Knut Wicksell Centre for Financial Studies

RESEARCH INSTITUTE OF INDUSTRIAL ECONOMICS

The Decline and Fall of the Stock Market

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and IFN

The roles of the stock market

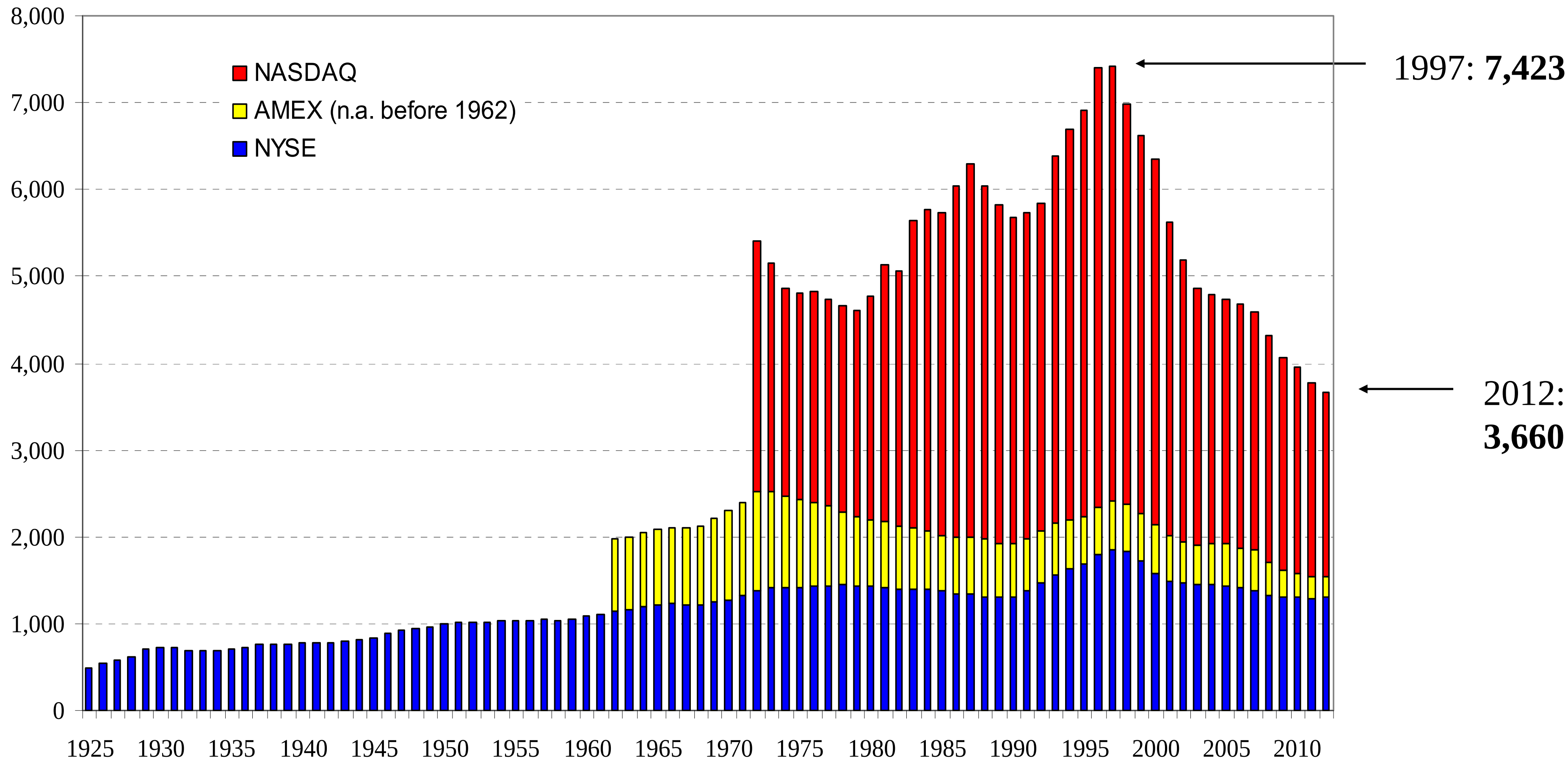
- "Primary" market function: capital formation
  - To enable firms to raise equity capital by issuing shares to the investing public

- "Secondary" market functions: trading
  - To serve as a trading venue for a firm's shares, thereby providing <u>liquidity</u> to the firm's shareholders and an opportunity for <u>diversification</u>
  - To price a firm's shares, thereby providing market feedback to the firm's management and aid in efficient capital allocation (<u>price discovery</u>)

Stylized macro facts

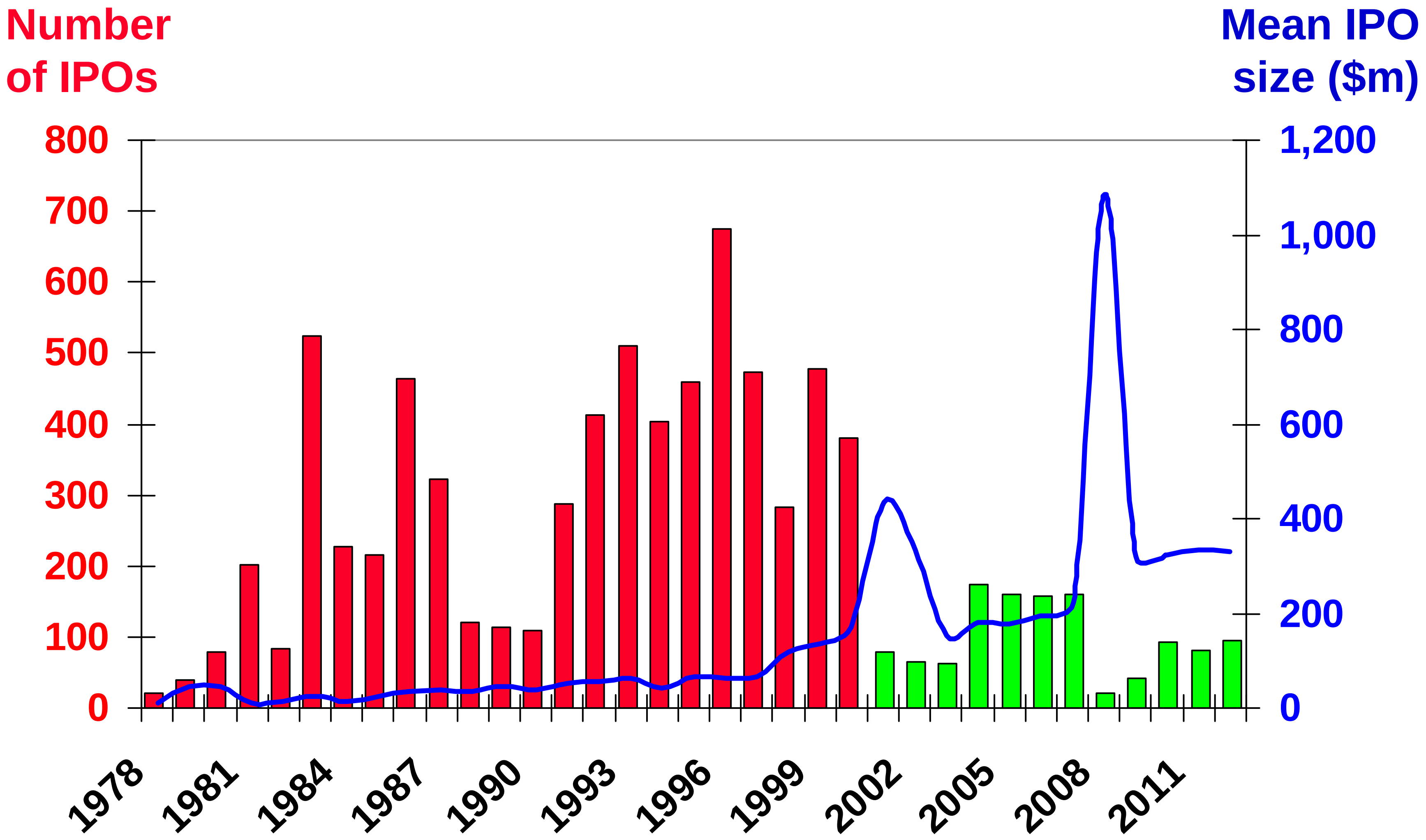
- Most U.S. firms are not stock market listed
  - Of the 5.7 million U.S. firms in 2010, 3,948 (=0.06%) were public
- This is true even for large firms
  - Among firms with >500 employees, only 13.6% are public
- Privately held firms account for a large part of economic activity
- Stock market listed firms rarely raise equity
  - Most listed firms never do; those that do, do so every 3-5 years
  - Listed firms raise more equity capital from employee option exercises than from the stock market
  - At macro level, stock market is a net use (not source) of capital
- Stock market listings (and IPOs) have fallen out of favor – dramatically so in the U.S.

