PUBLIC AND PRIVATE MARKETS IN TRANSFORMATION

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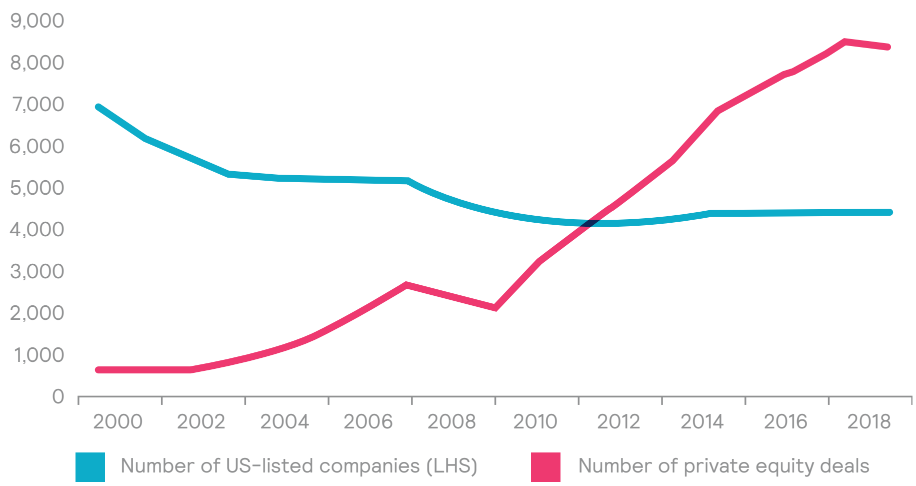
MERCER

The landscape for public and private markets has changed significantly over the past decade, with a marked shift in capital allocation to the private arena. This evolution is being driven in part by regulations, new technologies and the availability of financing alternatives. Other key drivers are the accommodative monetary policies following the financial crisis of 2007–2008 and the more recent investment capital inflows from sovereign wealth funds, which have been significant.

STATE OF PUBLIC MARKETS

Public equity markets have been through multiple waves of structural changes — including the increasing application of passive investing, exchange-traded funds (ETFs), high-frequency trading and factor investing. Additionally, mergers and acquisitions (M&A) surged while US initial public offering (IPO) activity fell by 75% over the last decade, thereby diminishing the replenishment of listed companies. As evidence of this, the number of listed companies in the US, the world's deepest stock market, has declined by nearly 40% from its height in 1996 as shown in Figure 1 below.[1] This trend is also apparent in other major public equity markets.

Figure 1. Private and Public Market Companies



Source: World Bank, PichBook, Neuberger Berman

Furthermore, the increasing regulatory and compliance burdens, coupled with the option of deeper private markets as a source of capital, have discouraged companies from going public. Businesses are staying private longer because they are able to raise more money than ever before. A consequence of these phenomena is the diminished number of new small capitalization public companies.

Business Model Differences

Public Markets

- Typically, higher capital requirements
- Slower growth
- Requires large scale to operate efficiently
- Large investor base, including individual and institutional investors
- Less influential ownership

Private Markets

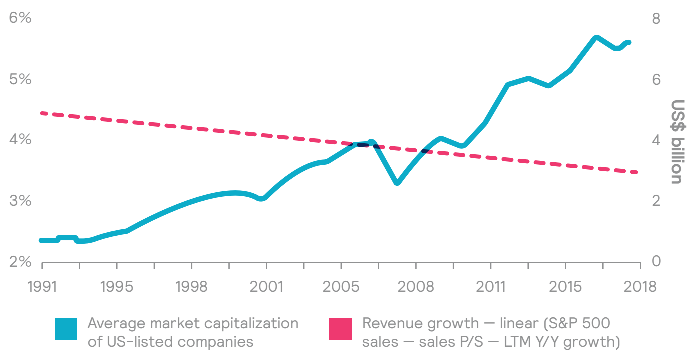
- Typically, less capital required
- More rapid growth
- Operational value creation potential
- Fewer and larger investors/ concentrated ownership
- Truly active ownership

Businesses are staying private longer because they are able to raise more money than ever before. A consequence of these phenomena is the diminished number of new small capitalization public companies.

[1] Doidge C, Karolyi GA, Stulz RM. "The U.S. Listing Gap," *Journal of Financial Economics*, Volume 123, Issue 3 (2017).

This, in turn, has led to a concentration of high-valuation companies in public markets. Figure 2 shows a steady increase in the average market capitalization as revenue growth has declined over the past 20 years.

