WHY ARE FEWER COMPANIES GOING PUBLIC?

ECGI - SSE Riga Roundtable

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Summary Report

Roughly 20 years ago, the suggestion – amidst the Dot Com bubble – that by now, the number of US listed companies would have dropped by half and that elsewhere as well, stock exchanges would be struggling to attract sufficient listings, may have seemed rather courageous. Unfortunately, however, that is exactly what has happened – or has it not? Appropriately acknowledging the importance of this theme for a variety of policy issues, the matter was discussed thoroughly during the ECGI Roundtable Why Are Fewer Companies Going Public?, held on June 10th and hosted by the Stockholm School of Economics Riga.

The ECGI Roundtable was opened with some warm welcoming words by **Anete Pajuste** (Professor of Finance, SSE Riga), **Anders Paalzow** (Rector and Professor of Economics, SSE Riga) and **Marco Becht** (Goldschmidt Professor of Corporate Governance, Solvay Business School and Executive Director, ECGI). The event gathered leading experts and contributed to a more complete understanding of the forces shaping the current situation. The papers presented and discussed indicate that there are many factors to be taken into consideration when going public or staying private. This report covers the exchange of ideas on June 10th along five distinct lines.

The Eclipse of the Public Corporation or Eclipse of the Public Markets?

The first presentation was delivered by **René Stulz** (Everett D. Reese Chair of Banking & Monetary Economics, Ohio State University). Building on his extensive experience with the topic, Stulz argued that the US has dramatically fewer listings than 20 years ago, and that the firms currently listed are rather different from their historic counterparts. In 1997, there were approximately 7,500 US listings, versus around 3,750 as of today and 5,000 in 1975. In recent years, the figure has been pretty much stable, also because of relaxed regulations. However, the mere absence of a massive inflow of fresh IPOs is in itself already striking, given that the stock markets have been performing well in recent years.

In Europe, the picture is similarly stable, although mixed amongst countries, whereas in emerging and frontier markets, the trend is generally more positive. Given that financial markets are known to have a strong preference for jurisdictions where the rule of law is strong, Stulz and his fellow authors calculated the size of the US listing gap since 1991. Currently, it is estimated at more than 5,000. Presumably, this gap is not unique to the US market – it is simply ahead of others. Given that the total market capitalization of US listed firms has increased sevenfold since 1975, listed firms tend, on average, to be much larger than they used to. Meanwhile, in GDP per capita terms, the market value of these companies is the same as it was in 1999. By contrast, small firms (as measured by a market capitalization smaller than $ 100 million) have virtually disappeared, from more than 60 % in 1976 to just over 20 % in 2015.

This US listing gap is due to both a drop in fresh IPOs and a continuous, elevated rate in delistings. In this story, mergers between listed firms are more frequent than going private transactions. As a result, the mean US listed firm has become twice as old (from 8 to 16) in the 20 years from 1995 to 2015. The number of loss-making firms remains relatively flat over time, at 38 %, but the top 10 % largest firms (as measured by assets) do well, with cash flows positive for every year between 1975 and 2015, averaging 8.3 %. Thus, 200 firms are delivering the large majority of earnings of all listed companies. Importantly, age and concentration may adversely affect productivity growth and innovation, and the stock market has essentially become a place to return (rather than to raise) capital - $ 3.6 trillion dollars from 1997 to 2016.

Stulz argued that the underlying factor could be the dramatic increase in the importance of intangible assets. Whereas public markets are great at financing tangible assets with low information asymmetries, intangibles are likely easier to finance privately, as the risk of losing one's advantage to competitors is smaller. This is compounded by the fact that private equity has become more institutionalized and, consequently, the traditional liquidity advantage of the stock market has decreased, whilst institutional investors' internal regulations often prohibit investments in small listed firms with a lower liquidity. Moreover, the drop in IPOs commenced before regulatory burdens (including the Sarbanes Oxley Act) increased, meaning that the argument that regulation killed small businesses is less compelling. Although recent reforms (such as the JOBS Act) have not aggravated the existing situation, they have neither provided a great stimulus. Finally, managing large, multinational firms has become easier due to technological advantages – email compared to the telegram – and the fact that increasing the scale of a business – for instance by expanding the availability of a smartphone app – is less capital-intensive than it used to be. To conclude, Stulz raised the question: does all of this matter? His answer was cautiously affirmative. If public markets shrink in size, most investors will simply not be able to participate, resulting in a freeze-out on an unprecedented scale. Although private equity can intermediate, this would create a shadow market economy, which may find it difficult to obtain societal support on a long-term basis.

