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Companies Rush to Go Private

Jakob Wilhelmus and William Lee

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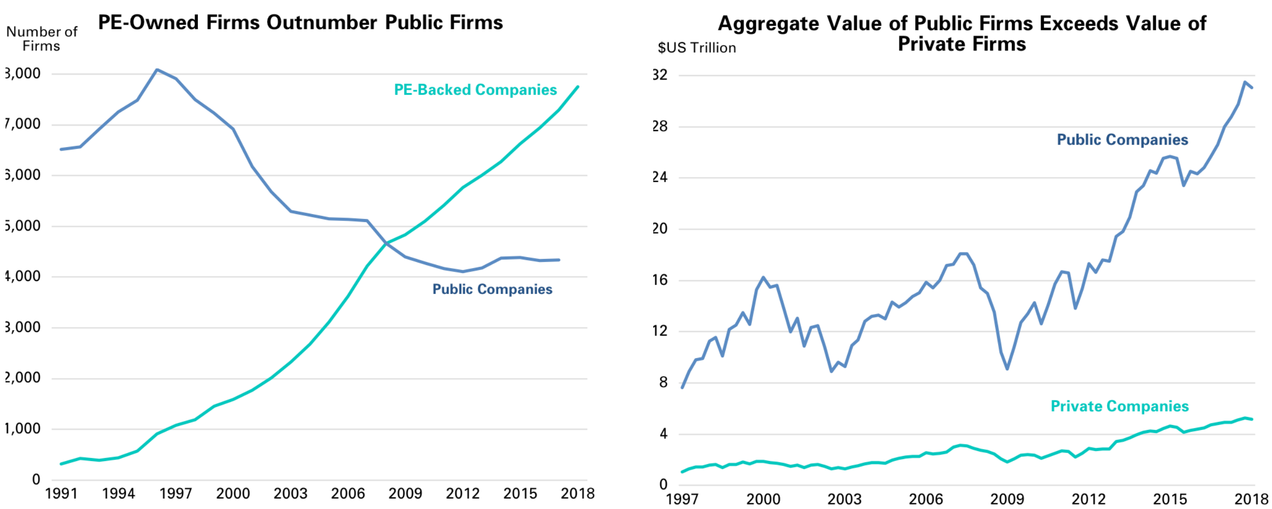
COMPANIES RUSH TO GO PRIVATE

The storm over Elon Musk's awkward attempt to take Tesla private is the latest wave of the continuing tsunami that began in 1995 when firms started their rush to "go private." Even Saudi Arabia has announced intentions to delay the listing of their nationally owned oil company Saudi Aramco until 2020 or beyond. We now have more firms owned by private equity (PE) investors than are listed on all the U.S. stock exchanges, although they are small when compared with their listed counterparts (Figure 1).[1] As market breadth narrows, questions are being raised about the efficacy of listing on U.S. equity markets. More investors and company managers are re-examining the role of public equity markets for financing new companies and innovative investments, which traditionally have helped boost U.S. productivity and sustainable economic growth.[2]

Figure 1. More U.S Companies Are Owned by Private Equity than Are Listed on Public Stock Exchanges



Source: World Federation of Exchanges, Federal Reserve, SEC, Thomson Reuters Eikon, and Milken Institute; March 2018
Note: Public domestic companies, excl. investment trusts

[1] The Federal Reserve estimates the total value of all publicly traded firms to be $31.1T at the end of 2018Q1 compared with $5.2T for all privately held companies.

[2] Demirguc-Kunt and Levine (1997) highlight "how stock markets might boost long-run economic growth" and Levine's (2005) literature review outlines the positive relationship between financial deepening and growth. Unfortunately, there is little empirical research on the implications of capital market broadening for boosting productivity and growth.

COMPANIES RUSH TO GO PRIVATE

Private capital markets have become a favored alternative source of company financing. In addition, private equity firms have become more innovative in developing options for financing the growth of small and emerging firms, and converting many publicly listed companies into private companies. Consequently, more companies are choosing to be privately owned, or are staying private for longer periods before becoming publicly listed.