Figure 2. Median Market Cap and Revenue Growth
1991–2018



Sources: World Bank, FactSet

The shrinking stock universe, coupled with increasing pre-IPO activities and direct financing opportunities in private markets, means that public market investors have limited options to access growth companies and are not able to participate in the full economic growth potential of those companies. Moreover, the role of public markets has changed significantly, with the remaining listed companies representing more-mature, larger and potentially slower-growing companies. As a result, for some companies, the stock markets have evolved from being providers of growth capital to representing an exit strategy for private market investors.

> Public market investors do not necessarily have access to the types of investments they did historically.

Even for those companies that do go public, public market investors do not necessarily have access to the types of investments they did historically.

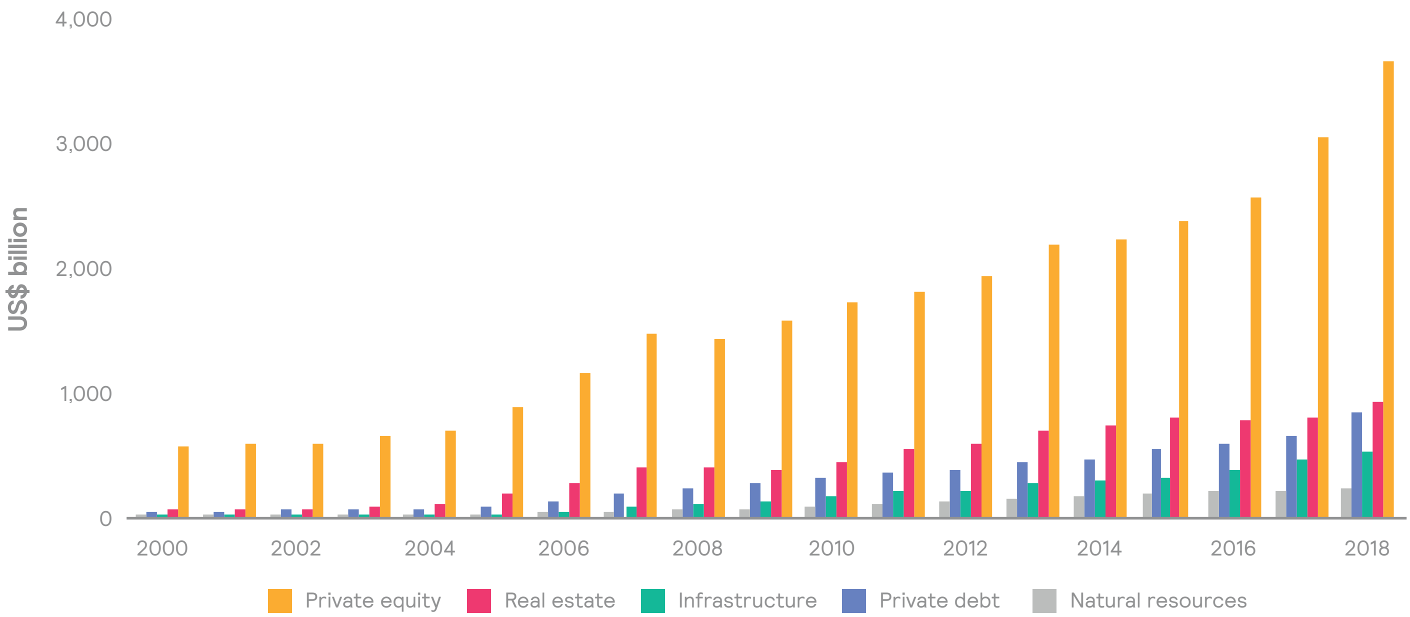
For example, some of the new technology IPOs have dual class shares (DCS) with different or no voting rights for public shareholders, allowing management to maintain full control while still accessing the capital markets. IPOs such as Facebook, Lyft and Snapchat have chosen this "super vote" structure to provide protection from short-term-focused activism while building out their innovative businesses. However, this quasi-public structure means investors won't be able to take action if the company is poorly managed, reducing shareholder influence. But these structures are not always positive for companies. A number of studies[2] illustrate that companies saw a significant increase in their valuations when giving up the DCS share structure.

