Is There an Imbalance Between Your Portfolio and the Economy?

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DeMarche

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Abstract

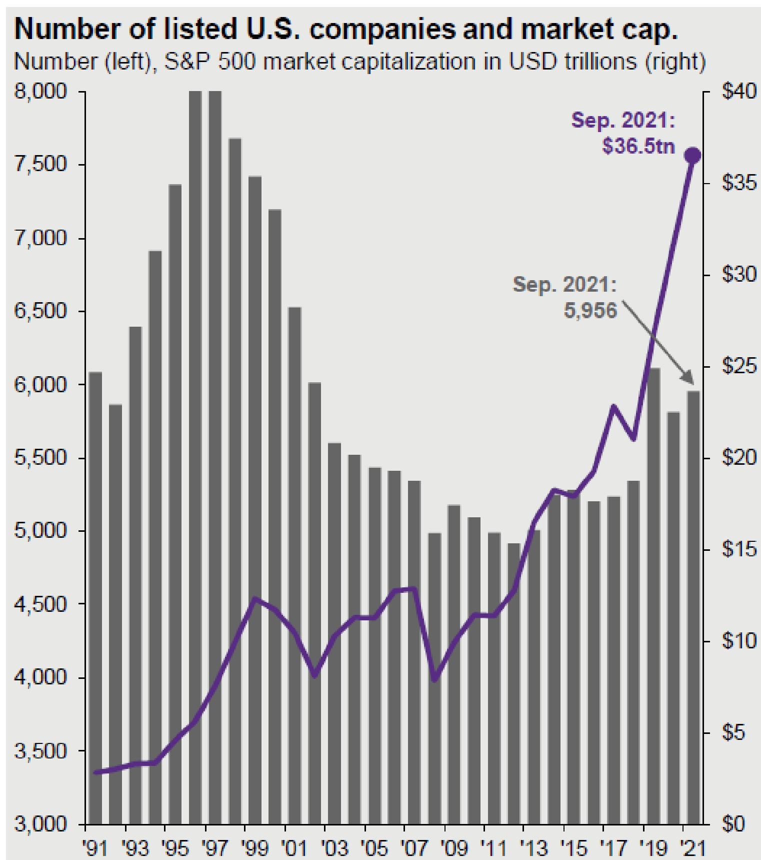
DeMarche has been recommending that clients consider allocating to private markets for quite a while, but allocations to private market investments, while increasing, are seemingly mismatched in most investment portfolios given the value and breadth of both privately owned companies and credit markets. In this research paper, the authors assess the changing dynamics affecting private markets, including equity and credit, which have been accelerating since the start of the pandemic.

Despite never ending coverage, including an entire television network devoted to reporting on its activities, stock market(s) do not necessarily represent the health or the economic activity associated with the global economy. In fact, a significant component of the economy, as measured by GDP, is driven by privately held firms. DeMarche believes that, if anything, private investments are underrepresented in the majority of institutional portfolios.

A Shrinking Market

The decline in the number of companies that are publicly traded has been a slow moving phenomenon that shows no signs of abating. This situation has largely gone unnoticed by the general investing public, but has been on the radar at DeMarche for several years, including a recent presentation at our client conference. There are myriad reasons for this shift. Proponents of private structures often cite improved access to investor capital, the ability to think long-term (and not chase quarterly