There is a myriad of reasons to explain why companies may prefer private versus public ownership but none are definitive. One often cited reason for companies going private are burdensome regulatory disclosure and reporting requirements of being a listed company. Yet there is little definitive evidence to substantiate such claims.[3]

The hostile interactions between Elon Musk and company analysts during recent quarterly earnings calls for Tesla illustrate the tension over public disclosure and accountability requirements, and company managers' desire for autonomy. In addition, firms that are publicly listed are vulnerable to managerial interference by activist shareholders who often agitate for disruptive changes in management strategies, especially after reported misses in achieving quarterly earnings expectations.[4] Even President Trump has joined in on this debate by asking the Securities and Exchange Commission to assess potential gains from changing corporate quarterly earnings reporting practices.[5] Certainly, PE firms may also require even more frequent reporting, and may impose severe measures to ensure accountability in the face of poor earnings performance. Indeed, PE owners may choose to make major changes in the management personnel, managerial strategies, and company operations. However, PE company managers are not subject to additional public pressure from stock price gyrations and judgmental company analysts.

[3] More key arguments and findings regarding regulatory burden will be detailed in our upcoming research report.

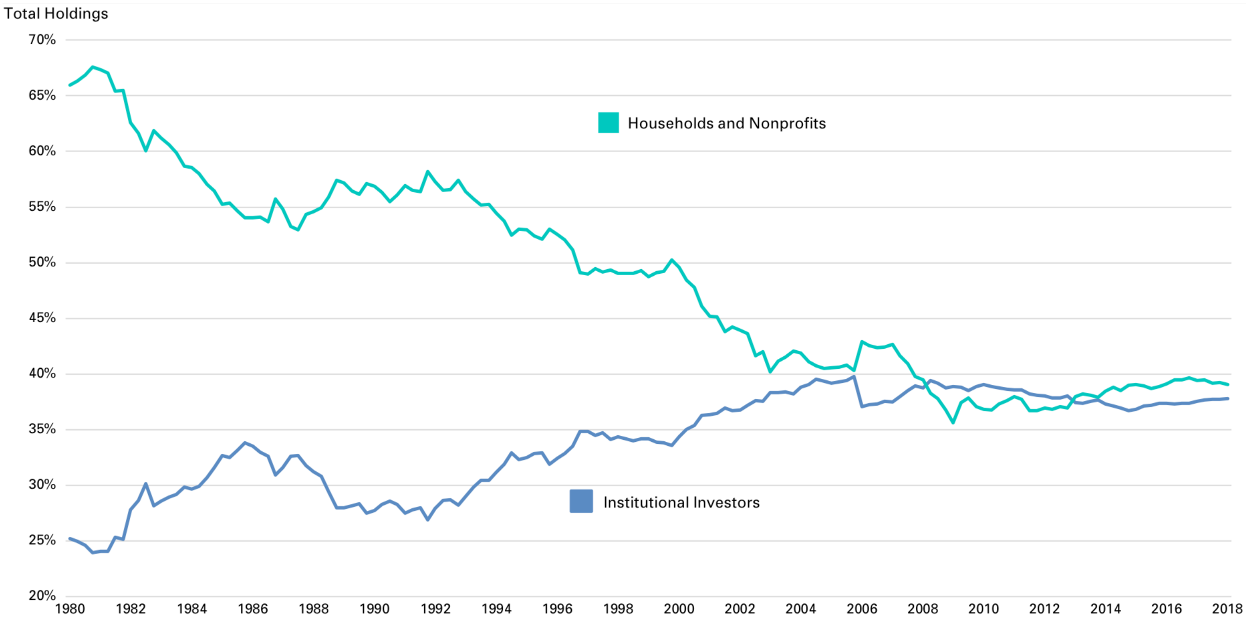
[4] Jamie Dimon and Warren Buffett propose eliminating quarterly earnings reporting for public companies to reduce shareholder pressure and stock market turmoil in response to earnings misses. This issue is discussed here.

[5] President Trump tweeted on August 17, 2017: "In speaking with some of the world's top business leaders I asked what it is that would make business (jobs) even better in the U.S. 'Stop quarterly reporting & go to a six month system,'" said one. That would allow greater flexibility & save money. I have asked the SEC to study!"

PRIVATE CAPITAL FAVORED BY SHIFT IN COMPOSITION OF EQUITY OWNERSHIP

Incentives for companies to favor private ownership increased in the late 1990s when institutional investors began to dominate individual/household equity investors. Following the end of WWII, households owned most of the shares in publicly listed companies directly, and until 1980, they held close to 70 percent of all corporate equity (Figure 2).[6] Since then, the household ownership share has declined steadily until 2003, after which it stabilized at approximately 40 percent. During the same period, institutional investors' share doubled from 20 to 40 percent.

