decreasing

  - When control held by parent co (e.g., equity carve-out)

Not value-decreasing

Field and Lowry (2022): *Bucking the trend: Why do IPOs choose controversial governance structures and why do investors let them?, Journal of Financial Economics*

Summary

Private Firm	IPO	Public Firm

Sources of capital / amount raised?

Private Firm	Public Firm
Venture Capital, Smaller amounts of $	Mutual funds, Hedge funds, etc Larger amounts of $
Mutual funds, Hedge funds, etc	Venture Capital

Different Governance structures?

Private Firm	Public Firm
Close control -> little emphasis on formal gov'ce	Regulations + External investor pressure -> distinct governance structures
Adopt Boards that have many features of public firms	Takeover defenses preserve control of founder, early investors

Outline

1. Numbers of public vs private co's over time
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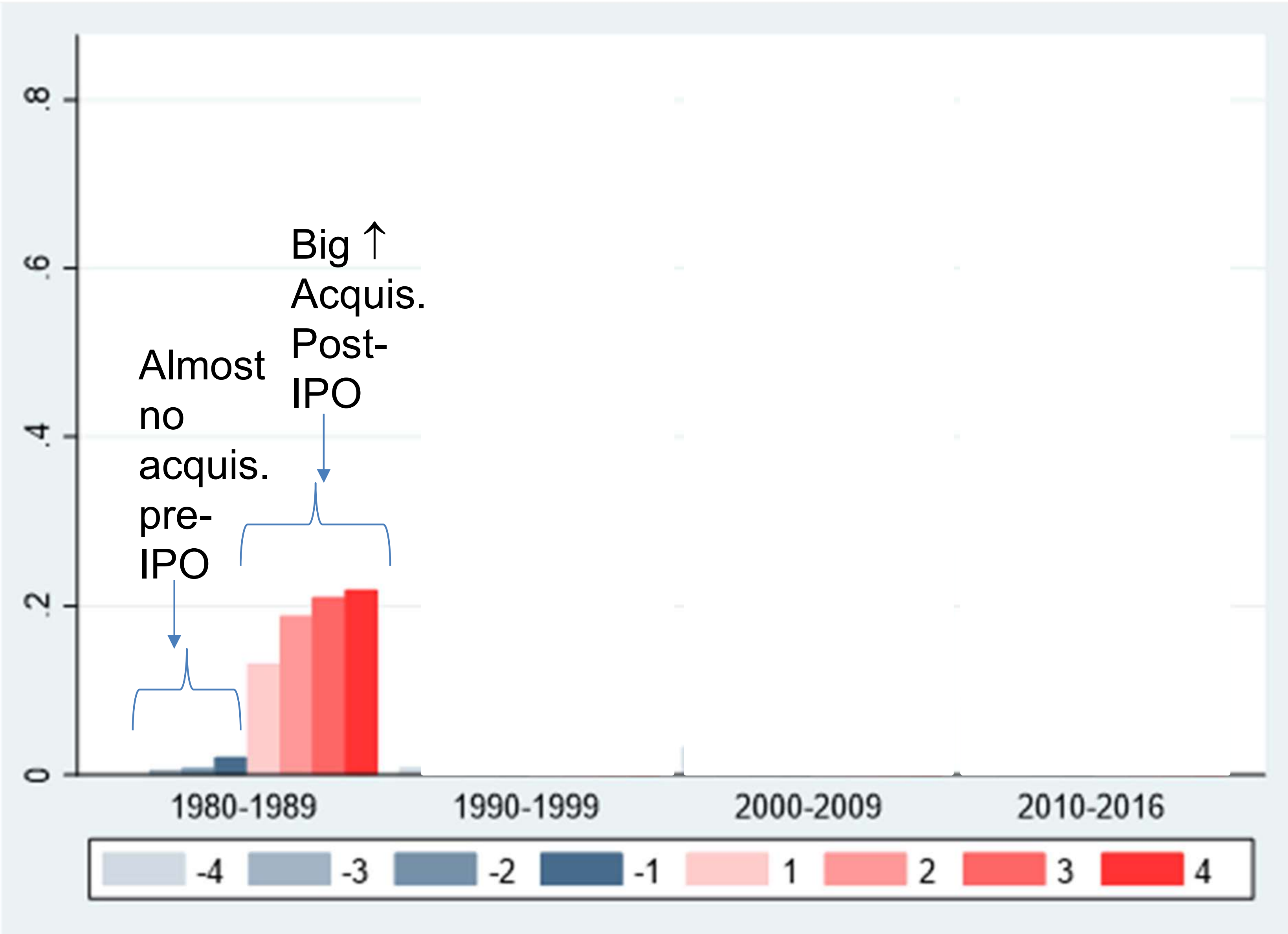
Blurring lines between private and public firms

Methods of growth

- If private companies increasingly resemble their public counterparts
  - Raise large amounts of capital
  - Governance structures such as larger, more independent Boards

- Do they also ‘grow’ like public companies

Frequency of pre-IPO vs post-IPO acquisitions



Conclusions and Implications

- Private firms increasingly resemble their public counterparts

- Private firms are staying private longer
  - Ownership: raising more capital, more disperse ownership
  - Corporate governance: larger and more independent boards
  - Methods of growth: pursuing more acquisitions

- Public firms include more firms with negative net cash flows
  - Harder to value
  - Raise more capital through private placements
  - Raise capital from intermediaries specializing in private firms (VCs, PEs)

Conclusions and Implications

- Public firms
  - Key competition comes from private firms, who disclose less.
- Private firms
  - You don’t have to go public to raise capital
  - But as you grow, imperative to consider factors previously emphasized only after going public: governance, acquisitions
- Regulators
  - Private firms are not subject to the same regulatory structures
  - As more firms stay private, what are the implications of this
- Investors
  - More economic output in private sector -> invest in these firms?
  - More barriers to investing in private firms.