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Investment Publications Highlights

The Deregulation of Private Capital and the Decline of the Public Company

Elisabeth de Fontenay, *Hasting Law Journal*, vol 68 (April 2017): 445-502

In this article, the trend of more US companies opting to remain private rather than trade publicly is explored. The authors discuss how the changing regulatory landscape has led to fewer companies going public, and conclude that the main cause of this trend is the declining benefits for firms that go public.

Since its inception, federal securities law in the United States has had separate sets of rules for public and private companies. The legal divide between public and private companies is built on the premise of a cost-benefit trade-off that ultimately supports a healthy market. Public companies are allowed to raise capital from the general public but must abide by additional costly reporting requirements to protect average investors; private companies avoid the burdensome disclosures, but their ability to raise equity capital is limited to certain types of investors.

The authors identify two long-term trends: (1) more companies are remaining private, and (2) companies that do go public are doing so later in their lifecycle. These trends are often attributed to companies avoiding the rising costs of public company regulation. Laws, such as the Sarbanes-Oxley Act of 2002, are blamed for making public company regulation too expensive, but the data show the trend was in place well before such regulations were made into law. Instead, the authors attribute the trend to the declining benefit of going public.

Over the past three decades, changes to securities laws have made it easier for private companies to raise ample, cheap capital—the main benefit companies receive when they go public. This on its own is not a problem, but the issue arises as the proportion of companies staying private gets too high to sustain the positive economic externalities of a thriving public equity marketplace. With fewer public companies, each one then bears a higher cost, making it even more beneficial to be a private company. Counterintuitively, this ultimately hurts private companies, too, because private companies rely on data from public companies for valuations. Others, such as government agencies and individuals, also rely on the data to make decisions.

As it stands, this issue will continue if regulatory policy maintains the status quo. The authors believe the overarching policy issue is that current law occupies a middle ground between stricter regulations and looser regulations—either of which would be better. In other words, the problem can be solved by either reducing public company reporting requirements or requiring stricter private company reporting requirements.

Are US Industries Becoming More Concentrated?

Gustavo Grullon, Yelena Larkin, and Roni Michaely (presentation, China International Conference in Finance, Xiamen, China, July 8, 2016)

Since the beginning of the twenty-first century, US industries have become more concentrated. The authors determine that this represents a structural shift, rather than a short-term trend. They find that this concentration has produced higher profit margins, positive abnormal stock returns, and more profitable merger & acquisition (M&A) deals.

The authors examine all firms in the CRSP-Compustat dataset for the period 1972–2014 and limit the analysis to US firms that trade on major stock exchanges. According to the data, the average publicly traded firm is three times larger in real terms today than it was in the 1990s. The Herfindahl-Hirschman Index (HHI), a commonly used measure of market concentration, indicates that over 75% of US industries have become more concentrated since the beginning of the 21st century.

According to the study, industries that have become more concentrated tend to be more profitable, mainly due to the improved ability to generate higher profit margins. In addition, the study finds that as the number of firms in an industry decreases and the industry becomes more concentrated, the market's reaction to M&A announcements improves.

To better understand industry concentration in the United States, the study investigates five potential forces, determining that two—greater barriers to entry and changes in the enforcement of antitrust laws by the Department of Justice and the Federal Trade Commission—contributed to its rise. The authors find no evidence to support the three other factors, which were that private firms have become more prevalent, foreign firms have replaced US firms, and consolidation primarily occurred in unprofitable industries.

The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer US Equities

Michael J. Mauboussin, Dan Callahan, and Darius Majd, Credit Suisse, Global Financial Strategies, March 22, 2017

The authors examine the fall in number of US publicly listed companies. They argue that changes in regulation, M&A activity, and initial public offering (IPO) markets have contributed to that reduction. Implications of this dynamic include concentrated industries, large and highly profitable public companies, and a more demanding opportunity set for investors.

The authors find the number of publicly listed companies in the United States increased by more than 2,500 from 1976 to 1996, as GDP grew by nearly 90%. However, in the subsequent 20 years, the number of listed firms fell by half, in spite of an economy that grew 60%. This sharp fall stands in contrast to the number of public listings in 13 other developed economies, which has increased by about 50% since 1996.

The authors argue the propensity to list fell over the 20-year period as the costs of listing rose. Increased regulation, including the Sarbanes-Oxley Act of 2002, likely contributed to the rising cost level. They do note, however, the delisting trend began well before Sarbanes-Oxley was implemented.

The authors argue M&A activity is the primary reason a company delisted. While strategic deals account for the majority of M&A activity, leveraged buyouts gained in popularity during the late 1990s. Companies taken private today by private equity (PE) shops are less likely to return to public markets, because trade sales and secondary buyouts have become more common exit strategies.

The authors also note the average number of IPOs per year since 2000 is roughly 60% lower than in the period from 1976 to 2000. One explanation they point to is the abundance of late-stage venture capital (VC) financing. As a result, companies seeking IPOs are, on average, older than in the past and more valuable. Even public equity investors such as mutual and hedge funds now participate in late-stage VC financing rounds.

Thus, industries in the United States are more concentrated than in the past, catalyzed by lenient antitrust enforcement and higher barriers to entry. The public companies remaining are older and larger than their predecessors, resulting in higher total payouts. These distributions are supported by greater average profitability and operating margins.

Since the equity opportunity set shifted, the authors argue it is more difficult today for investors to achieve complete US equity exposure. Whereas in the past an early-stage VC fund and public equity index would suffice, today's allocation requires early- and late-stage VC funds, PE buyout funds, and public equity indexes. ■

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