Figure 2. Corporate Equity Investors Shift from Households to Institutions, January 1980-March 2018



Source: Federal Reserve and Milken Institute; as of June 2018
Note: Institutional investors include insurance companies, private pension funds, mutual and closed-end funds, and exchange-traded funds

The growing presence of institutional investors allowed companies to raise funds more efficiently and without many of the reporting and disclosure requirements necessary for publicly traded companies with retail investors. That is because institutional investors tend to rely on other intermediaries (e.g., venture capital and private equity firms) to monitor and manage how companies use investor funds. By comparison, less-sophisticated retail investors generally are presumed to need a higher level of investor protection, which implies stringent regulatory, disclosure, and governance requirements enforced by various government agencies.[7]

[6] Corporate equities in the Federal Reserve's Financial Accounts include both public and private equity.

[7] See "Remembering the Forgotten Investor" by then acting chairman of the SEC Michael S. Piwowar. It questions the sharp delineations in the definition for accredited or qualified investors stemming from Regulation D of the 1933 Act. They are individuals with an annual income of at least $200,000 in each of the past two years ($300,000 for joint income) or a net worth of at least $1 million

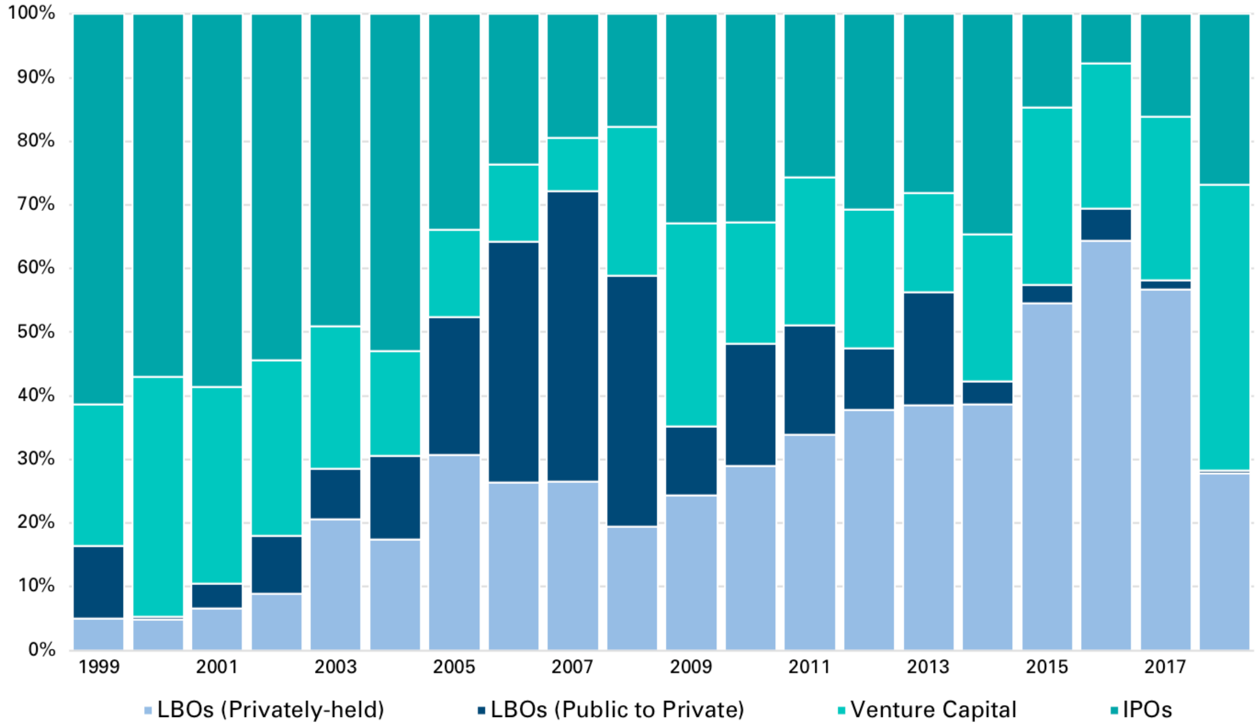
PRIVATE CAPITAL BECOMES FAVORED ALTERNATIVE FOR COMPANY FINANCING

Private equity firms provide financing options that have become the favored alternatives for companies that are eager to raise funds. Companies can raise capital more efficiently (e.g., at a lower administrative cost) with private placements to "qualified" investors than by a public offering.[8] In addition, households may continue to benefit from corporate gains by buying shares in the few publicly traded firms conducting private financing (e.g., listed PE firms), or by allowing their pension funds to do the investing for them. Investing indirectly with institutional investors such as pension funds would allow households to own indirectly a more diversified portfolio containing securities that would otherwise not be available for small investors.