The first discussant, **Roni Michaely** (SFI Professor of Finance, University of Geneva), was happy to agree with large parts of the observations made by Stulz. Particularly, he supported the view that the number of listed companies is declining – across various industries – causing the average firm to be larger in size, and that this is not some sort of cyclical phenomenon. Furthermore, Michaely indicated he was on the same page as Stulz with respect to other factors, such as the insignificance of regulatory costs. Regarding the continued usefulness of public firms, he pointed towards possible changes in the structure of markets. Most industries are experiencing increased concentration, as measured by HHI (Herfindahl–Hirschman Index), by the market share of the four largest competitors and by the number of corporations with in excess of 10,000 employees. Concentration affects not only public, but also private markets. The increased concentration has economic consequences. Based on results form a paper by Grullon, Larkin and Michaely, (forthcoming in the Review of Finance), Michaely presented evidence that the increased concentration is associated with increased profit margins, and increased profitability. There is no evidence of increase in efficiency that can justify the increase in profitability. There is prima facie evidence that this increase in concentration is a result of failing anti-trust enforcement; and at the same time increased barriers to entry due to significant increased investment in technology by many industries' leaders. In turn, smaller firms –because of fixed costs – may find if ever more difficult, if not impossible, to compete.

The second discussant, **Andris Grafs** (Baltic Institute of Corporate Governance), remarked that in the Baltics, a majority of the companies are privately held. If a private business needs additional funding, bank loans are usually the most obvious choice. Traditionally, it has been held that banks only pay limited attention to corporate governance matters. However, a recent survey indicated that the matter has a weight of up to 25 % for internal credit calculations. Consequently, the quality of governance standards may be increasing. These requirements may also help to diminish the perceived magnitude of the step of becoming listed. Indeed, not only public markets are paying attention to governance standards. Particularly State-Owned Enterprises may present an untapped reserve of firms that could go public. In this regard, ensuring that competent independent oversight is in place remains pivotal.

Subsequently, a few shorter comments were made. **René Stulz** (Everett D. Reese Chair of Banking & Monetary Economics, Ohio State University) pointed towards the relative importance of antitrust enforcement versus technological change. Indeed, the question what causes the shift in firm profiles carries important implications for the policy debate. **Alessio Pacces** (Professor of Law & Finance, University of Amsterdam) commented that if smaller firms are hampered by barriers to entry, market prices may become more opaque. In his view, this could be even more worrying than the decrease in listed firms. **Marco Becht** (Goldschmidt Professor of Corporate Governance, Solvay Business School and Executive Director, ECGI) remarked that if technological advancements were the dominant factor, one should observe a decrease in listed firms outside the US as well.

Disclosure Standards for Ownership, ESG, and Political Contributions

The ECGI Roundtable then continued with a panel session, featuring presentations by **Anete Pajuste** (Professor of Finance, SSE Riga), **Yupana Wiwattanakantang** (Associate Professor, National University of Singapore) and **Erik Berglöf** (Professor in Practice, London School of Economics).

First, Pajuste highlighted some of the complications investors may encounter when attempting to determine the equity stake and/or voting power of controlling shareholders at dual class companies. Pajuste took Alphabet (Google), with A (one share, one vote) B (ten votes per share) and C (non-voting) class shares as an example. Whereas the current situation may be difficult to grasp, the future may pose even more challenges. For instance, under the Transfer Restriction Arrangement concluded in 2012 – when the C Class shares were issued – a sale of Class C shares by the founders should be accompanied by a sale of similar magnitude of B class shares. However, such subtleties are difficult to take into account for the average investor. Additionally, local issues may apply. For instance, listed companies in Eastern Europe, notably smaller ones, often do not publish an annual report in English. Consequently, ownership structures may be virtually impossible to analyze, even more so when legal intermediaries are used. Thus, even annual reports that fully comply with applicable laws may fail to effectively disclose control figures.

