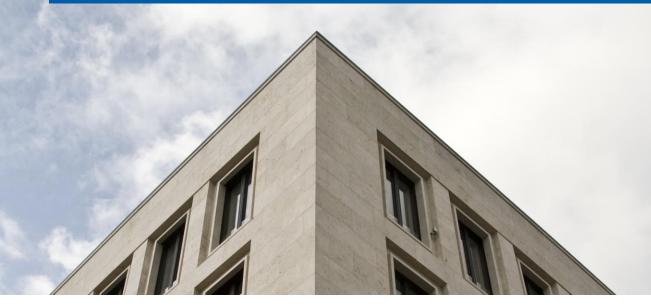
The Oscillating Domains of Public and Private Markets

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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

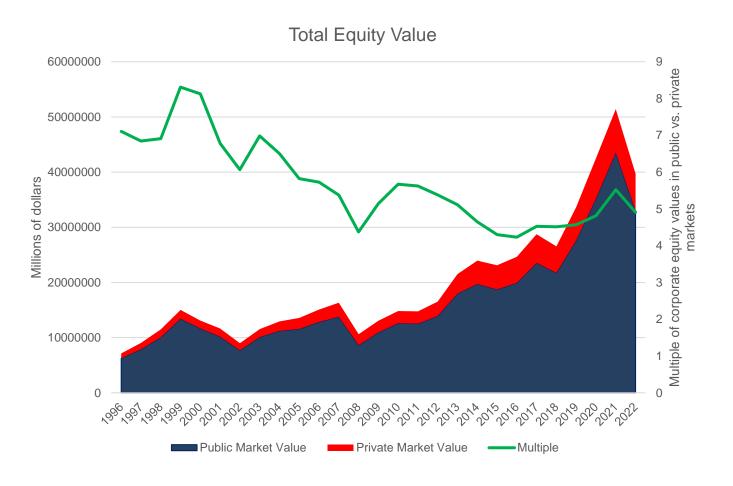
Our hypothesis



- 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

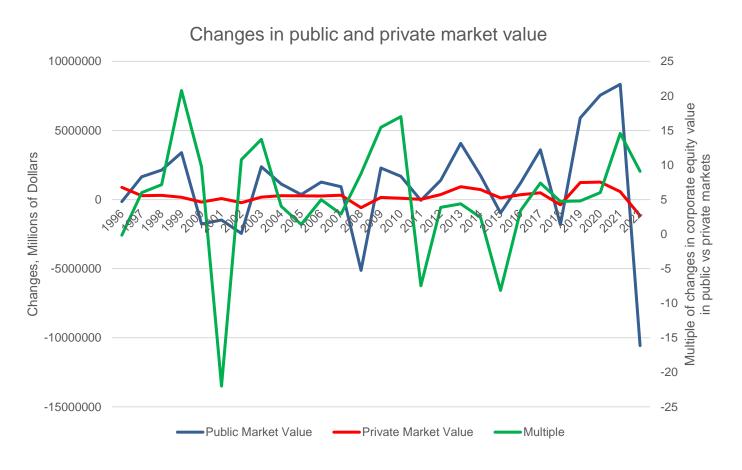




source: FRED; authors' own calculations

Changes in US market cap of public and private firms





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

S A F E

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

Pub Benefits Priv

Priv Benefits Pub

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



- 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 gozlugol@safe-frankfurt.de