Regulations that segregate investment opportunities, and exclude large groups of investors from profitable investment opportunities have severe consequences that include worsening the distribution of wealth. Such exclusionary practices raise thorny social justice issues regarding whether all investors should have equal access to investment opportunities. Because they are considered "unsophisticated," most households are not even given the opportunity to choose to invest in some opportunities regardless of their level of education or investment experience. They will not meet necessary regulatory requirements for being a "qualified" or "accredited" investor that is necessary to invest in most private equity funds. Indeed, current regulatory policies limit most individual and household investments to a segmented (and shrinking) universe of publicly listed companies.

[8] A private placement is a debt or equity security that does not involve a public offering, and is therefore exempt from registration with the SEC. These investments are limited to accredited investors, see previous sidenote.

Figure 3. IPOs Account for a Diminishing Share of Capital Raised/Invested



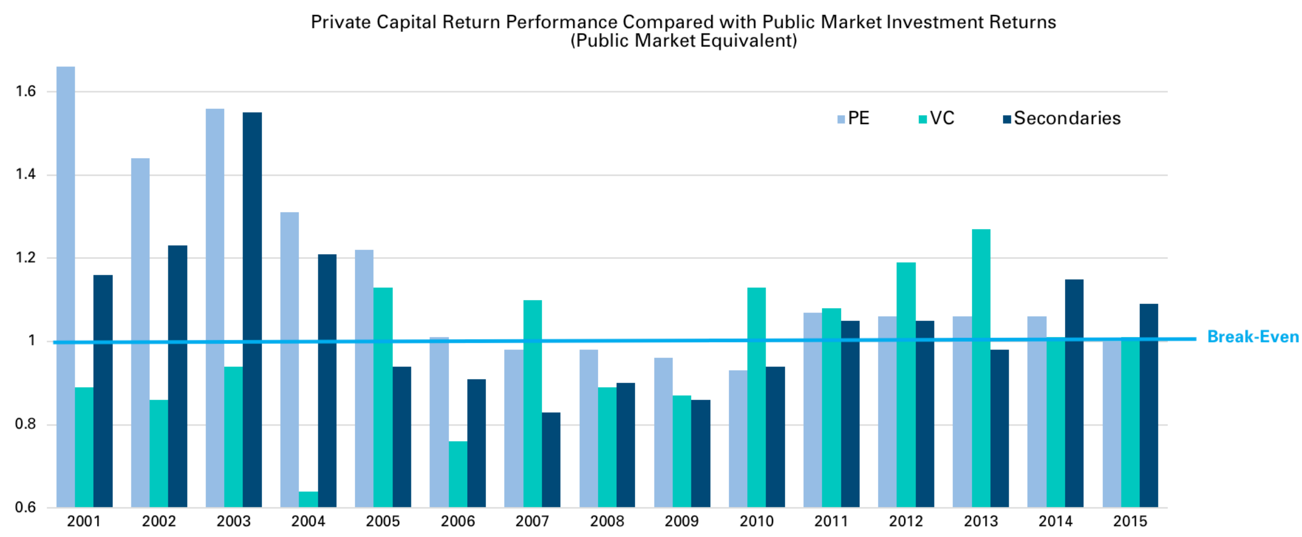
Source: Pitchbook, Thomson Reuters Eikon, and Milken Institute; 2018 reflects the time period through May 2018
Note: Limited to companies headquartered in the U.S. and initial public offerings on NASDAQ or NYSE

Notwithstanding their limited investor base, private equity (PE) firms are becoming a major source of funding for companies that do not wish to list on the public stock exchanges, or for those listed companies desiring to "go private." PE now provides five times more capital than raised with IPOs. By comparison, less than two decades ago PE-supplied capital was only 75 percent of the capital raised by IPOs (Figure 3). The dramatic shift began in 2004, when PE sponsors spent more than $150 billion to take public companies private; a year when IPOs did not account for more than 50 percent of all equity capital raised.