Second, **Yupana Wiwattanakantang** (Associate Professor, National University of Singapore) provided an elaborate perspective on disclosure practices in Asia. Her presentation mainly targeted family businesses, and her observations largely confirmed those of Pajuste. Wiwattanakantang indicated that traditionally, Asian listed

companies simply refer to their controlling shareholder as 'promotor'. For outside investors, meanwhile, determining actual ownership and control figures from the annual report is quite a chore, because of a dense network of cross-ownership blocks – let alone identifying personal relationships between directors. Indeed, the most prominent figure may not always style oneself as Chair or CEO. The cases of Samsung (South Korea) and C.P. Group (Thailand) serve as interesting cases in this respect. In conclusion, family connections are still a highly valuable asset for doing business in Asia.

Third, **Erik Berglöf** (Professor in Practice, London School of Economics) analyzed the potential of disclosure stemming from publicly accessible beneficial ownership registers. Currently, there still exists a wide varience in compliance with disclosure obligations amongst companies and jurisdictions. The opacity of beneficial ownership structures has many negative consequences for minority shareholders, including reduced accountability, heightened risks for the financial sector in respect of related party transactions, corruption and money laundering. However, the UK has recently launched an initiative to register any financial transaction by a company listed either in the UK or abroad. Interestingly, approximately 40 other jurisdictions – with the notable exception of the US – have followed suit. Although data quality is still developing, this opens up a theoretical avenue for using data on an unprecedented scale to trace beneficial ownership globally. Indeed, every entrepreneur could be assigned a code, with transactions linked to that person. In fact, the first suits based on these data have been launched recently, meaning that enforcement is starting to bite. Out of 1.3 million companies, 3,000 had their address in a tax haven – which is prohibited – whilst more than 75 had a beneficial owner with an identical name and birthday as an individual on the US sanctions list. Undoubtedly, the technology will be developed further to undress oligarchic structure and trace wealth derived from questionable sources.

Following these shorter introductions, **Jeroen Delvoie** (Partner, Eubelius and Professor, Vrije Universiteit Brussel) inquired whether, by contrast, superfluous disclosure could be harmful. **Erik Berglöf** (Professor in Practice, London School of Economics) responded that for certain jurisdictions, this may indeed be the case. However, especially for emerging economies, other factors are more important in the trade-off. **Guy Jubb** (Honorary Professor at the University of Edinburgh and Interim Chair, ECGI) further commented that institutional investors are inundated with information, meaning that the marginal value of information is decreasing. Additionally, bilateral meetings between management and institutional investors are exceedingly important, also because of non-verbal signals. However, for such meetings, disclosure standards are notoriously flexible. **Marco Becht** (Goldschmidt Professor of Corporate Governance, Solvay Business School and Executive Director, ECGI) also pointed towards the distinction between disclosure obligation in respect of public and private companies.

The Monitoring of Index Funds

After a savory lunch, kindly offered by the SSE Riga, **Roni Michaely** (SFI Professor of Finance, University of Geneva) presented his paper on the quality of monitoring conducted by index funds, with a view to analyzing the impact of the shift to passive investing on corporate governance and firm performance. The amount of Assets Under

Management held by passive investors has increased spectacularly in recent years, due to the fact that most active investors do not outperform their passive counterparts, whilst the costs of investing passively are getting lower and lower. Currently, passive funds hold 30 % of US equities. Theoretically, one can argue that because index funds have (almost) no choice but to hold most stocks in an index, and as committed long-term investors they have a strong incentive to monitor firms they hold in their portfolio However, a more dominant force that might govern funds monitoring behavior is the fact that their managers do not have any incentive to monitor: first, they are not compensated for performance or on any alpha they produce but only on how they track the index.