Number of listed U.S. firms



Source: Author's calculations using CRSP data
(ordinary common shares only)

Decline and fall



Source: Author’s calculations

Mega IPOs still happen …

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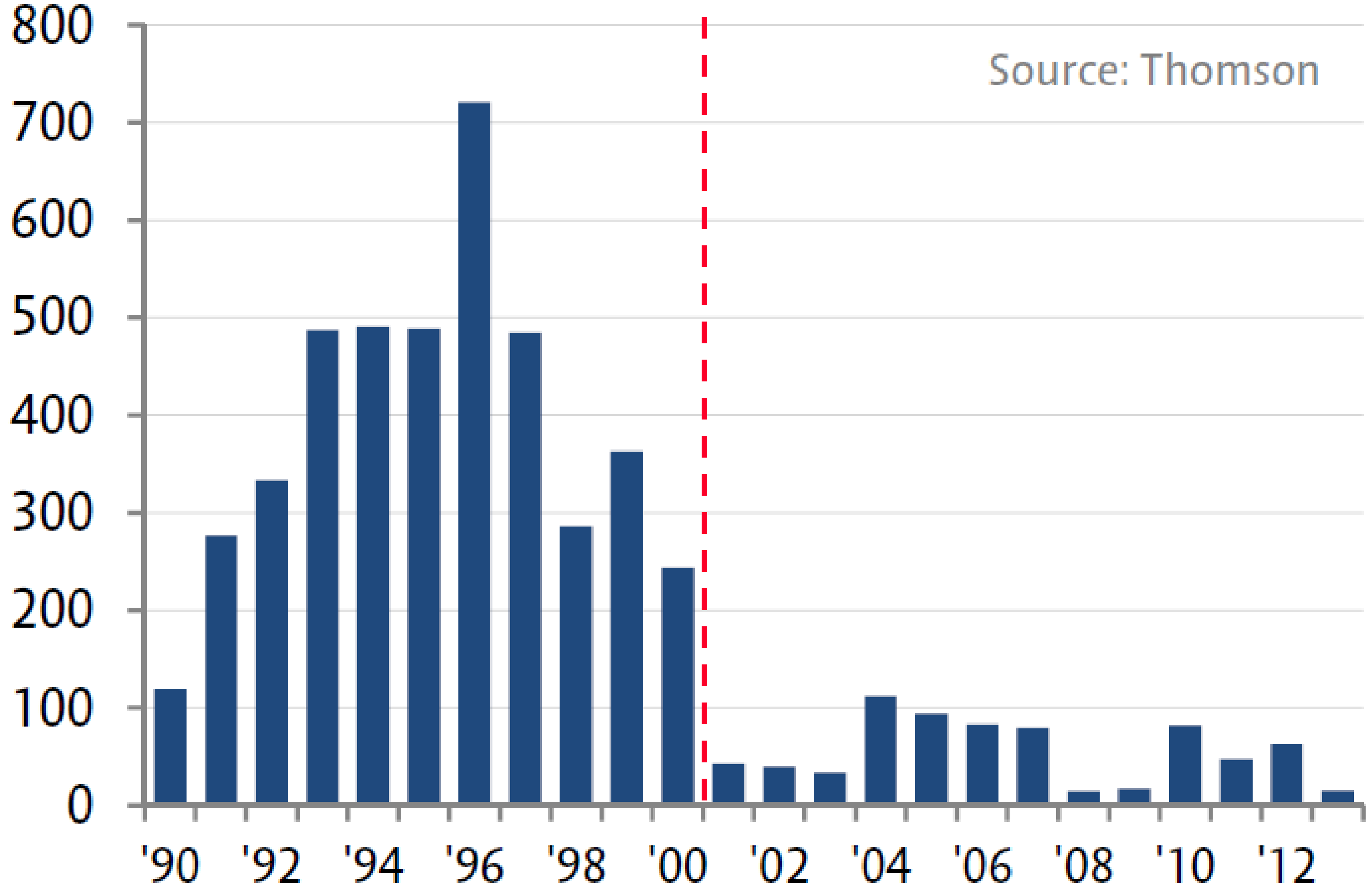
Mega IPOs still happen …

