The Decreasing Number of Public Companies, Part II

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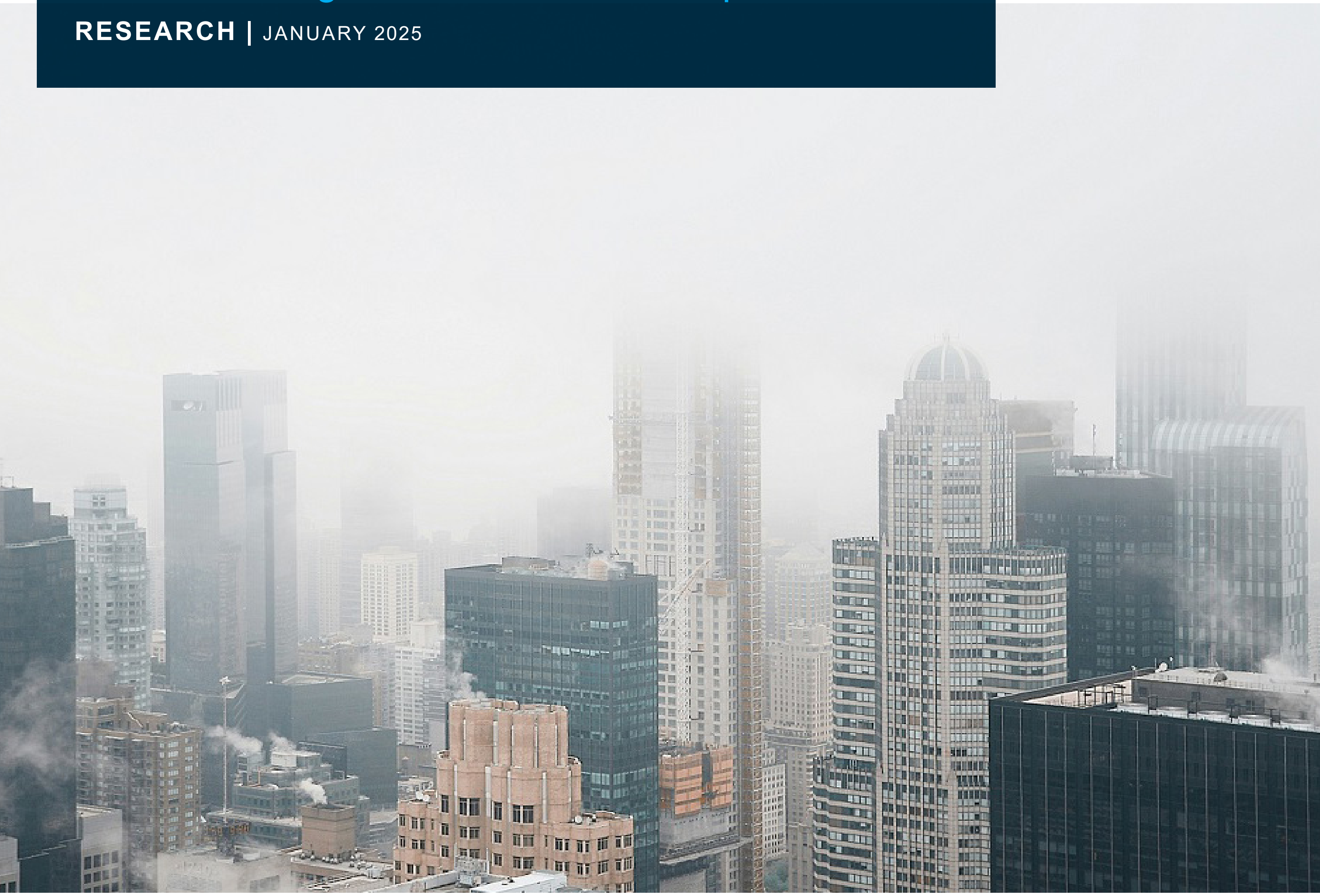

In this second and final part of our [Decreasing Number of Public Companies] series, we continue our in-depth look at this significant trend and its drivers. The number of public companies in the US has fallen by nearly half since the late 1990s. After peaking at more than 8,000 companies in 1996, the number of domestic publicly traded companies trading on the major U.S. stock exchanges has declined to roughly 4,700.[1]

For companies considering the decision to go public, several regulatory and market forces have reshaped the cost-benefit equation. Factors such as the high cost of an IPO and the growing availability of private capital have all contributed to the declining number of public companies.

