The Oscillating Domains of Public and Private Markets

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Research questions and approach

- What is the relationship between private and public capital markets and which developments can we expect over time?
  - winner takes all competition?
  - oscillation in equilibrium?
- What are the implications for regulation?
  - What can they achieve with their interventions?
  - What should be the regulatory aim?
- Conceptual paper

Background and motivation

- Jensen‘s prediction of the eclipse of the public corporation
- Time and again, developments arguably came close to Jensen’s prediction
  - 80s LBO spree
  - 2000-2008 PE boom
  - recent episode of bullish private markets
- Debate on
  - why private markets outpace public ones
  - how regulators can address undesirable market developments

Our hypothesis

- Relative size of private and public markets oscillates.
  - multiple factors determine how much activity (e.g., capital raising) takes place on either public or private markets.
  - the resulting equilibrium at a time favors one market relative to/at the expense of the other.
  - this is not stable and only temporary: in response to any shift, other factors (also subject to adaptation) eventually push into the other direction.
  - new (unstable) equilibrium emerges.
- No secular trend towards one market

Aggregate market values over time for public and private equity markets

Total Equity Value

Millions of dollars

60000000
50000000
40000000
30000000
20000000
10000000
0

Multiple of corporate equity values in public vs. private markets

9
8
7
6
5
4
3
2
1
0

1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022

Public Market Value
Private Market Value
Multiple

source: FRED; authors' own calculations

Changes in US market cap of public and private firms

Changes in public and private market value

Changes, Millions of Dollars

10000000
5000000
0
-5000000
-10000000
-15000000

Multiple of changes in corporate equity value in public vs private markets

25
20
15
10
5
0
-5
-10
-15
-20
-25

1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022

Public Market Value
Private Market Value
Multiple

source: FRED; authors' own calculations

Illustration

- Assume private markets promise higher risk-adjusted returns
  - more investment and capital in private markets, including by non-traditional investors (mutual funds, hedge funds etc.); which could be observed in the recent bullish phase.
  - more capital committed, and thus more promising companies can stay private (longer).
  - at this point: shift from public to private markets
- But consider what comes next
  - competition to invest: more investor expropriation, less due diligence and more bad-apple investments
  - potentially aggravated by fund managers‘ incentives
  - anecdotally, private markets dealt negative experiences to both venture tourists and seasoned investors recently

Illustration cont‘d

- Ultimately, the system reaches a turning point.
  - overheated markets trigger backlash.
  - trend reversed towards public markets
- One step further, the cycle may start again.
  - less capital available for deals allows returns to increase again.
  - private market investments become more attractive.

Complementarities as growth restrictions

- Coexistence of public and private markets enhances efficiency due to complementary functions.
  - public markets provide exit opportunity for private investors/improve conditions for alternative exits, and thus facilitate investments in private markets in the first place.
  - public market transparency creates positive information externalities for private market pricing.
  - private markets nurture companies, not yet suited for public markets, but ultimately feed into them.
  - the private market for corporate control disciplines managers of public firms.

Pub Benefits Priv

Priv Benefits Pub

- Extreme dominance of one market foregoes efficiencies, creating a distinct cost factor that militates against winner-takes-all outcomes.

Regulatory dialectics (boundedly rational social planners)

- Regulators might (try to) shock the system but will only trigger oscillations between unstable equilibria (or: will not unhinge equilibrium).
  - regulation can produce the intended effect in the short-term but will induce responses which attenuate the effect over time.
  - the second-round responses may, in turn, affect regulation itself at a later stage, i.e., induce another round of regulatory interventions.
  - regulation is exogenous in the short run but becomes increasingly endogenous as the time horizon lengthens.
  - consider the JOBS Act inducement of public listings

Original policy implication

S A F E

- Regulation that seeks to invigorate capital raising on markets should not prioritize public or private markets.
  - no a priori reason why one market would be more suitable than or preferable to the other
  - grow the pie!: improve overall market efficiency and be mindful of cross-market effects
- Positive effects unique to public markets?
  - transparency and positive externalities (cross-market and stakeholders)
  - wealth distribution (retail investors)

Thank you!

Questions and comments are welcome to

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