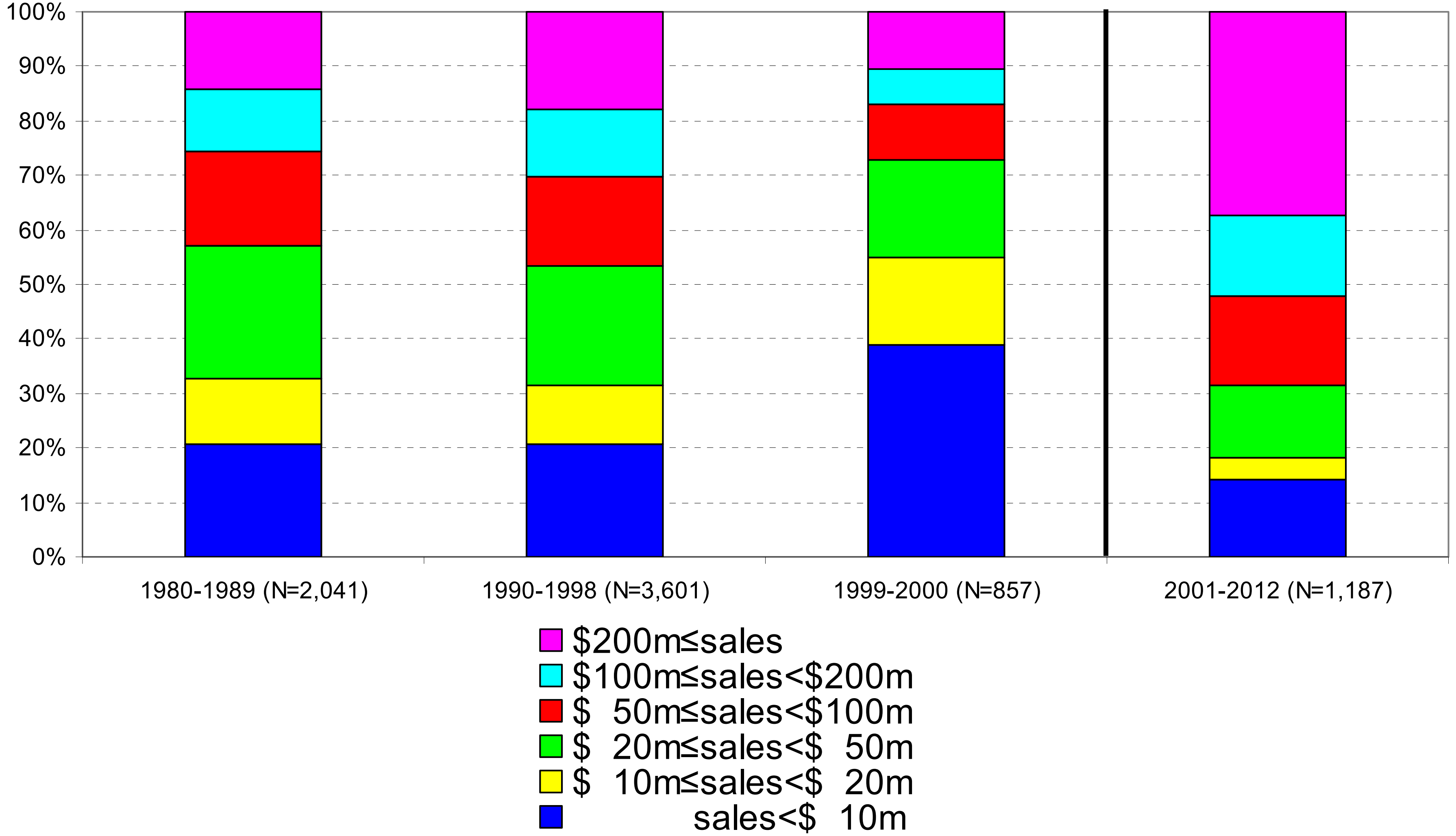
… but smaller IPOs stay away

U.S. Offerings less than $100M



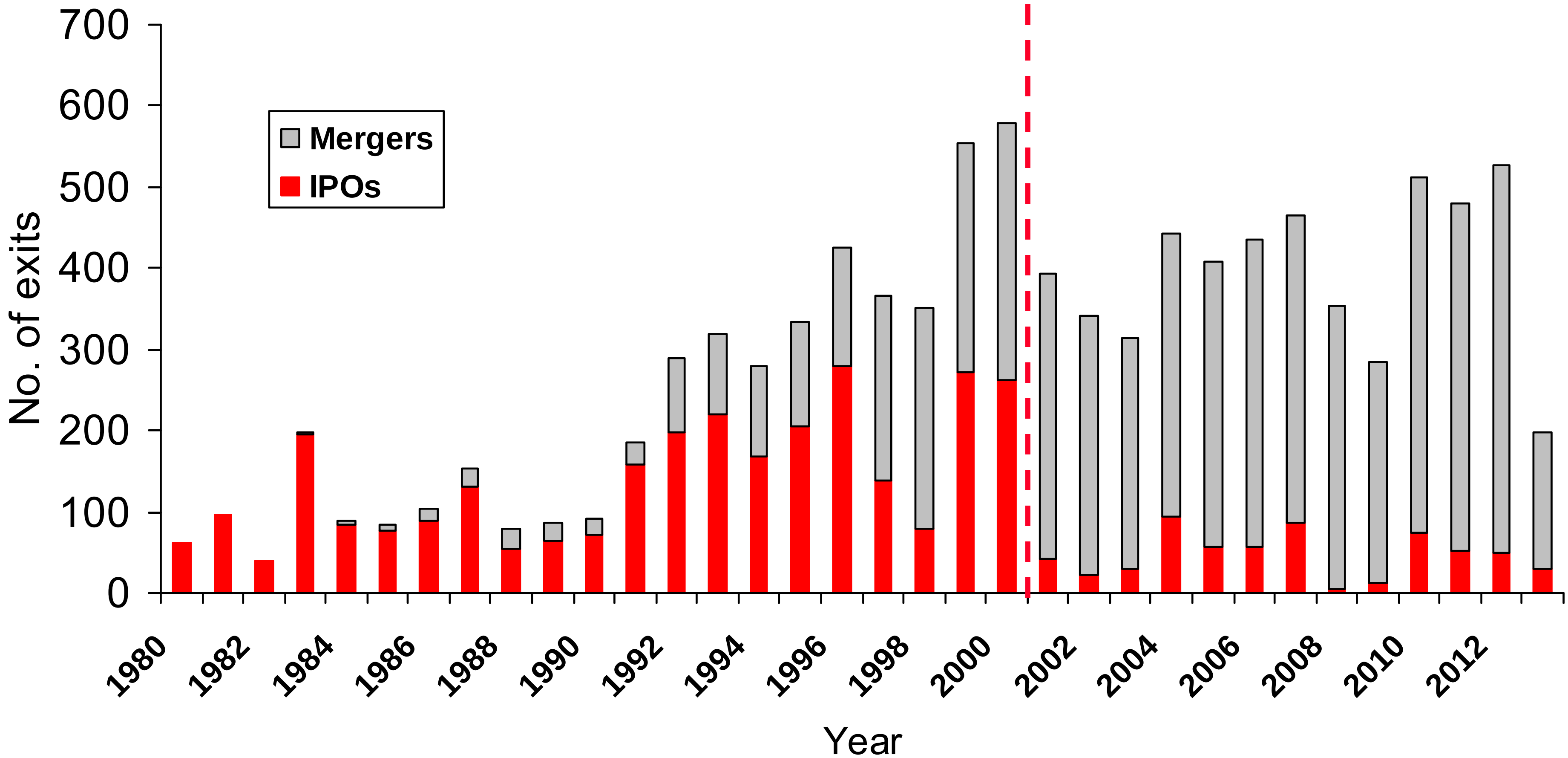
Source: NASDAQ OMX, April 2013

… as do SMEs



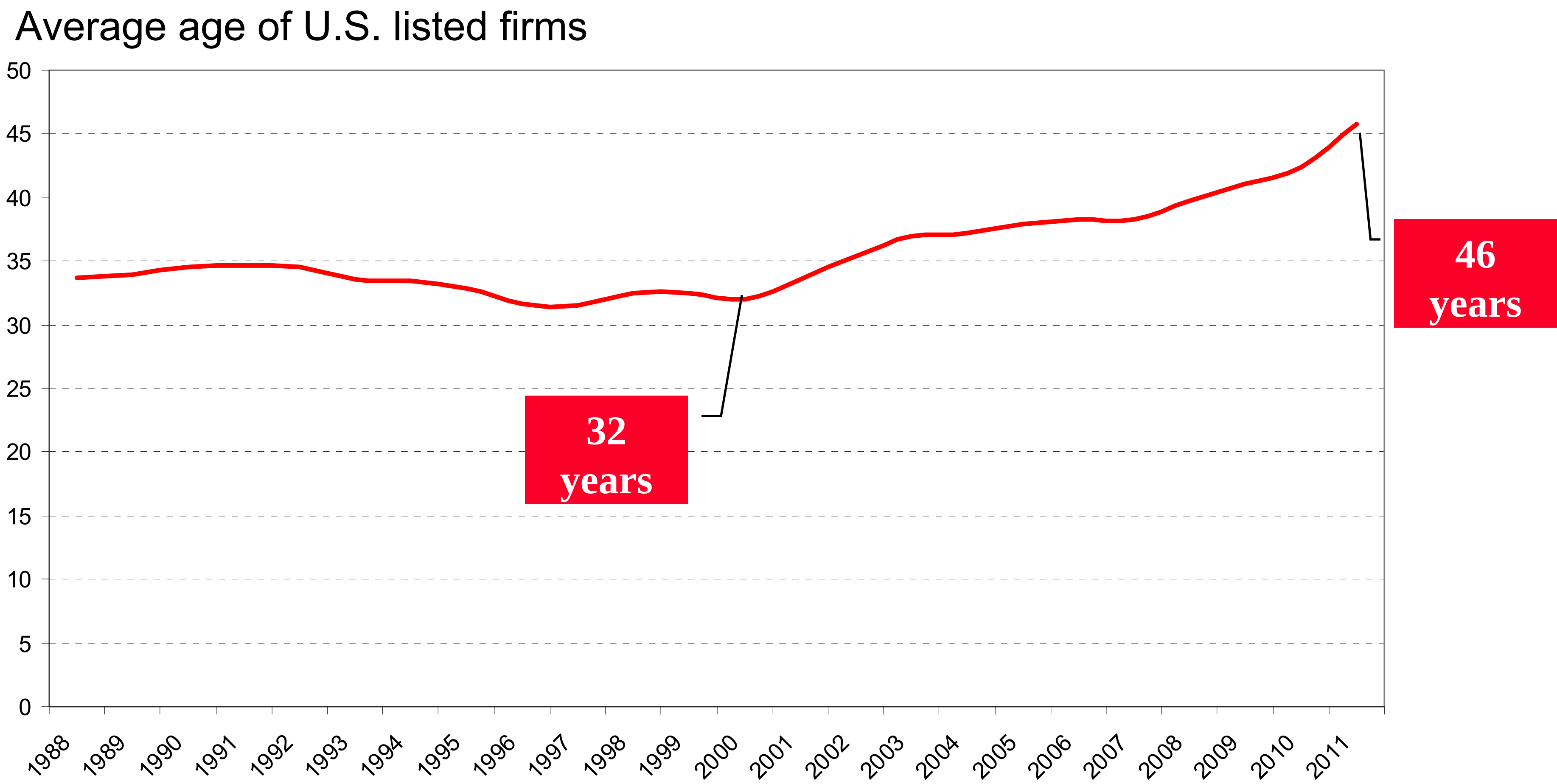