1 Source: The World Federation of Exchanges Database and CRSP as of August 2024.

Key Takeaways

- → **Decline in Public Companies |** The dramatic decline in the number of publicly traded stocks in the US is due to a number of factors that have simultaneously improved investor rights and corporate transparency, while at the same time supporting more robust, though fewer, publicly traded companies.
- → **Regulatory Pressures |** The cost of compliance with regulatory requirements, such as those imposed by the Sarbanes-Oxley Act, has discouraged many companies from pursuing public listings, contributing to the growing preference for remaining private.
- → **Private Market Opportunities |** With regulatory changes like the 2012 JOBS Act that raised the number of investors who could privately provide capital to a company, executives now have greater flexibility to raise capital privately, reducing the need for public offerings.
- → **Portfolio Diversification |** As private markets expand and offer the potential for higher risk adjusted returns relative to public markets, investors are increasingly shifting capital toward private equity and venture capital, encouraging a more balanced approach between public and private investments.

Evolution of Regulatory and Market Dynamics

A number of regulatory and market dynamics have shaped the cost-benefit analysis for private companies pursuing an initial public offering. But these legal and financial changes have also impacted a public company's decision to delist, go private, or merge with another company. The regulatory costs of listing and maintaining financial, legal, and audit requirements may partially explain why publicly traded companies have either stayed private or elected to delist from major exchanges.

In the wake of a series of scandals at publicly traded company such as Enron, WorldCom, Global Crossing, Adelphia, and Tyco, Congress enacted the Sarbanes-Oxley Act (SOX) on July 30, 2002.[2] SOX was intended to increase regulatory oversight of public companies and thereby protect investors from the possibility of these companies engaging in fraudulent activities. This Act imposed numerous compliance requirements in areas like revenue recognition, audit, internal controls, record keeping, and others. SOX prohibited an accounting firm from providing audit work for a public company while contemporaneously providing a host of other services. In addition to requiring an independent outside audit, SOX required each public firm to have an audit committee composed of independent directors, and it prohibited company loans to certain executives and directors.

In 2009, the Securities and Exchange Commission (SEC) found that the "cost of complying with the requirements in section 404 of the [SOX] Act had been generally viewed as unexpectedly high."[3] And PricewaterhouseCoopers (PwC) estimated that, on average, companies incur more than $1 million of annually recurring costs by being public instead of private.[4] PwC was not along in its assessment. The management consulting company Protiviti similarly estimated that average annual SOX internal compliance costs range

[2] Source: Securities Exchange Commission Historical Society Timeline, August 2024. https://www.sechistorical.org/museum/timeline/1990-timeline.php

[3] Source: SEC, "Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirement," Office of Economic Analysis 2009.

[4] Source: PriceWaterHouse Coopers, "Considering an IPO to Fuel Your Company's Future" Insights into the Costs of Going Public & Being Private," November 2017. PWC's report includes IPO data from 2015 and 2017.

between $600,000 and $1.6 million per year between 2002 and 2018, excluding external audit-related fees.[5] "Staying private also lets a business avoid hiring lawyers and accountants to make the required disclosures and regulatory filings with the SEC."[6]

One-time IPO costs are not trivial, companies need to deal with multiple expenses for accounting, legal, underwriting, and other services. Further, the smaller the company, the greater the proportion the IPO costs would be of their revenues and presumably of their value.

[5] Source:"Benchmarking SOX Costs, Hours and Controls" Protiviti, 2018.

[6] Source: Stanford Business, L. Lec, "The Decline of the IPO: With Fewer Companies Going Public, Corporate Transparency Gets Murkier," April 18, 2023.

