EXPERT COMMENTARY

The changing function of public and private markets in financing the real economy represents a long-term structural shift, writes Partners Group's Steffen Meister

Public and private markets' role reversal

The financing of business has undergone a major transformation over the past decades. At one time, IPOs were the pinnacle of corporate development – a signal that a business had proven its value and truly come of age.

Today, this no longer appears to be the case. The companies that come to public markets are not necessarily mature businesses, often they are young companies driven by hope and speculation.

These are essential characteristics for a fledgling business, but they are not the traditional territory of IPO financing. IPOs have arguably become the tactical exit instrument of venture capital and growth investors.

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Meanwhile, private markets have also shifted their attention. Once known as a venue for opportunism and financial engineering, private markets have increasingly turned to financing mature enterprises, building businesses and creating value through organic growth and operational excellence.

This trend has been underway since at least the turn of the millennium and is now reflected in the landscape of both public and private markets.

Opportunism versus investment

In the 1980s, private and public markets had distinct roles. Public equity markets were the home of mature businesses with long heritages and wide, sometimes global, footprints. Equity markets and the flow of IPOs included companies from every industrial sector, from retailers to heavy industry, and from manufacturers to utilities. IPOs were typically of well-developed, profitable businesses such as Nike, which had been trading successfully since the 1970s, and by the 1980s when it came to market had grown to become the largest athletic shoe brand in the US. Through IPOs of profitable and growing businesses, public markets accounted for a meaningful share of the financing of the real economy.

Private markets were quite different. Private buyouts were niche strategies with an event-driven character and as such were much more opportunistic. Private equity bought up businesses that were undervalued by public markets – often where the stock price for an aggregate business was lower than the sum-of-its-parts valuation and the typical sectoral focus was on consumer and industrial businesses. The other common ingredient of private markets investments in the 1980s was debt. Private markets transactions were typically heavily leveraged, with 80-95 percent of the capital deployed in private buyouts funded by debt. Buyouts hardly contributed much to the financing of the real economy back then.

These differences between public and private markets were also reflected in the typical investors in each respective market. IPOs attracted the deep pockets of institutional money or the largest family offices. Private markets were the realm of more adventurous investors.

Turning of the tide

The role reversal of public and private markets began to take hold in the late 1990s and accelerated in the 2000s as the typical strategies of public and private markets came closer together. Private markets began to institutionalise their investment processes and move away from opportunism towards being an institutionalised alternative asset class.

Public markets, however, developed an appetite for 'hype' companies: businesses that were generating almost feverish excitement, and with that excitement the scale of the valuation arbitrage available in public markets grew rapidly. The depth of capital available in public markets and hope for a 'winner takes all' business would typically lead to higher valuations, especially for unproven and unprofitable business models.

85%

Proportion of public companies in the US in 1990 which had positive earnings at the time of IPO

21%

Proportion of public companies in the US in 2022 which had positive earnings at the time of IPO

Source: Ritter, JR, 2023. Initial Public Offerings: Updated Statistics, Gainesville: Warrington College of Business, University of Florida

While public markets got carried away by their opportunism, private markets were shaking off their speculative reputation. Private equity firms began to shift their attention from underperforming or undervalued assets and event-driven strategies to buyouts of more solid and promising companies with strong growth potential.

In parallel, numerous studies by industry groups or academics began to highlight the outperforming returns that had been delivered by private markets. With these returns in mind, and often based on advice from investment consultants, institutional investors began to adopt allocation strategies that included a small but meaningful percentage allocation to private markets.

The role reversal is almost complete

Today, the roles of public and private markets have almost completely reversed from those in the 1980s. When it comes to raising new capital, public markets are the realm of opportunistic IPOs, while private markets are the realm of real economy investment and strategic corporate development. The change we have witnessed has not happened at a consistent rate. The dotcom bubble saw a drop in IPOs of profitable companies and, on the eve of the great financial crisis, the profitability of listed firms was better. But these are acute moments and should not confuse our view of the clear downward trend in the profitability of companies at the time of their IPOs, which has been underway for the past three decades.

At the same time, private markets have turned away from the dominant use of debt in capital structures. Leverage is still a valuable tool for private markets but is no longer a defining feature.