Figure 1 – Source: JPMorgan

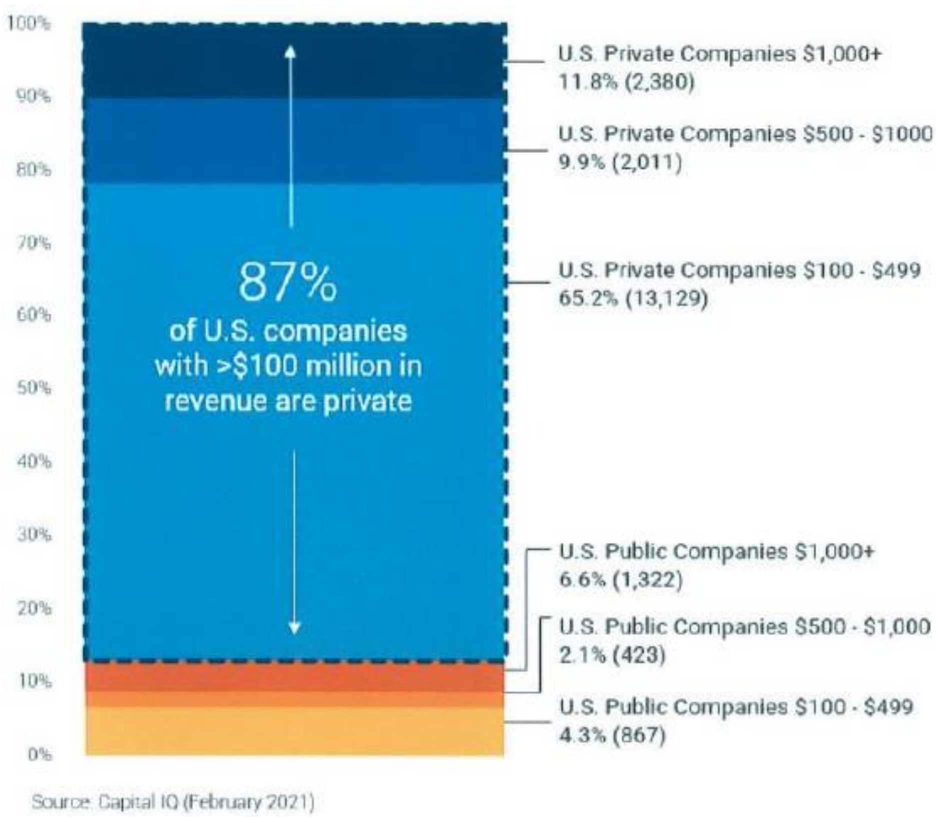


results), the avoidance of the time and expense associated with regulatory compliance and reporting, and the desire to protect sensitive financial information. Figure 1 above illustrates the movement away from publicly traded companies, which peaked during the late 90's. As one would expect, this downward drift has impacted the number of constituents in the various indices. Specifically, our analyst team took a recent snapshot of various indices and identified that the Russell 1000 Growth currently has 496 companies, while the Russell 2000 Growth only has 1170. Finally, the Wilshire 5000 currently has about 3500 companies (down from a peak of 7562 in July 1998), although the index did contain 5000 companies when introduced in 1974. Interestingly, the index has not had 5000 constituent companies since December 2005.

The Stock Market is Not the Economy

Although it can be difficult to gather private-company economic data because these companies are not required to disclose their financial results to the public, broader based metrics tell us a lot about the importance of private companies to the U.S. economy and their role as both a principal job creator and employer. For example, a recent look at Forbes' annual list of the largest private companies indicated that 85% of U.S. firms with more than 500 employees are in private hands. Further, a recent Department of Labor report essentially confirmed this fact by noting that about 25% of workers in the U.S. are employed by publicly traded companies. Shifting to the revenue side of the equation, the results are even more interesting. Figure 2 from Capital IQ indicates that 87% of U.S. companies with more than $100 million in revenue are privately held. Digging deeper (and comparing apples to apples), there were over 13,000 U.S. private companies with revenue between $100-$499 million, compared to 867 publicly traded companies with the same revenue profile and this pattern remains consistent across the revenue spectrum.

Figure 2 – Source: Capital IQ



The New Owners

Considering that the stock market is shrinking (and often dominated by a handful of companies from a market capitalization perspective) and that most of us work for private companies, an obvious question is: What role will private equity play in the ownership structures of these companies? Once again, a slow moving phenomenon is occurring as the number of private companies owned by private equity funds has doubled from about 5,000 to 10,000 since 2007 (Pitchbook). This shift in ownership is important, as privately held firms account for about 55% of spending on plants and equipment (Capital IQ). A study by Capital IQ illustrated that privately held companies invest substantially more than publicly traded companies (controlling for company size and industry).

Private Capital Fundraising Impacting Expansion

The landscape of company formation has also shifted dramatically over the last few years, and especially since the beginning of the pandemic. Since 2020, U.S. applications for business formation have more than doubled, as seen in Figure 3. While the number of publicly listed companies has been shrinking, the opposite has been occurring in private markets. For example, venture capital financings set a record in 2021 with $621 billion in combined deals, more than double the $294 billion recorded in 2020.

Fueling that total was a record of 1,556 rounds of venture capital funding valued at $100 million or more, greatly surpassing the old record of 620 from 2020. This record fundraising shows how rapidly private markets are expanding. In addition, companies are staying private for longer and are growing larger before IPO. The number of private companies valued at $1 billion or more rose 69% in 2021 to 659 companies, which is the highest total ever.

