Public vs Private Equity

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The private equity market is a rarefied area of Finance. It is much smaller, compared to public equity. In January 2006, in the US, public equity was valued at about $ 18 trillion whereas private equity added up to only hundreds of billions of dollars.

Private equity investors expect a much higher return compared to those who put their money in public equity. So, it is widely perceived that private equity is a more expensive source of capital, compared to public equity. But this perception is not quite correct. If a proper cost benefit analysis is done, public equity may turn out to be far more expensive than it looks.

The costs of raising public equity can be substantial. There are fees to underwriters, auditors, attorneys and other intermediaries. Compliance and investor relations costs can also be heavy. These direct costs are large but the indirect costs can be even bigger.

Research indicates a 3% average fall in stock prices after the announcement of seasoned equity offerings. Say a company, with an existing market cap of $ 1 billion, wants to raise $ 100 million from the market. A 3% drop would amount to $ 30 million or 30% of the new equity offering! In 1983, AT&T announced a $ 1 billion public offering. The 3.5% drop in price amounted to a loss in market cap of $ 2 billion, i.e. 200% of the new equity offering!

Public investors are sceptical providers of capital. The more complex the company and its business plan, the more difficult and expensive it becomes to raise public capital. Public investors have less information about the company than the insiders. Their natural response to this disadvantage is scepticism, which is reflected in lower stock prices.

The paradox of public capital is that it is most readily available when the company does not need it and least available when the company does need it. Clearly, public capital falls short on the criterion of financial flexibility.

Private equity investors bring a different value proposition to the table. They do not merely offer capital as public investors do. They assume more accountability and ownership and try to contribute in various ways. The fortunes of PE investors are directly tied to the success of their investments and the performance of their fund.

In case of PE, unlike mutual funds, past performance appears to have some predictive power. PE funds operate in a market with a significantly lower degree of efficiency and liquidity. The skills needed to succeed in this market are much broader and deeper than those needed to invest in public companies. The variation in such skills among private equity firms is also much more pronounced.

Early stage companies while choosing a venture capital firm, when they have multiple offers, do not only go by valuation. They also look at the skills which the VC firm has to offer. Public companies issuing private securities sometimes do so at a discount to private equity investors, effectively compensating them for their skills. These PIPES (private investments in public equity securities) are often associated with positive stock returns of about 10% on an average compared to a seasoned equity offering where, as mentioned earlier, there is usually a negative reaction.

PE investors do not see themselves merely as buying low and selling high. They see themselves as active investors who contribute complementary skills to the management teams and the companies they sponsor.

Professional PE funds are typically limited partnerships consisting of highly creditworthy investors who are legally committed to provide funding at short notice even if the market conditions are not good.

PE funds are also mostly contrarian by nature. They invest more aggressively when public market appeal for an industry is low.

In PE investments, a small group of investors gain access to significantly more information than what is disclosed in an SEC filing. PE investors do a fairly comprehensive due diligence, often tailored to a specific industry. The process emphasizes a critical examination of every piece of information that involves any subjective judgment that may materially affect the valuation of the company. PE investors being better informed, come in as willing investors. They are also in a position to recognize and reward good management performance even in difficult conditions and fully support their management teams.

Alignment of management and shareholder interests through significant pay for performance plans is an essential part of the PE philosophy. The link between pay and performance is greater and more flexible than in the case of public companies. For exceptional performance, the management can be provided additional incentives. The success of the PE investors' success also means management earns a substantial life changing pay-out.

Large public investors avoid board membership which makes them *insiders* under SEC regulations and result in less flexibility to sell shares. So big investors in public companies view selling off their shares as their only practical response to dissatisfaction with the company's performance. In contrast, PE investors actively seek board representation. While on the board, they work closely with the CEO playing the role of coach, consultant, investment banker, advisor and provider of additional capital. The boards of PE companies have key investors but fewer members. These boards are far more vibrant and effective, compared to the boards of public companies. PE investors also bring a wealth of contacts that may provide potential suppliers, customers and even additional members of management.

VC sponsored firms face less costs when going public. They also receive more favourable pricing compared to an equivalent non-VC IPO candidate. VC backed companies also attract more reputed underwriters and accountants. Thus, VC investors seem to play a certification role in the IPO process.

In PIPES transactions, the positive market reaction is due to the certification role of PE investors. The involvement of informed investors is a reassurance to public investors. Markets begin to bet on an improvement in corporate governance through board participation by the PE investors and their value adding role as financial and business partners.

Concluding notes

Well-functioning public markets are needed to support the development of private equity markets. Public markets provide the exit route for many VC investors. Thus, private and public markets seem to complement each other well. But there are situations where PE clearly scores. One example is mature companies with stable and predictable cash flows. Companies with credibility concerns and those undergoing rapid change may also benefit from PE investment. Whenever public investors find it difficult to evaluate and monitor the company, PE investors can step in. Even some of the most successful public companies may find that at some point, going private or doing a significant recapitalization could be the value maximizing answer.