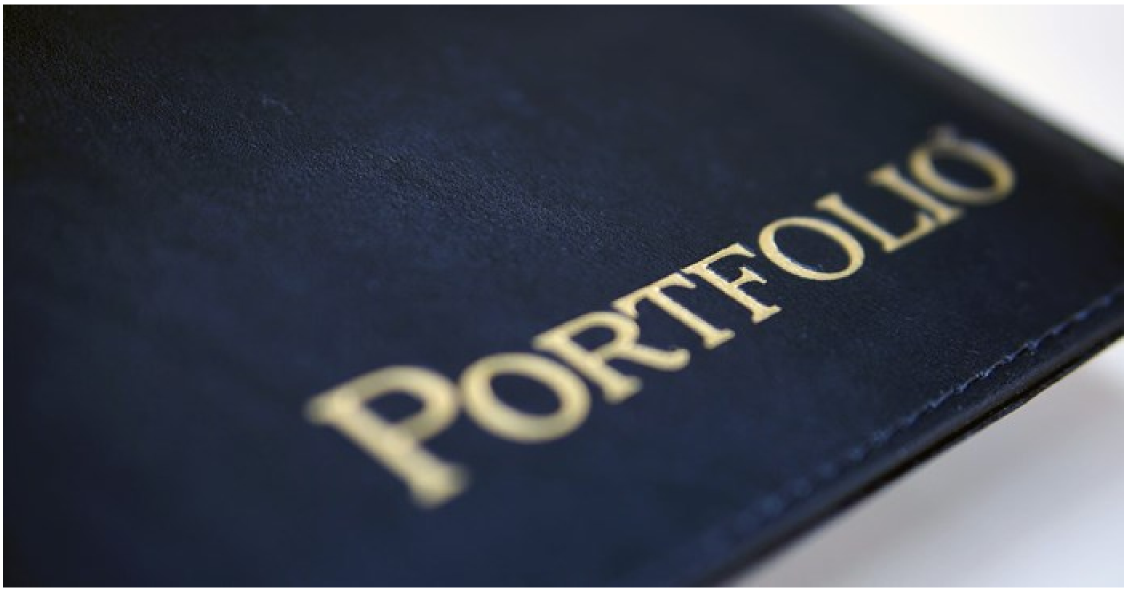
Private vs public markets. What's the difference?

Private equity's value proposition has shifted over the years from a focus on financial engineering, to the creation of operational value in investee companies. Consequently, the lines have become blurred between private and public markets, as the underlying asset for investors is essentially the same for both - an operating company.



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At the end of the day, private equity is still an exposure to an underlying operating company. “Whilst the mode of access to these companies differs in terms of private versus public markets, the underlying exposure remains the same – there’s an operating entity that employs people, has a growth vision and generates returns, just like its listed peers," says Craig Beney, co-CEO of Helical Capital Partners.

On an international level, investors are becoming increasingly aware of this attractive value proposition of private equity. “The asset class has experienced a growing percentage allocation by international funds, with the US private markets reportedly raising more capital than public markets last year. This means that more companies are accessing private funds during their growth phases and staying private for longer," he says.

This increasing fluidity between markets is testament to the idea that equity is equity – but while some equity is publicly listed, private equity is not. “Both markets essentially provide investors the ability to invest into an underlying company; they just use different mechanisms to do so.

Going private

“Some public companies are seeing the benefit in going private, with the number of companies listed on the NYSE having halved over the last 20 years from over 7,000 to some 3,500 today,” says Carlos Ferreira, co-CEO of Helical Capital Partners.

“Public markets provide relatively small parcels of shares to invest into, whereas private markets shareholders typically own much larger shares of the underlying companies. As such, while buying or selling a share of a publicly listed company is relatively easy and facilitated through stockbroking channels, private or unlisted equity shares can typically only be bought or sold in larger, more complex transactions between private parties,” Ferreira explains.

An important difference in this regard is that shareholders in listed markets have relatively little influence on the management and strategy of the business they’re invested in, whereas private equity shareholders are typically actively involved in the strategy of the business and tend to hold majorities to drive their targeted returns. “In private equity-owned firms, the shareholders and management are therefore much more closely aligned, as they typically both have board representation and work together to drive the agreed strategy of the business.”

This close alignment between the goals of a business’ management and its shareholders is a key driver of private equity firms’ superior earnings over the long term. “When comparing the general returns of public and private indices, the 10-year MSCI world total returns index delivered 6.6% (in USD), while the US and EU private equity funds returned 14.2% and 16.3% respectively (also in USD) over the same period.”

Alternative asset class

Despite a growing awareness and interest among international investors, Beney believes that private equity’s regulatory categorisation as an alternative asset is still a source of misperception for many. “Private Equity is often unfairly lumped together with high-risk alternative assets such as hedge funds and even commodities such as physical gold and Kruger Rands. As a result, there is the misconception that private equity is a high-risk asset, when this isn’t the case.”

Beney says of the current trend of private equity investors looking to their private equity fund managers for longer investment horizons. “While historically, private equity fund managers targeted exiting investments in three-to-seven years, with a typical hold period of five years, investors are now looking to longer-term hold periods as they are less inclined to want capital returned.

“This shift is testament to the investment view that private equity will continue to generate better returns than public markets in the future. Having acknowledged that they’re mostly reinvesting returned capital back into the same fund managers, investors are opting rather to entrust the private equity managers with these funds for longer hold periods, instead of incurring the friction costs of constantly receiving funds and reinvesting into the same funds,” Ferreira concludes.