PRIVATE MARKETS ARE GROWING UP

In contrast to the decline in the number of public companies, private market growth has accelerated, and strategy innovations have surged across all sub-asset classes. Private market growth is being driven by strong investor demand coupled with a significant increase in supply (that is, a growing number of increasingly larger private market funds). Another key driver is the increasingly strong relationship between private equity fund managers and private debt providers. Private debt providers are offering direct financing to privately owned companies (in place of traditional bank financing) with increasing frequency. Private market investors provide the capital by investing in private debt funds. Following the financial crisis, assets under management for alternatives tripled to more than US$9.5 trillion (including hedge funds). Although private equity still dominates the market in terms of total capital, private infrastructure, private debt and natural resources are growing at higher rates than private equity.

[2] Jackson RJ, Jr. "Perpetual Dual-Class Stock: The Case Against Corporate Royalty," 2018, available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty. CFA Institute. *Dual-Class Shares: The Good, the Bad, and the Ugly*, 2018, available at https://www.cfainstitute.org/-/media/documents/survey/apac-dual-class-shares-survey-report.ashx.

Figure 3. Growth of Private Markets



Source: Preqin

More recently, private equity has faced some headwinds as fundraising has slowed and unallocated private capital hit record levels. Compounding the latter trend is an increase in the use of fund-level lines of credit, which encourage general partners (GPs) to delay capital calls. Conveniently, the use of credit lines serves to enhance internal rates of return and mitigate a fund's J curve. In addition, rich asset valuations present a significant challenge to private equity fund managers in effectively deploying capital. Lofty valuations are also an issue for public markets as the economy moves closer to its late-cycle stage.

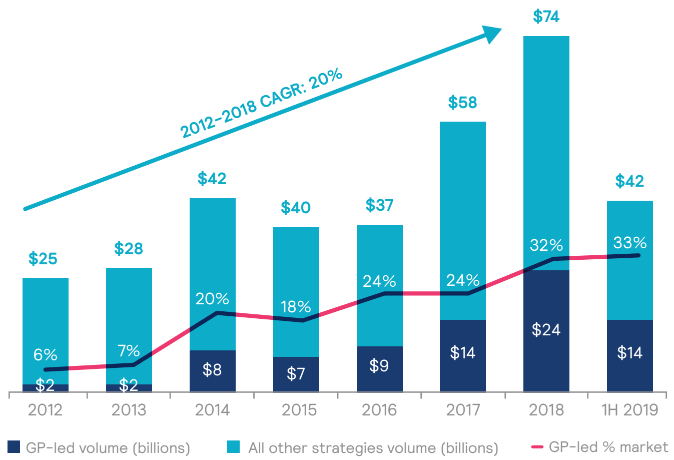
The trend toward private assets may persist as investors seek to participate in growth across the corporate lifecycle spectrum.

That said, private markets appear to represent a growing proportion of overall economic growth. For example, according to Growth Economy,[3] between 1998 and 2017, employment in US private-equity-backed companies grew by 60%, whereas all other US companies increased jobs by 24%.

Hence, the trend toward private assets may persist as investors seek to participate in growth across the corporate lifecycle spectrum — from startup to early-stage growth opportunities all the way to "take-private" investment strategies. Additionally, the flexibility of private markets enables investors to profit more directly from market dislocations; for example, in the private opportunistic debt space. At the same time, private markets continue to evolve, offering sophisticated investment strategies, such as the maturation of secondary markets and the related evolution of GP-led secondary transactions.

[3] Growth Economy, available at http://growtheconomy.org/.

Figure 4. Growth of Secondary Markets — New Volume Record



Source: Greenhill

Private markets continue to evolve, offering sophisticated innovations such as maturation of secondary markets, the related evolution of GP-led secondary transactions and in-perpetuity financing vehicles.

Another innovation is the launch of long-term fund strategies, or "in-perpetuity financing vehicles," for companies that don't wish to ever go public or become a target of a leveraged buyout. This is a relatively recent innovation, and it remains to be seen how receptive limited partners (LPs) will be to this strategy and what ultimate structures develop to mitigate the inherent conflicts of interest and liquidity issues.

In order to enhance returns, reduce costs and/or participate more directly, LPs are increasingly pursuing co-investments or direct investments. Further, some LPs are developing direct investment programs or strategic relationships, which bypass the traditional LP/GP structures. GPs, on the other hand, have established private equity fund of funds to take advantage of opportunities across more investment types and asset classes. At the same time, hedge funds and traditional investment managers access growth opportunities via late-stage pre-IPO private rounds.

Private markets may enjoy an additional tailwind from an improving regulatory environment. Currently, the Securities and Exchange Commission is evaluating options to expand investor access to unregistered securities and enable emerging companies to more easily raise capital. This initiative could result in amended rules, greater access to financial products and more sale options.