PRIVATE EQUITY OFFERED INVESTORS HIGHER RETURNS THAN LISTED COMPANIES

For some time, private equity has offered investors returns that were substantially higher than those available from investing in listed companies. Prior to the Crisis, the returns on PE funds exceeded the returns offered by publicly listed firms (e.g., the S&P 500) by a wide margin (20 to 60 percent) (Figure 4).[9] However, in the years after the Crisis, the performance of PE funds deteriorated significantly, and barely paced the S&P 500 in 2015.[10] The development of secondary markets for PE assets have allowed PE firms to realize higher returns in the post-Crisis years. However, because secondary PE market transactions are negotiated, pricing and realized returns may not be as efficient as under full price discovery in public equity markets. Secondary PE market valuations may be ephemeral once companies are listed on public stock exchanges.

Figure 4. Private Equity Returns Were Much Higher



Source: Pitchbook and Milken Institute

The increased use of leverage has helped boost apparently sagging returns. PE firms often finance funds participating in the leveraged loan market that helps finance leveraged buyouts (LBOs). Often the companies involved with PE funds already are

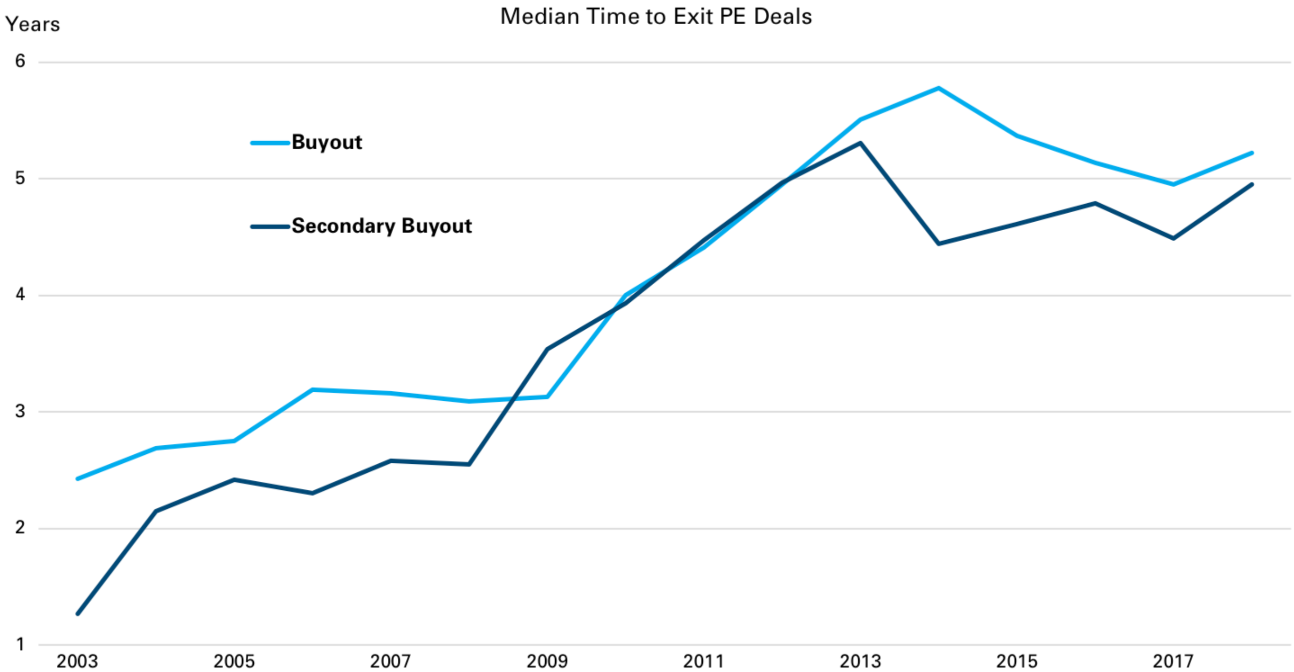
[9] To compare private equity returns we used the "public market equivalent" measure, which compares the return of PE funds relative to the S&P 500; a value greater than 1 implies outperformance. See "PME Introduction" by Henly (2013) for more detail.

[10] The breakeven point is where private capital returns equal the returns from the S&P500 or an alternative stock market index representative of the private capital investment. Venture capital funds (who supplied capital to firms at an earlier stage of development) had slightly better returns than PE funds during the 2010 to 2013 period.

heavily indebted and the loans to fund LBOs have weak lending terms ("covenant lite").[11] Credit rating agencies have recently issued warnings about the risk associated with such corporate borrowing as interest rates rise and the pace of PE deal-making surges.