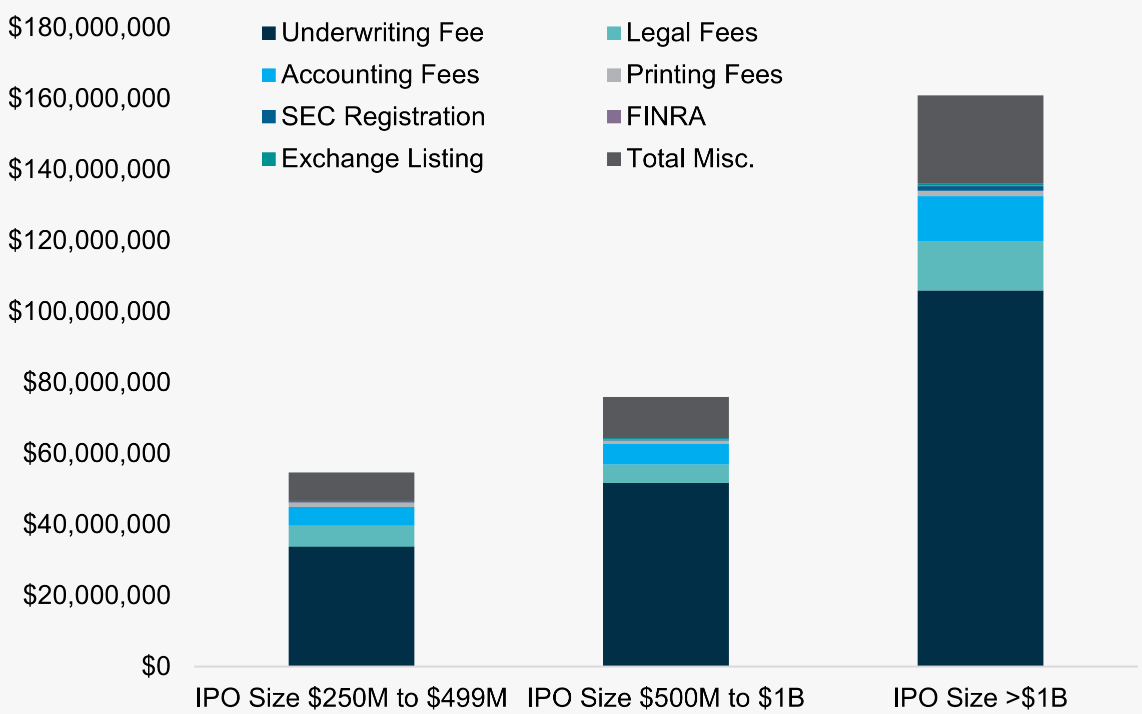

FIGURE 1
One-time IPO Costs

Source: PriceWaterHouse Coopers "Considering an IPO to fuel your company's future?" as of September 2024.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

While company executives contended with the impact of Sarbanes-Oxley, there was a new wave of regulation that may have turned the tides of bringing a company public. The 2012 Jumpstart Our Business Startups (JOBS) Act raised the number of investors that could privately provide capital to a company. Under the previous limit, companies with over $10 million in assets and 500 individual investors were required by the SEC to comply with reporting requirements similar to those of public companies. However, the higher investor limit of 2,000 provides private companies with more flexibility to access private capital without the burden (and costs) of compliance reporting or becoming public.

Investor Considerations

The change in the number of public US companies has potential ramifications for investors. These include an increased level of concentration in public markets, and a broader opportunity set in private markets. Some investors worry that one potential consequence of the decreasing number of stocks is market concentration. It would be reasonable to expect markets to be more concentrated if there are less stocks available.

Another consideration is that if investors want to access the growth of a broader swath of companies, they may want to consider investing more in private equity. More than 85% of companies with annual revenues over $100 million are private companies.[7] Some recent analysis suggests that the return on investment for firms backed by venture capital and private equity are notably higher than those of the companies in the S&P 500.[8]

Many of the businesses in today's private markets tend to be small but profitable, with a solid track record of providing core products or services. They are often the same kind of companies that would have gone public in a previous generation. They typically reflect the broader economy more so than the largest public companies (e.g., the "Magnificent Seven") that comprise an increasing share of the US stock market, as noted above. And there appears to be a greater alignment of interests than was once the case, with private investment markets becoming long-term oriented while public markets fixate on short-term earnings.

Private markets investors appear to have noticed, and due to these trends, they have committed an increasing amount of capital to private equity, the AUM for which now represents more than one-third of GDP (see Figure 2).

7 Source:Bain & Company, using data from S&P Capital IQ as of December 2022 and Statistics of US Businesses as of 2017.

8 Source: NBER, B. Jovanovic et al., "Private Equity and Growth" October 2020. The authors' analysis suggest that venture and buyout equity investment of approximately 5% to 7% may contribute to growth between 14% and 21% between 2001 and 2019. See also, NBER, N. Garleau et al., "Finance in a Time of Disruptive Growth," March 2024.

