Comment w/c 6th November

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Will the dominance of Private Equity become the Achilles Heel of the free market?

There was a particularly interesting article by Matthew Lynn on Tuesday 31 October in the Telegraph business section. It drew attention to the chronic decline in the number of companies listed on both UK and American markets, and the far-reaching consequences that this will have for both markets and investors. To quote from the article: "In New York, there were 8,000 listed companies at the peak. Now there are fewer than 4,500. London has seen a similar trend. Ten years ago there were more than 3,000 companies quoted on the main and junior markets. By this year it had dropped to only slightly over 2,000. At one point, the emerging markets were filling that void. But as JP Morgan figures make clear, that is no longer true. The traditional equity is now in absolute global decline." It begs the question: 'Why?' This has happened notwithstanding the generally healthy state of the world economy and the businesses that support it. In the UK employment has been rising and corporate earnings are generally good. The article hints at some answers to that question, and I would like to focus on the role of Private Equity in undermining public markets: as Matthew Lynn says, "The rise of the buy-out industry means there are lots of alternatives for company owners who wish to sell. At the same time, a massive rise in regulation, and layer upon layer of governance codes, has made public listing a burden that many directors can no longer be bothered with." The article speaks of far-reaching consequences for markets and investors, but I believe it is even more significant than that, by far. The real casualty is popular support for the free market itself: because, if individuals are denied access to investing directly in shares, they can have no sense of ownership in, nor responsibility for, the great engines of industry which create wealth in such abundance - and they will turn elsewhere, potentially back to socialism. This is a really big issue for our whole economic system: indeed this scale of intermediation is exactly what drove the 'Occupy' protests of some years ago and the electoral disquiet which has been so evident over the past year. As a trustee of a major institutional investor for most of the past 18 years (the Church Commissioners' Assets Committee), I have been struck by the rising proportion of asset allocation dedicated to Private Equity, and the strong performance it has achieved. The Commissioners are certainly not alone as an institutional private equity investor: most are heavily involved in the sector, and for good reason. They include your pension funds - so individuals do share in their performance, if not in any sense of business ownership. The great Family Offices, Sovereign Wealth funds, hedge funds and insurance companies are all investing in Private Equity. This is because they all share the benefits of size: they can invest in the large amounts that Private Equity managers are prepared to accept, whereas personal investors can not. A recent article in Forbes magazine showed graphically the out-performance of Private Equity over public markets: their charts below, drawn from Bain and Company's Global Private Equity Report 2017, show how over a 10 year horizon buy-out funds (another name for Private Equity) have substantially outperformed both the US and European public markets in terms of pooled net internal rate of return (IRR). So we can't blame institutional investors from going where the money is. However we can ask the question 'why?', and what can be done about it:

- Focused Management: there is no doubt that the management of Private Equity owned businesses is tightly targeted compared to publicly listed companies. In listed businesses executive company directors are selected by their non-executive colleagues, with little appetite for 'hire and fire' - and they're subject to extensive corporate governance procedures. In contrast, if a Private Equity owned business executive doesn't deliver they're out. In addition, within Private Equity investors such as Family Offices there is a high preponderance of investment bankers, familiar with controlling the destiny of whole companies and therefore handling their executive directors accordingly.
- Interest Rates are really important for Private Equity, which finances a huge proportion of its investment by debt. Interest rates have been super-low now for a whole decade, and in any case Private Equity can offset their cost of borrowing against gross profit before tax is calculated. These two interest benefits have substantially whetted their appetite for buying out whole companies, whether from entrepreneurs pre flotation or from the public markets themselves, sometimes doing deals with incumbent executive directors (this can be questionable, due to their conflicted responsibilities).
- Immense buying power for trade sale exits: particularly in the tech sector. There are a range of megaliths with global buying power greater than individual countries, such as Apple and Amazon (Motley Fool last week: ' Big Tech is getting bigger '). These enormous wealth magnets, often operating beyond the reach of tax and competition authorities, are just waiting to absorb many of the restructured businesses coming out of Private Equity. The sheer scale of finance available for trading in whole companies has made public market flotation irrelevant: the control premium for a total buy-out is enormous. With control comes the power to change both business and operating models: that cannot be

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done with a minority stake, and anyway the protection afforded by corporate governance to minority shareholders can easily thwart a majority owner's plans for change. They'd much rather go for a straight trade sale.

Do not underestimate the significance of trading whole companies in this way: this is the new currency for big money. So what can be done? For, if this situation is not re-balanced, Matthew Lynn may well be right in fearing for the future of listed markets, and I may be right in fearing for the impact of that on our whole socio-economic system. **Firstly** , Government can re-balance the scales between Private Equity and public markets. They could exclude interest costs as an allowable expense for tax, for example. To be realistic, this is unlikely to happen in the throes of the Brexit process since they would not wish to exacerbate any exit from London by Private Equity managers. However they could also abolish stamp duty for trading in shares on public markets. This has already been done in the AIM market for smaller companies, and has made a huge difference. **Secondly** , the regulators need to revisit the weight of private of corporate governance and regulation on listed equities, thereby reducing the burden on company boards and improving the ability to issue and trade shares on public markets. In particular, this should enable and encourage personal investor participation in both primary and secondary markets. This is why our colleagues at The Share Centre have asked for a new drive for individual share ownership in its 2017 Budget proposals, including a cross departmental working party to consider and introduce new measures to bring it about. This should include the great institutional investors, because it is very much in their interest to see healthy public markets and popular support for the free market. **Thirdly** , the huge concentration of wealth, in both corporate and individual respects, must be addressed. The enormous super-rich technology giants need taming, in terms of both tax avoidance and competition. In their role of providing trade sale exit for so many Private Equity investments, they are driving the decline of public markets - in spite of the fact that some of the tech giants (not all) have their own market listing. But don't imagine that any of this will be quick and easy - it won't. It is an endemic problem built up over years, and has a powerful industry lobbying for it. However it is jeopardising the future wealth-creating potential of the free market, by alienating the people from their share in the ownership of industry.

Gavin Oldham

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