WHAT IS THE IMPACT?

As private and public markets are becoming more mature, new trends are emerging that may impact future investment approaches. The distinctions between private and public markets may lessen, and return, risk and liquidity may be accessed in different ways. It is foreseeable that private market funds would consider investing in a company during its private, rapid-growth phase and remain invested once the company goes public.

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The following tables illustrate some notable trends in public and private markets from two perspectives — the underlying company and the investor.

Table 1: Company Perspective

TRENDS	PUBLIC MARKETS	PRIVATE MARKETS
Ownership	Shareholder activism is on the rise, but the ownership dilution of most public companies makes it difficult to effect change.	Private markets continue to represent a highly active ownership approach, with greater focus on value creation through operational improvement. There is less emphasis on financial engineering elements to generate gains in private equities.
Regulation	Public markets face increasing regulatory pressure, higher disclosure/listing requirements and higher associated costs.	Private markets continue to enjoy relative obscurity compared to public markets. Expectations of expanded investor access should further benefit private market growth.
Financing	Public companies are utilizing debt financing for nonexpansion purposes (for example, stock buyback programs).	As purchase multiples increase, acquisition debt levels have also increased. Debt availability is high for purchasers from private funding sources, driven by favorable terms (such as fewer lender protections, fewer borrower restrictions and more repayment flexibility). Companies are staying private longer, given the availability of financing options (for example, private pre-IPO).
Sustainability	Reputation risk is growing given the high level of public awareness and emerging interest in responsible investing topics.	A higher level of control and transparency should allow private equity firms to impose more responsible company management actions. However, widespread adoption has not yet occurred.

Table 2: Investor/Limited Partner Perspective

TRENDS	PUBLIC MARKETS	PRIVATE MARKETS
Liquidity	Increasing public market concentration may eventually weigh on liquidity. Currently, however, public markets remain highly liquid. Additionally, ETFs and the rise of digital platforms improve liquidity.	The growth and maturation of secondary markets has marginally increased liquidity for both LPs and GPs. However, private markets remain largely illiquid investments.
Returns	Gradually shrinking small-cap and growth opportunities may require adjustment in capital market assumptions and return expectations. ETFs and direct listings are impacting alpha opportunities.	Private markets are continuing to provide excess returns over public market equivalent benchmarks. However, late-cycle dynamics are in play, including high valuations and recession scenarios impacting return expectations and underwriting models.
Portfolio construction	Public asset classes may include private market sleeves (for example, pre-IPO investments).	The broadening of private market options is increasing the opportunity set as well as introducing new return drivers and diversification opportunities. Secondary markets are becoming a bona fide portfolio management tool.
Active/passive	Performance persistence appears to have declined, leading to an increasing emphasis on passive investing. Active management may benefit as a result of market concentration.	High active management and related alpha opportunities continue to be available in private market funds. One key is the ability to access top-tier managers. Truly passive options do not yet exist.
Products	Some consolidation and contraction has occurred among traditional strategies. At the same time, there has been some product innovation along the lines of systematic strategies trading and factor investing.	Conversely, there has been a high level of product innovation in private markets, including long-term funds, complex secondary strategies, more demand for direct co-investments and the emergence of private debt.

WHY SHOULD INVESTORS PAY ATTENTION?

Some investment growth opportunities have shifted from public to private markets, with companies staying private longer or seeking a private placement rather than an initial public offering. As a result, public market investors may not have access to the full and diversified investment opportunity sets that were previously available.

> Alpha generation will be more critical, with market concentration increasing in public markets, whereas true long-term risk premia may prevail only in private markets.

Consequently, public market investors are unable to participate in the rapid growth and high equity appreciation phase of many companies. As such, risk/return expectations may need to be reevaluated in both public and private markets, which, in turn, may also ultimately have implications for asset allocation decisions. Moreover, alpha generation will be more critical, with market concentration increasing in public markets, whereas true long-term risk premia may prevail only in private markets.

Liquidity budgeting and scenario-testing will continue to be important as the lines between public and private markets continue to blur, at least at the margin.

With public market valuations being rich, investors are looking past return optimization to seek downside protection, diversification and lower correlation in private markets. Institutional investors have been increasing their asset allocations to private markets to get exposure to a broader range of industries as well access to companies earlier in their developmental cycles. This trend is changing the way asset owners and asset managers think about return assumptions, portfolio construction and implementation.

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