Second, there is the free-rider problem. Any added performance their monitoring actions might produce will be shared by all other funds who track the index. Third, it is difficult to imagine how index funds who charge very low fees and hold 100s of firms can effectively monitor even a fraction of firms in their portfolio. Put differently, their resources to monitor are very limited, whereas the benefits of successful interventions are to be shared with other investors. Indeed, there exists a heated debate in the recent empirical literature, with claims being made that an increase in passive ownership correlates to better governance. Taking this state of affairs into consideration, Michaely and his fellow authors empirically show that index funds cede power to management. In contentious votes, they are significantly (12 percentage points) more likely to side with management compared to active investors, and also being less likely to abstain. Formulated differently, the default policy of passive investors is to vote in accordance with management recommendations. This observation held across a wide range of items, including compensation, disclosure and entrenchment. In fact, index funds are more likely to vote with management as the fund expense ratio decreases, suggesting that lower resources leads to even lower propensity to monitor. Additionally, although passive funds sometimes do exit (4 % of the portfolio annually on a voluntary basis, with only complete exits taken into account), they almost never exit in response to losing votes: the exit strategy is not used in a strategic manner – after a vote has been lost. Finally, any evidence of engagement, behind the scenes or direct communication by index funds is absent.

In sum, to date, a large literature has examined the effect of index fund ownership on corporate outcomes without checking the direct relation between investors and management. Michaely and coauthors provide the first evidence on this fundamental question. Specially, examining the monitoring behavior of index funds relative to active funds. Michaely presented a wide variety of samples and tests ranging from the universe of funds and firms in the data to smaller and precisely identified subsamples. All results uniformly indicate that, relative to active funds, index funds cede power to firms’ management.

The first discussant, **Benjamin Maury** (Wahlroos Professor in Finance, Hanken School of Economics) addressed the issue of index monitoring from an “agency costs of agency capitalism” perspective. One of the potential sources of agency costs is the short-term horizon of investors. Increased passive ownership may mitigate this cost type. However, as a result bonding costs and residual loss may increase, meaning that firm value as a whole may decrease. Whereas the classical shareholder-board agency conflict is likely larger in firms without a controlling shareholder, effects of index funds present a somewhat intermediate situation. Thus, an interesting avenue for future research could be to compare a set of firms controlled by a single blockholder with firms having multiple major index funds amongst its shareholder base. In such a study, one factor that should be taken into account is the possibility of coordinating or forming coalitions beyond fund families, as Hermes has demonstrated, amongst others. Indeed, this practice reduces costs and increases the likelihood of an intervention being successful.

The second discussant, **Toms Kreicbergs** (CEO, Indexo) presented himself as a loyal ally to the cause of index investing, having co-founded a pension fund, now with € 130 million in AUM, to help Latvian workers reach retirement in a financially healthy condition. Additionally, the initiative transformed the local industry, with price competition increasing and management fees having dropped dramatically. Kreicbergs highlighted the fact that index investing, initially a relatively marginal phenomenon, has globally now grown beyond the point that it will have only a marginal effect on corporate governance. He suggested four ways in which the current situation could develop. First, index funds could be obliged by means of legislation to pursue higher governance standards. However, this approach assumes active behavior, and is therefore broadly inconsistent with the concept of passive investing. Second, there is the option of total democracy, allowing beneficial owners to vote directly. Given the large number of companies index funds typically hold shares in, registering these votes may give rise to all sorts of practical issues. Third, investors could be requested to state their default preferences on a number of frequently arising topics. Fourth, passive investors could be prohibited by law from voting, leaving the voting process to investors who actively decide to invest in a company and rendering passive investors truly passive. However, the legislative changes required could take some time to enact.

The subsequent round of discussion was initiated by **Roni Michaely** (SFI Professor of Finance, University of Geneva) who commented that in the fourth situation, the influence of activists could increase, to which **Toms Kreicbergs** (CEO, Indexo) remarked that under an efficient market hypothesis, an increase in the value of control should attract more competition for control and, therefore, swing the needle back toward active investing. **Marco Becht** (Goldschmidt Professor of Corporate Governance, Solvay Business School and Executive Director, ECGI) added that important differences between retail and institutional passive investors exist, with the latter considerably more vocal in expressing in their (ESG) wishes to asset managers. This also relates to differences in shareholder ideology. **Beni Lauterbach** (Raymond Ackerman Family Chair Professor in Israeli Corporate Governance, Bar-Ilan University) mentioned that it could be worthwhile to analyze whether index funds that exit (parts of) a position achieve higher returns than those that do not. **Alessio Pacces** (Professor of Law & Finance, University of Amsterdam) observed that there could be an element of endogeneity to the situation as well, in the sense that hedge funds may have a higher propensity to trigger a shareholder vote if the company has a bigger passive shareholder base.