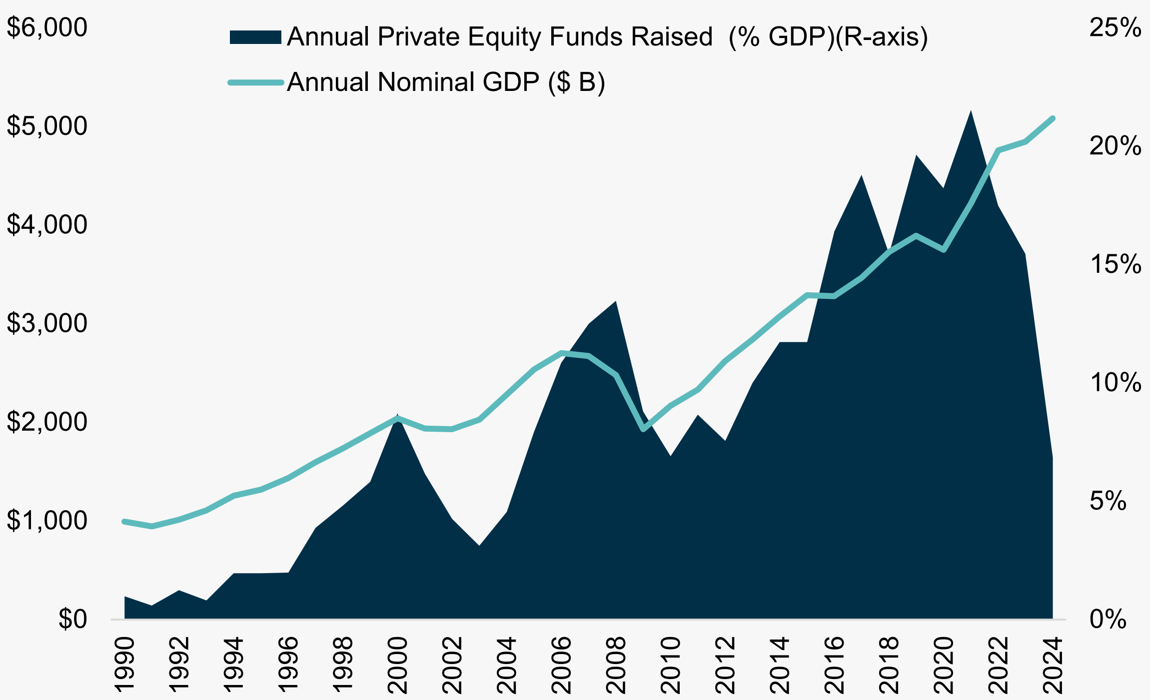

FIGURE 2

Private Equity Funds Raised as a % of US GDP

Source: FRED nominal GDP as of June 30, 2024. Prequin annual private equity fund raising as of June 30, 2024. Private equity funds raised includes venture, buyouts and growth equity. There is no complete and reliable data set for private investments. The information is extremely limited, and most data is compiled from funds that elect to self-report and tend to be biased toward higher performing funds. Losses are underreported. Funds included in these measures lack commonality and transparency. Over time, components of the data may change. Funds may begin or cease to be represented based on these factors, thereby creating a "survivorship bias" that may additionally impact the data reported.

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What's Next for Investors?

As regulatory and market dynamics continue to evolve, investors face a rapidly changing landscape that demands strategic adaptation. Looking ahead, investors may need to navigate a world where private markets play an increasingly prominent role. The rise of private equity, venture capital, and private credit has opened new avenues for capturing growth and diversification. With private equity assets under management now exceeding one-third of GDP, these markets offer a broader opportunity set that was once predominantly available to institutional investors.

For individual and retail investors, recent innovations such as interval funds, private market ETFs, and increased access to private placement platforms offer new ways to participate in this growing segment. However, investing in private markets requires careful consideration of factors such as liquidity, fees, and the long-term nature of these investments.

Institutional investors will likely continue to allocate more capital to private markets in search of higher returns and diversification. This trend underscores the importance of due diligence, access to high-quality managers, and understanding the nuances of private market investing.

Ultimately, the future for investors lies in balancing exposure between public and private markets. As private companies increasingly represent a significant portion of economic growth, investors seeking robust portfolio performance may find themselves embracing a more holistic approach that includes both public equities and private assets. The key question for investors moving forward is how to effectively incorporate private market opportunities into their broader investment strategy while managing risks and ensuring liquidity.

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