There is a further development in understanding what is driving private markets and that is the growing recognition from company founders, owners and management teams that their own interests are not necessarily best served by an IPO. The IPO was originally seen as the pay-off – the moment when owners and managers monetised the value they had created. Some still think in these terms, but there is also an increasing understanding of how private equity can provide a superior return to management through longer-term value creation.

Private markets offer management a stake in the future that can be far more valuable than a speculative IPO payday. There is also an increasing reluctance among some companies to be exposed to the 'governance correctness' typically found in public markets, whereby the requirement to adhere to corporate governance codes and industry 'best practice' is in danger of overshadowing the need for a value-enhancing strategy. This is why today, a call from a reputable private markets firm for financing is often seen as driving more excitement than the prospect of an IPO.

Changing attitudes towards IPOs have led to private markets becoming the more relevant source of financing for developing the real economy. This has largely been driven by two key factors: annual private markets fundraising has exceeded public markets equity issuance since 2016, and private markets are typically more focused than public markets on what we would describe as 'foundational' companies and assets. Foundational companies deliver the products, services and infrastructure that are essential to the real economy and are typically rich in assets, both tangible and intangible, with high barriers to entry and skilled workforces.

Macroeconomics is not the determining factor

We are currently in a more volatile environment characterised by higher interest rates and inflation and lower real economic growth prospects. Looking ahead, this more challenging macroeconomic environment will likely continue to slow global financing activity and dampen returns in both public and private markets.

Amid this more challenging environment, some observers have warned that private markets are particularly exposed and that we are at the end of the era for buyouts. We disagree, not least because we have heard this tale before. Such predictions were voiced in 2000 after the strong rise in technology, media and telecoms buyouts, when private markets were valued at about $1 trillion. No such bust took place and a decade later private markets had tripled in size to about $3 trillion. And again, after the great financial crisis, it was predicted that private markets had peaked. Since then, private markets have more than tripled again to $10 trillion.

As we have seen in previous downturns, we believe that private markets will continue, on a relative basis, to outperform public markets and a more difficult market environment will not reverse the trend we have been describing. Quite the contrary. The switching of roles between public and private markets is not cyclical; it is a structural change that has been underway for the past 30 years.

The private markets model of the future

The role reversal between public and private markets will drive an equally important change among private markets firms, especially because the rising significance of the asset class will see new entrants to the market, including major established financial groups looking to benefit from this growing segment. Naturally, investment firms will distinguish themselves through their offerings, cost structures and client service, but most importantly they must differentiate themselves by their approach to investment.

Active and passive investment are familiar terms in public markets. A similar distinction will be key to the differentiation between private markets practitioners – some will be more passive, others more active. But in private markets this difference will mean something quite distinct. In public markets, an 'active investor' is a stock-picker who targets outperformance by choosing the right stocks at the right time – usually with little evidence of success. In private markets, being active means far more and accounts for greater outperformance.

Truly active private markets firms are business builders that combine scale of resources with an industrial-style transformational investing approach to deliver real value creation. But how should private markets firms go about developing this value-creation strategy? We believe they can learn a lot from successful, diversified industrial groups or, as they are sometimes known, conglomerates.

A classic conglomerate and a private markets group have more similarities than one might at first assume. In both cases there is an array of separate operating companies owned by an overarching entity. There are also similarities in the network effects that a conglomerate and an active private markets group can realise between their subsidiaries/portfolio businesses.

Active private markets participants must take the best that the conglomerate model has to offer, while studiously avoiding its mistakes and risks. Studying diversified industrial groups, the most successful rank very highly in five specific dimensions: strategic rigour, entrepreneurial governance, operational excellence, the use of proven playbooks and talent strategy.

Across these five factors, the single unifying theme is an understanding of what real value creation looks like and where it takes place within companies. Modern and successful active private markets firms are not financial services companies. Astute acquisitions and financial efficiency are essential, but the modern private markets firm should be focused on active investing and outperformance rather than a more passive, scale-driven approach.

With rapid change across global giga themes such as digitisation, decarbonisation and changing consumer preferences, as well as accelerating technological disruption, private markets firms will need to continually transform and adapt assets to build the resilient business models of the future. Active private markets firms will focus on agility, innovation and entrepreneurial ownership to keep pace with this changing environment – and in doing so will build our future sustainable economy. Offence will be the new defence. ■

Steffen Meister is a partner and executive chairman of the board of directors at Partners Group