Source: Author's calculations
using data from Jay Ritter

… and VC exits have shifted to M&A

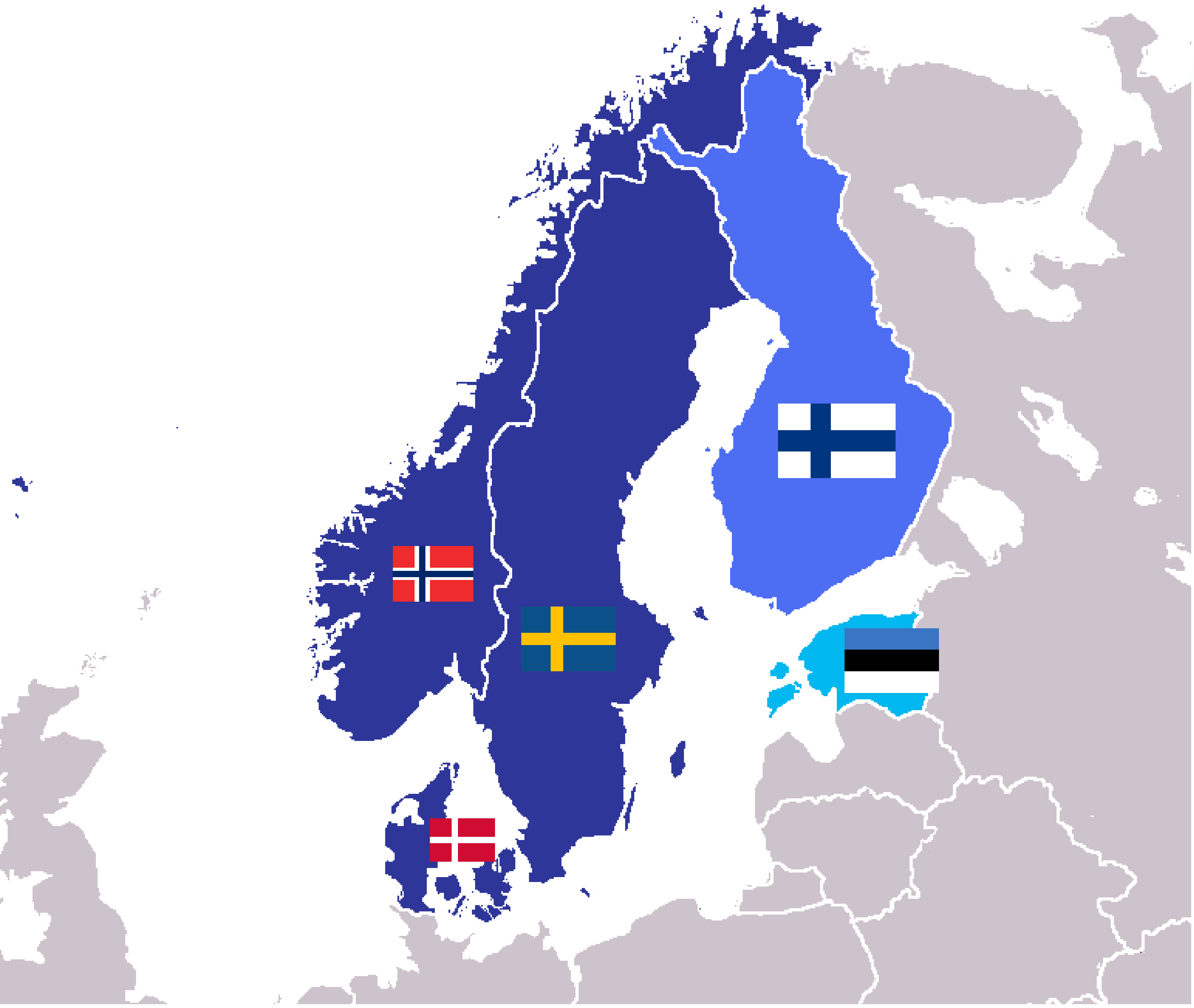


Source: National Venture Capital Association
(2013 data is for H1)