Figure 3 – Source: JPMorgan

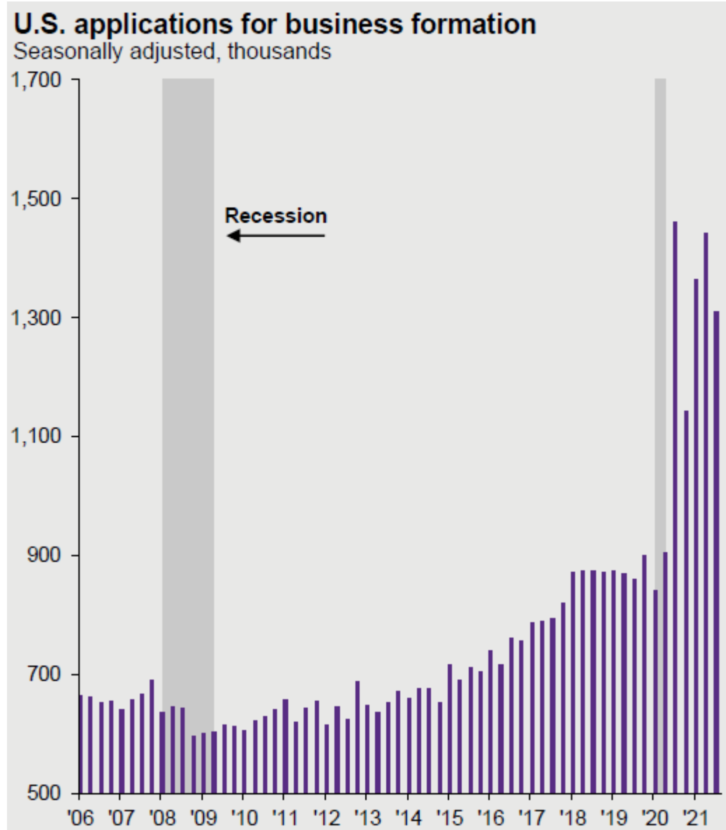
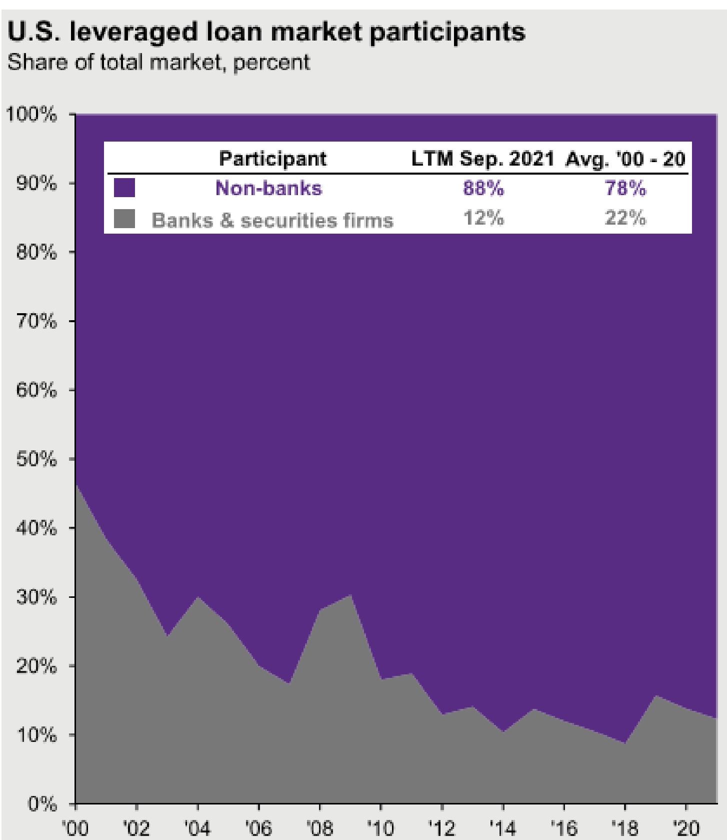


Figure 4 – Source: JPMorgan



Private Credit's Expanding Role

While we have seen tremendous growth in private equity deals and the amount of money invested in the space over the last few years, a similar phenomenon has been occurring in the credit space for quite some time. Historically, banks have provided much of the financing for private companies but that changed around the turn of the century. In 1999, Non-bank lenders outpaced banks in the leveraged loan space for the first time (S&P). As seen in in Figure 4, today, only 12% of the leveraged loans to private companies are backed by banks, while the rest are backed by institutional investors and other non-bank lending companies. The increasing amount of large private companies also brings a need for more debt financing which banks have been moving away from. Direct lending totaled over $100 billion for the first time in 2021 as companies increasingly need financing for business expansion.

Conclusion – What Does this Mean for Investors?

Allocations to private market investments, while increasing, are seemingly mismatched in most investment portfolios given the value of both privately owned companies and credit markets. While investors have typically looked at private markets for return enhancing potential, the case for diversification today is stronger than ever before. There are more private companies with over $1 billion in revenue today than there are public companies, showing the maturation of private markets as a result of companies staying private for longer. Private markets have been increasing in size steadily over the past couple of decades and the pandemic has seemingly accelerated that growth. Many investors have stated liquidity as the biggest hindrance to allocating to private markets, but many investors can take much more illiquidity than they realize, and the liquidity of the space has evolved as record amounts of capital has been raised. Like with most asset classes, investors in private markets should reassess and make sure their allocation matches the opportunity set and the growing importance of private companies in the economy.

Put Research To Work
with the DeMarche Team

Don Lennard
Senior Consultant
(913) 384-4994

Houston McConnell, CFA, CAIA
Consultant
(913) 384-4994

Sources Utilized:

- *Capital IQ*
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- *JPMorgan*
- *CB Insights*