The larger range of financing options (including secondary PE market sales) utilized by PE firms appears to have lengthened the duration firms remain private. The time for firms to "turn-around," i.e., between a fund's entry and exit from PE ownership, has increased significantly over the last two decades. Indeed, the median time to exit for both initial and secondary buyouts has tripled since 2002 (Figure 5). Providing company managers more time to shape and execute their strategic and operational plans could allow these companies to be more profitable once they do "go public."

Figure 5. Private Equity Deals Take Longer to Exit



Source: Pitchbook and Milken Institute, May 2018

[11] Leveraged loans are debt of companies with below investment grade credit ratings. Leveraged loans are typically senior to the company's other debt and are used mainly to fund leveraged buyouts.

CONCLUDING THOUGHTS

EXPANDED PRIVATE FINANCING IS IMPORTANT FOR ADVANCED CAPITAL MARKETS

The means by which companies raise capital have changed over time. As the headlines for Elon Musk's recent misadventures with Tesla suggest, so have the relative advantages of private over public ownership. While the decline in the number of listed domestic companies is well documented, little attention has been paid to the consequences of the growing private equity market and its institutional investor base. As equity owners shifted from households to institutional investors, the importance of private financing as a means for improving the efficiency and profitability of U.S. companies has amplified.

Investing in PE firms has become more popular among institutional investors, despite fading expectations for earning higher-than-market returns from investments in companies restructured by the PE managements. PE firms make extensive use of a rich menu of securities and leverage to shape capital structures that can incentivize more efficient company operations and provide better stakeholder returns.

In addition, corporate managers have sought PE financing to escape the frequent disclosure requirements and costly internal controls aimed at investor protection that come with public listing. Moreover, we see that nationalized companies, such as Saudi Aramco, are reassessing the balance of benefits from listing on U.S. and global stock exchanges against potential disclosure requirements and legal liabilities that may arise. Some corporate managers want shelter from stock price pressure and interference from shareholder activists. In addition, the development and expansion of secondary private equity markets for trading assets among PE firms has benefited PE investors and company managers. Investors may realize their gains sooner, while corporate managers are able to prolong the time for improving corporate strategies and operations before listing on a public stock exchange.

CONCLUDING THOUGHTS

We believe the severe drop in the volume of domestic IPOs and rise of PE financing reflects an ongoing evolution in U.S. capital markets. Such market broadening is a byproduct of financial innovations that occur when companies and investors continuously re-optimize their capital structures.

However, as more companies are owned by PE funds in which households cannot invest, social policy questions about the fairness of maintaining an unequal distribution of investment opportunities need to be addressed. Moreover, legislation that mandates listed companies to meet more social and wealth distribution objectives that are not directly related to the operations of the company, likely will incentivize even more delistings from stock exchanges and exits into private ownership. This, in turn, likely will exacerbate the unequal distribution of investment opportunities and worsen the already skewed distribution of wealth.

Nevertheless, private capital plays an important and growing role connecting financial resources to investment opportunities. IPOs, publicly listed companies, and private equity are all complementary investment vehicles. Each plays a vital role that allows companies more efficient access to capital for improving productivity, boosting long-term growth, and creating better jobs.

ABOUT US

ABOUT THE AUTHORS

Jakob Wilhelmus, FRM, is associate director in the international finance and macroeconomics team at the Milken Institute. Concentrating on market-level information, his work focuses on topics relating to financial risk, credit markets, and the economics of public and private equity. He is also involved in organizing Institute conferences, roundtables, and workshops aimed at bringing regulators and market participants together to exchange views. He holds an M.Sc. in economics from the Free University of Berlin, Germany, and is a certified Financial Risk Manager by the Global Association of Risk Professionals (GARP).

William Lee, Ph.D., is chief economist at the Milken Institute. He leads the Institute's effort to develop collaborative policies to improve the functioning of, and access to capital markets, strengthen financial stability, and foster global macroeconomic, financial, and regulatory conditions to bolster job creation. Prior to joining the Milken Institute, he was managing director and head of North America economics for Citi. Before joining Citi in 2011, Dr. Lee was deputy division chief at the International Monetary Fund, where he established its Hong Kong office, improved financial market surveillance protocols, and was the IMF resident representative in Hong Kong from 2000 to 2003. His IMF country work included being mission chief for Singapore and deputy division chief covering the United States and Germany. Before the IMF, Dr. Lee was division chief and economist at the Federal Reserve in NY, and at the Board of Governors, respectively. Dr. Lee holds a B.Sc. in operations research and a Ph.D. in economics, both from Columbia University.

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