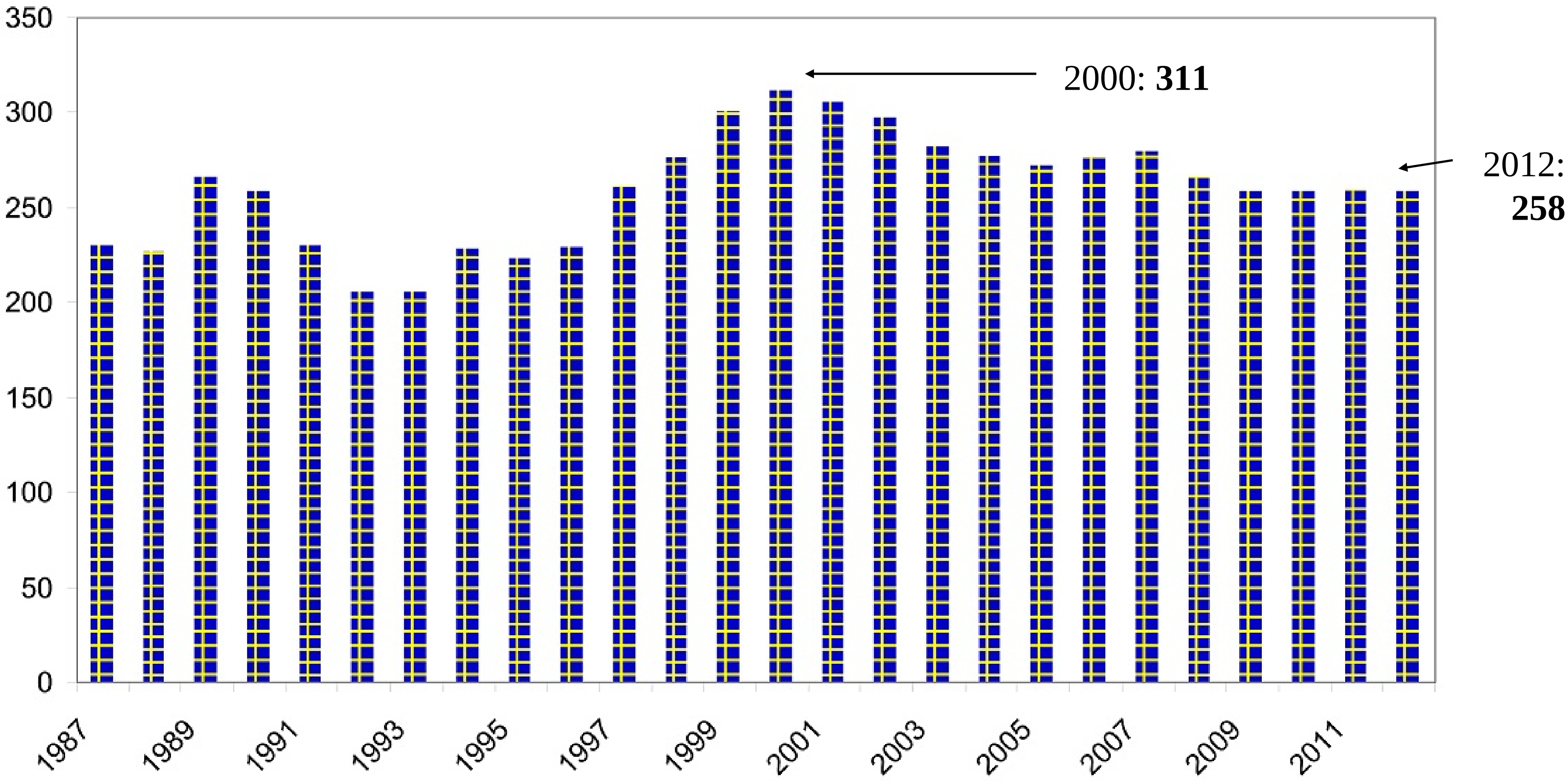
The “greying” of the U.S. stock market



Source: Author’s calculations using CRSP data

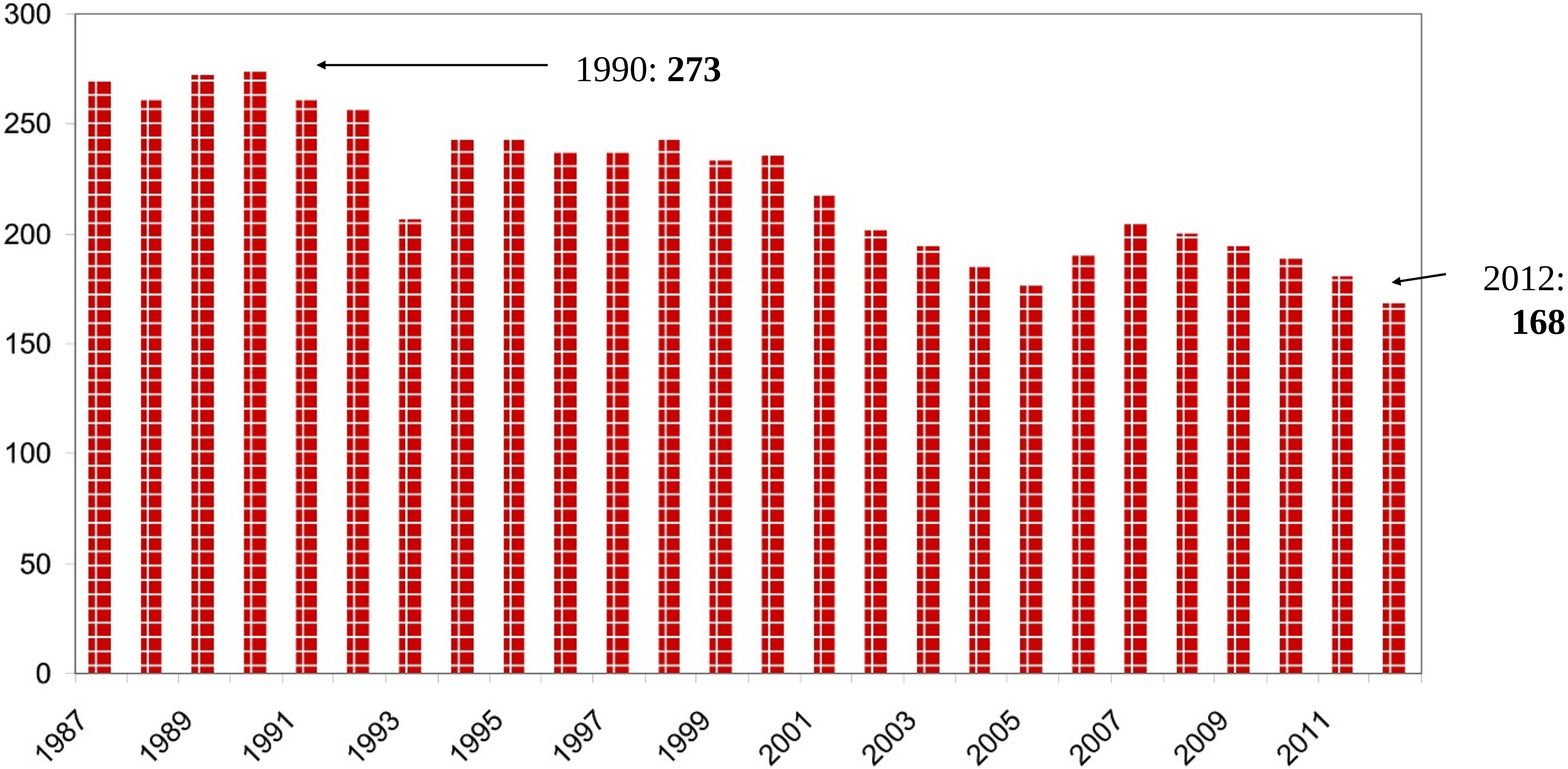


Nordic listings: Sweden



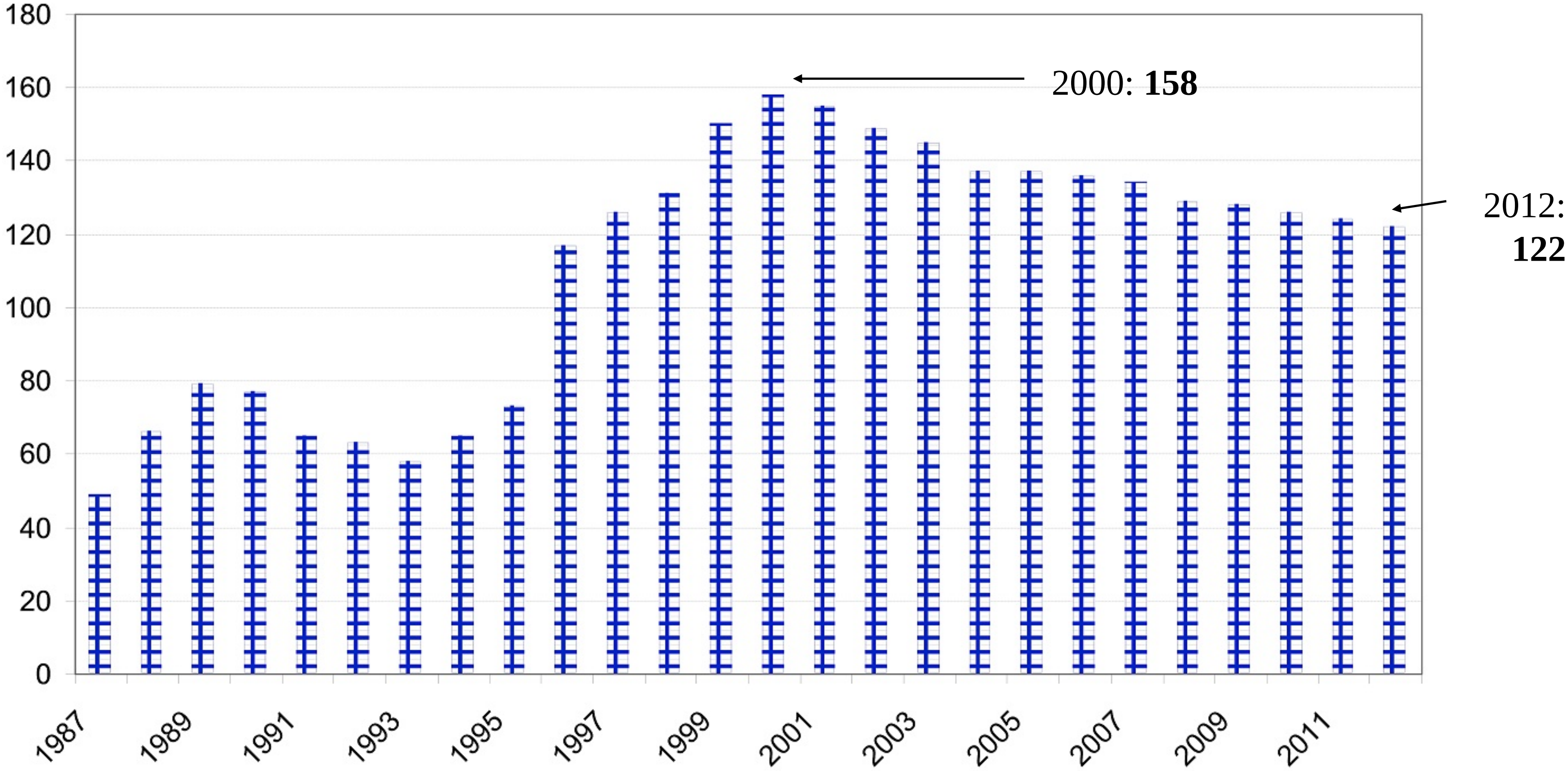
Source: NASDAQ OMX

Nordic listings: Denmark



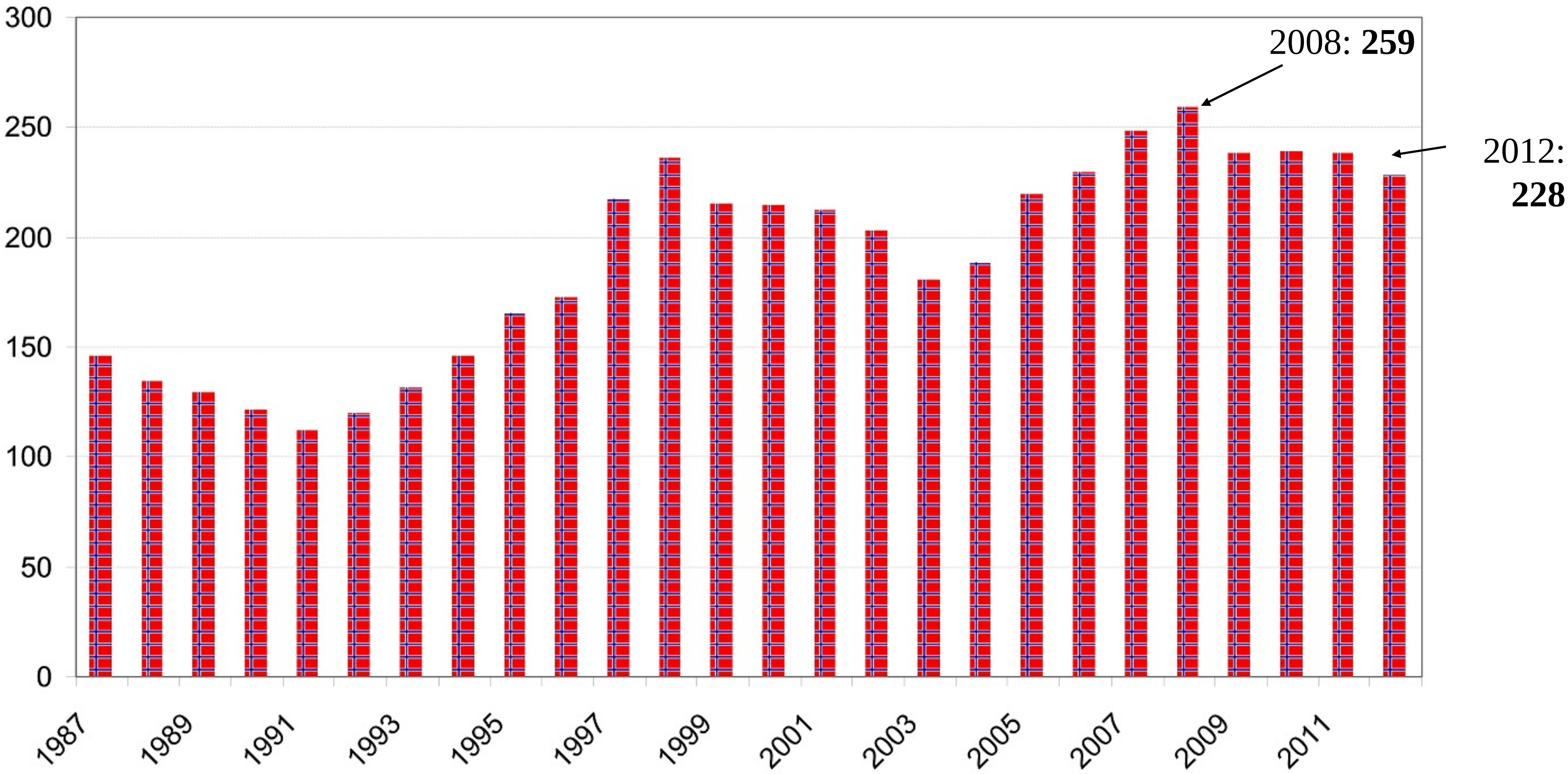
Source: NASDAQ OMX

Nordic listings: Finland



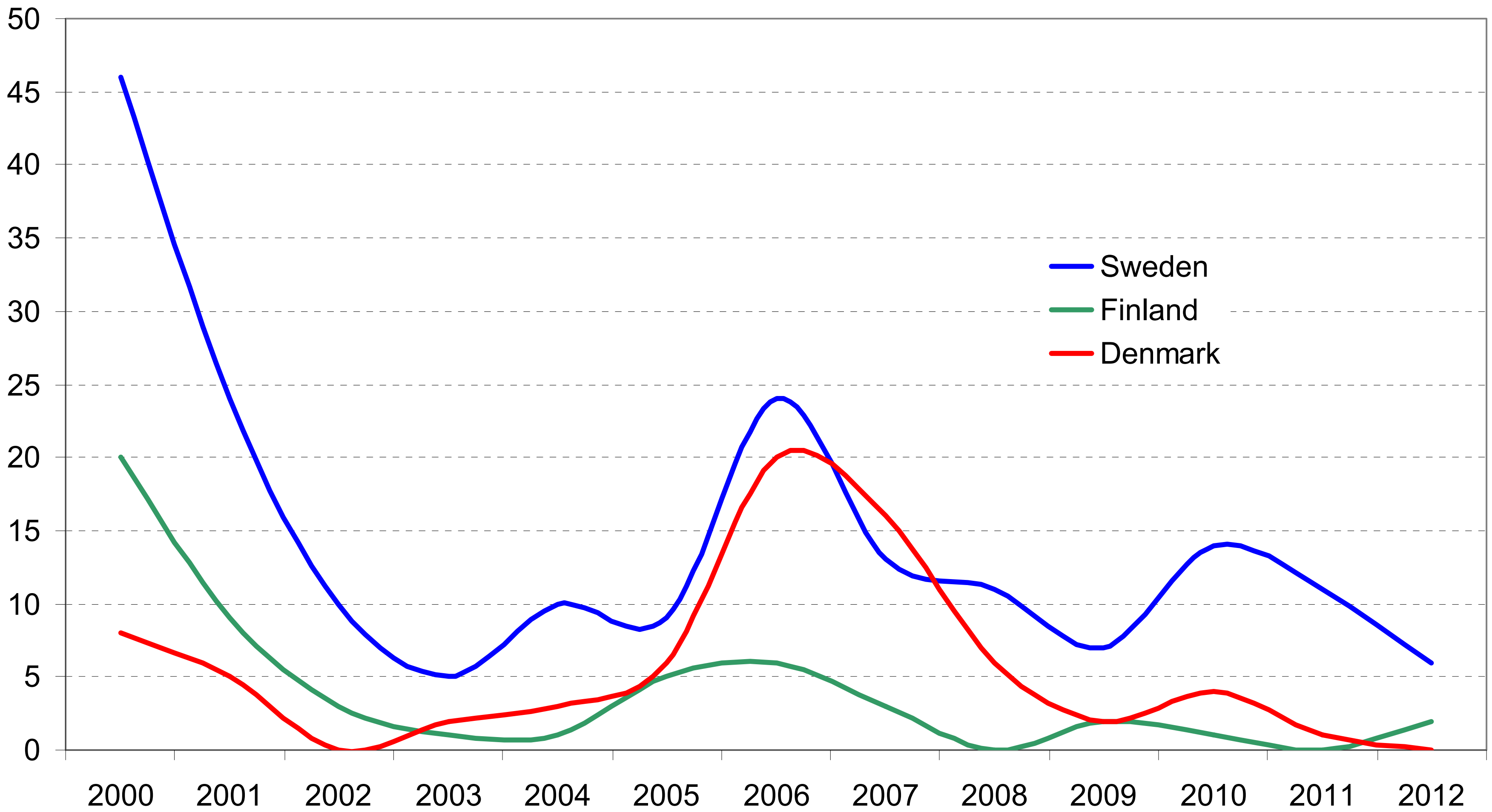
Source: NASDAQ OMX

Nordic listings: Norway



Source: World Federation of Exchanges;
European Federation of Stock Exchanges

Nordic IPOs



Source: NASDAQ OMX
(excludes First North)

Exchanges are fighting back

Sept. 2013	NASDAQ OMX Stockholm: Proposals for improving IPO climate in Sweden
May 2013	NYSE Euronext: “EnterNext”
March 2013	LSE: “High Growth Segment”
April 2012	Borsa Italiana: “Elite Program”

Causes

A shifting cost-benefit trade-off

Increased costs?

- Regulatory burdens
  - disclosure
  - Sarbanes-Oxley
  - Dodd-Frank
  - (various initiatives aimed at reducing regulatory burdens: JOBS Act, MiFID II, revised “Transparency Directive”)
- Onerous governance rules
  - say on pay
  - “expensive distractions”: proxy battles with shareholders (Ed Knight, General Counsel, NASDAQ)

Reduced benefits?