The Impact of Institutional Investors on Freeze-Out Tender Offers

Beni Lauterbach (Raymond Ackerman Family Chair Professor in Israeli Corporate Governance, Bar-Ilan University) subsequently presented a paper on the interplay between institutional investors and freeze-out tender offers. Accordingly, the listing gap is not only present on the US stock market, but extends to the Israeli stock markets as well, which witnessed a 30 % drop in listed companies between 2008 and 2018. However, as opposed to the US, most public companies in Israel have a controlling shareholder. Thus, delistings are not achieved by mergers, but through freeze-outs. Interestingly, Israeli freeze-out tender offers (but not mergers) are considerably less regulated than their US counterparts, with no Board or Special Committee approval being required or fairness opinion having to be obtained, so that minority shareholders depend largely on themselves. Whereas freeze-outs may serve legitimate business purposes (including synergies, regulatory costs and confidentiality), there is also a risk of expropriation of minority shareholders, because of the timing of the offer. Thus, the question is whether institutional investors step in to protect their interests and, in the process, those of retail investors. To answer this

question, a data set comprising of 201 transactions, mainly involving smaller companies (median assets of $ 50 – 100 million) was studied. Some firms have one or more institutional shareholders, whereas others have none. Institutional presence increases the offer premium, but only in case pre-negotiations are conducted with the controller. Importantly, size of institutional holdings is irrelevant. Additionally, their presence decreases the probability of a freeze-out offer being accepted, but only in case pre-negotiations are absent – otherwise, the relevance of this factor is nullified. Naturally, not all offers succeed. In fact, more than 40 % of the public offers get rejected, also due to the fact that the barriers for launching an offer are comparatively low. Furthermore, firms with an institutional investor amongst its shareholders are more likely to reject. However, the returns from rejecting an offer on average exceed the offer premium (measured on a 6-month interval). Specifically in case pre-negotiations were held, a projection results, by contrast, in significant losses. In these situations, the rejection may be considered a show of power, and the presence of institutional parties will – at least in the short term – hurt other shareholders.

The first discussant, **Janis Berzins** (Associate Professor, BI Norwegian Business School) analyzed some of the structural features of freeze-out transactions, which remain a relatively rare phenomenon in the overall M&A context. In the US, a compromise between the interests of majority shareholders (to take the company private for strategic purposes) and those of minority investors (to prevent expropriation) has been achieved in the form of the MFW framework, which includes a switch over from the Entire Fairness Standard for board behavior to the Business Judgement Rule upon a recommendation by a Special Committee and a Majority-of-the-Minority vote. Empirically, it has been established that most freeze-outs are initiated during industry downturns or in times of undervaluation. Thus, additional investor protection may be warranted. The Norway appraisal procedure, which may be triggered by a 10 % majority, could serve as an example in this respect, although it was acknowledged that in that particular constellation, the transaction is slowed down considerably. Berzins suggested that Lauterbach could relate the paper more closely to such existing studies, but also expressed his praise for the unique (more lax than many others) legal environment that it targets.

The second discussant, **Māris Vainovskis** (Senior Partner, Eversheds Sutherland) discussed some of the particularities when launching a public offer in Latvia. Three types of offers can be distinguished, being a voluntary offer, mandatory offer, triggered at 30 %, and the squeeze-out offer, with a threshold of 95 %. In the latter case, a fair price should be offered, which is the highest of the i) price paid by an investor in the last 12 months, ii) the weighted average share price in stock exchange over the last 12 months and the iii) Net Asset Value based calculation. Regulatory approval shall be obtained from the competent authority (Financial and Capital Market Commission of Latvia) as to the compensation method selected and other terms of the offer. Interestingly, the regulator adopts the view that, due to Latvian legal peculiarities, subsidiaries in which a company holds, for instance, a 50 % equity stake should be fully consolidated for Net Asset Value based share price calculation method in case of mandatory offer or squeeze-out offer (i.e. non-controlling share participation value is not being deducted) and there is ongoing litigation process in respect of the issue with Latvian administrative courts.