- Less trading liquidity for small-caps
  - less analyst research
  - less institutional interest
- Increased competition from other sources of capital and trading venues
  - equity: crowdfunding (?), angels, venture capital, growth equity
  - debt: “business development companies”
  - trading venues: SharesPost, Second Market

Consequences

Consequences

- If growth companies turn their backs on the public equity markets – is that necessarily such a bad thing?
  - Probably bad for the exchanges
    - reduced revenue from listing fees
    - if the primary market dies, can the secondary market survive?
  - But innovation disrupting businesses is nothing new
  - What is lost to the economy?
    1. Unlisted firms have a higher cost of capital, which impacts investment, innovation, growth, job creation …
       - but the cost-of-capital gap may be shrinking
    2. "Ordinary" investors miss the opportunity to participate in the wealth created by growth companies
       - wealth inequality may widen; public support for shareholder capitalism could decline
  - Might something be gained as well?

Short-termism vs. patient capital

Two notable concerns (among others)

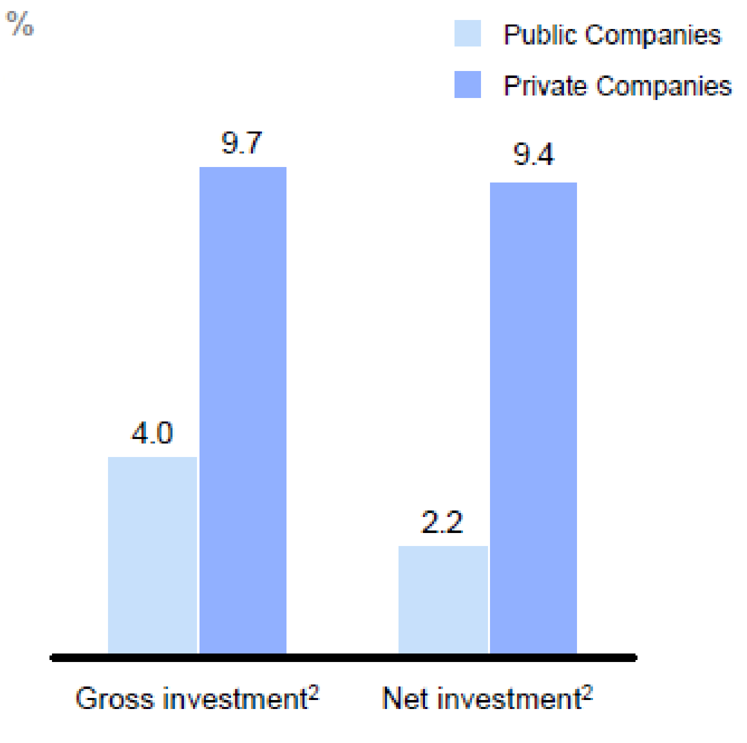
1. Quarterly reporting cycle may encourage excessive focus on short term results, at the expense of long term wealth creation
   - Graham, Harvey, and Rajgopal: “The majority of [US] managers would avoid initiating a positive NPV project if it meant falling short of the current quarter’s consensus earnings [forecasts].”
2. Disclosure requirements may hinder a firm’s ability to build support for a change in corporate or financial strategy
   - how easy is it to cut the dividend to finance a profitable investment opportunity, without a) panicking investors and b) revealing too much sensitive information to competitors?

- Attractions of private ownership:
  - more “patient” capital
  - more “private” dialogue with shareholders

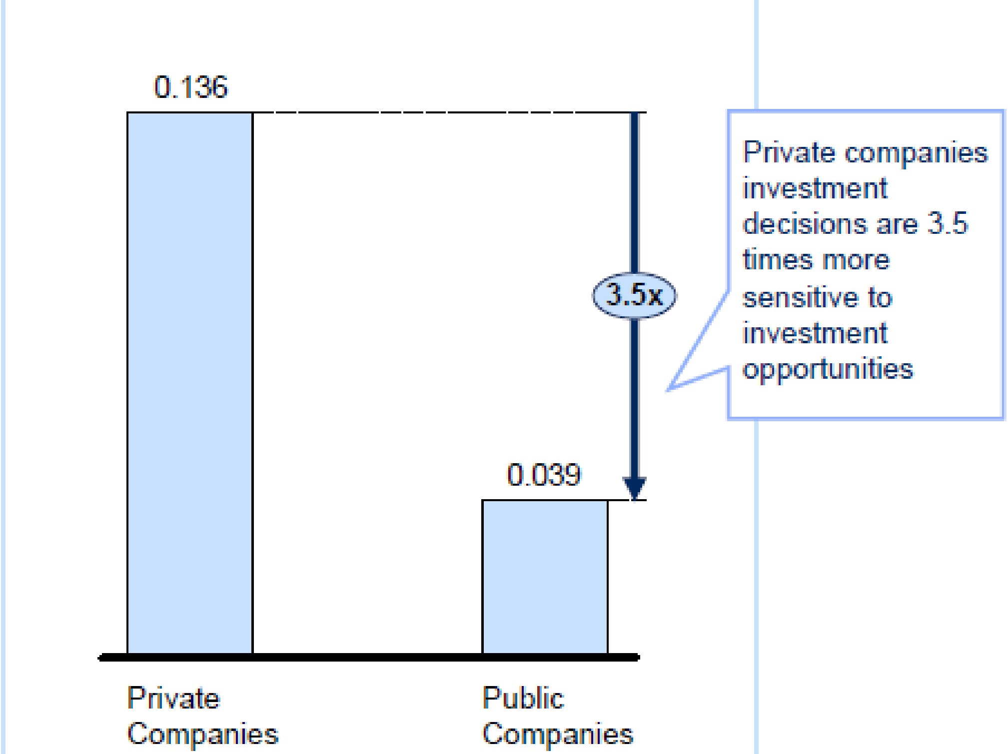
Public companies invest less and are less sensitive to investment opportunities than matched private companies

For matched private and public companies[1]

Investment levels (yearly change in total assets)



Coefficient estimate for regression of gross investment[2] on investment opportunity[3]



1 Using NAICS 4 matched on size and industry (North American Industry Classification System)
2 Gross investment defined as annual increase in gross fixed assets scaled by beginning of year total assets; net investment defined as annual increase in net fixed assets
3 Investment opportunities considered using sales growth

SOURCE: "Comparing the Investment Behaviour of Public and Private Firms", Asker, Farre-Mensa, Ljungqvist

Take-aways

The decline and fall of the stock market

- Dramatic decline in the demand for listing services: companies increasingly don't use the stock market to fund investment and growth
- In fact, more capital formation among <u>private</u> firms in the U.S., despite their cost of capital disadvantage

Does it matter?

- Stock market still the most efficient way to supply capital to growth companies – but the gap may narrow, eroding the stock market's competitive advantage
- Hard for 'ordinary' investors to participate in wealth created by privately held firms
- But private firms may have advantages: more patient capital and better long-term investment incentives