A Global Perspective on Disproportional Economic and Control Rights

Pedro Matos (John G. Macfarlane Family Chair Professor of Business Administration, University of Virginia) presented a study on the prevalence of dividend and voting dual class stocks around the world, having created a dataset involving 45 countries. The continued relevance of this theme was illustrated by the initiative, launched in 2017 by US and UK index composers, to exclude dual class companies: on the day of the announcement, their stock prices lost significantly in value, and more so when institutional holdings were higher. Additionally, the Singapore and Hong Kong Stock Exchanges have been reconsidering their traditional prohibition on dual class listings, suggesting there exists a clear interplay between regulatory initiatives in various jurisdictions. One methodological complication is that sometimes, deviations in cash flow rights coincide with deviations in control rights, as is for instance the case regarding non-voting preference dividend shares prevalent in Brazil and Germany. This somewhat raises the question how a dual class structure should be defined.

The empirical findings presented by Matos suggest that the discount for dual class stock appears more pronounced when institutional holdings are larger. For the US, the discount applies to stocks both inside and outside the index, whereas abroad, only companies outside the index suffer from this discount. On an operational level, there is no evidence that dual class underperform (in fact, they slightly overperform). The likelihood to unify a dual class structure correlates with institutional ownership, and more so in case the institutional investor is an active rather than a passive one. The value of the firm is also slightly higher post-unification.

The first discussant, **Beni Lauterbach** (Raymond Ackerman Family Chair Professor in Israeli Corporate Governance, Bar-Ilan University) showed himself an advocate of the life cycle perspective on dual class stock. Referring to the case of Google, he maintained that dual class shares should not be banned. Instead, the mechanism allows founders to implement their idiosyncratic vision. Only after time has passed, for instance 7 years, investors should consider unifying a dual class structure. According to Lauterbach, one interesting aspect of the paper presented by Matos is that it confirmed that institutional investors act, by and large, in accordance with their express policies, which often principally reject dual class stocks and press for unification. An interesting avenue for further research could be whether institutional investors are more willing to accept – perhaps at a more discounted price – a dual class structure for certain firms than for others.

The second discussant, **Ilmars Osmanis** (CEO, HansaMatrix) then shared some of his personal experiences gained from taking his company public on the Latvian Stock Exchange 3 years ago. After early contributors, including VC and PE parties, expressed their intention of exiting the investment, additional funding had to be obtained. This was corroborated by the fact that the firm operated in a rather capital intensive industry. Despite initial hesitations, also because of the firm's authorized capital of only € 15 million, roadshows actually resulted in a rather positive response. Investors included both pension funds and private individuals. Only common stocks were issued, despite the fact that dual class options were available, in order not to overly disturb the markets. Osmanis actually admitted that he felt rather comfortable with ceding control. Thus, the firm became less dependent on a single individual, allowing it transition to the next stage of maturity instead. He also cautiously noted the difference in perspective of the entrepreneur, whose principal activity is risk taking, and that of independent directors, who mainly aim to minimize risks. Whereas they can, for instance, assure investors, there exists a trade-off between initiative and control. In that sense, additional oversight is not a free lunch.

Closing Remarks

Some concluding remarks were made by **Marco Becht** (Goldschmidt Professor of Corporate Governance, Solvay Business School and Executive Director, ECGI) and **Anete Pajuste** (Professor of Finance, SSE Riga). The event provided some clarity on the questions addressed while also raising some suggestions for new avenues of research. As such, the Riga Roundtable contributed to the ECGI's agenda of keeping research in motion through a vivid exchange of ideas.

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About the European Corporate Governance Institute (ECGI)

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The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

About Stockholm School of Economics (SSE) Riga

www.sseriga.edu

The Stockholm School of Economics in Riga (SSE Riga) is a business school in Riga, Latvia, founded in 1994 and over the years has acquired a reputation as the leading business school in the region. Its mission is to provide a state-of-the-art education in business and economics that contributes to the economic and social development of the region, in particular Estonia, Latvia and Lithuania. SSE Riga aims to produce state-of-the-art research of relevance to the Baltic countries, while actively participating and fostering public debate in its fields of competence.

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