The Decline of IPOs in the US and the Rise of Entrepreneurial Finance

Edo Marchesi

University of Chicago, Booth School of Business

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The Rise in Private Markets

Are we witnessing a rise in prominence for entrepreneurial finance?

- Global equity funds raised across the full private capital spectrum hit \$1.2 trillion, a 14% increase from the 2020 total and the highest level ever reached (Bain and CO. 2021).
- Global private debt surged by 13 percent of the world's gross domestic product in 2020 (IMF 2021).
- Capital raised by private, venture capital-backed startups grew from an inflation-adjusted \$28.9 billion in 2002 to \$118.2 billion in 2019 (Ewens and Farre-Mensa 2022).

Decline in IPOs in US

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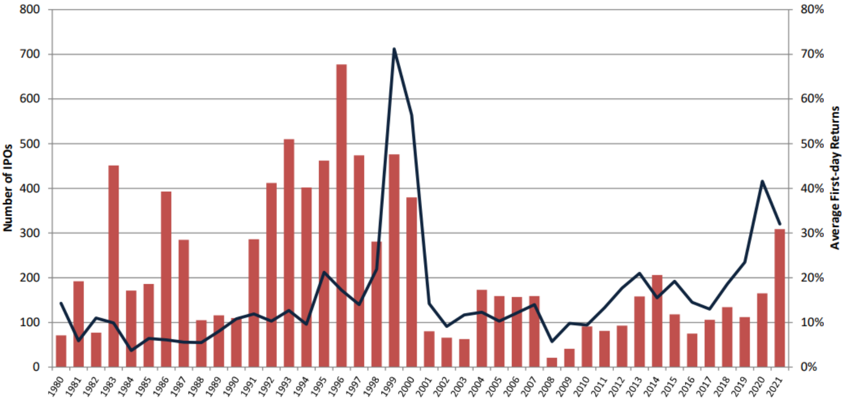
Stylized Fact

Number of Initial Public Offerings (IPOs) in US has experienced a decline since peaking in 1996 (Doidge, Karolyi, and Stultz 2013; Doidge Karolyi, and Stultz 2017)

- Average yearly number of IPOs for period 1980-2000: **310**.
- Average yearly number of IPOs for period 2001-2012: **99**.
- Steepest decline is seen among small firms.

Decline in IPOs in US

Figure: Time Series of IPOs in the US



Possible Explanations for Decline in IPO

- Access to public market features harsher barriers to entry (costs to comply to regulation etc...)
- Structural market changes leading to change in entrepreneurial preferences (more profitable exit strategies)
- Smaller financial needs for companies (less demand for capital)
- More favorable private market environment (entrepreneurs no longer need to relinquish control to access funds)

Access to Public Markets

One possible explanation to the decline of IPOs in the US is structural changes in the public market environment which place heavier burdens on companies.

Regulatory Overreach Hypothesis

Additional compliance requirements for public firms placed by the Sarbanes-Oaxly Act of 2002 (SOX) hindered profitability of small firms (Gao, Ritter and Zhu 2013).

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Gao, Ritter and Zhu (2013) shows that the explanation is unlikely:

- Timing is off. Decline in IPOs starts in late 90s.
- JOBS Act of 2012, relaxed the burdens on small firms to go public, yet we see no real increase in number of small firms going public.

Lower Demand for Capital

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- Less entrepreneurial activity over all.
- Technological changes reduced liquidity needs for entrepreneurs?

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Why are private markets booming then?

Structural Market Changes

Economies of Scope Hypothesis

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Small firms can create greater operating profits by selling out in trade sale (being acquired by a firm in the same or related industry).

- Higher valuation under acquisition than by going public or operating as a stand alone. Optimal strategy for entrepreneur is to be acquired.
- This would explain the rise in serial entrepreneurship (Lafontaine and Shaw 2016).

Private market still need to play a role, otherwise they wouldn't experience growth.

Changes in Private Market Environments

Ewens and Farre-Mensa (2020): Regulation to access financing through private markets has become laxer.

- Change in incentives for both demand-side and supply-side of capital caused crowding out.
- Small firms can avoid regulatory disclosure burden from going public while still access capital needed to grow operations.
- Entrepreneurs can retain control.

Deregulation of Security Laws

National Securities Market Improvement Act (NSMIA)

Passed in October 1996, the law made it easier for private startups to raise funds in private markets.

- Startup side: superseded *blue sky laws*.
  $\Longrightarrow$ Bettered incentives to supply securities in private markets.
- Investor side: increased maximum number of investors after which funds have to regularly disclose investment portfolios.
  $\Longrightarrow$ Bettered incentives to demand securities in private markets.

IPO Decline and Financing of Late-Stage Start Ups

SUPPLY SIDE:
The authors present a series of results to push the idea that IPO decline and private market conditions are related. Following the enactment of the law

- Late-stage startups are more likely to raise capital from out of state investors.
- Size of financing increases more for late-stage startups than for early-stage startups,
- Startups stay private longer.
- Startups reach size (sales, employment) that was previously accessible only to public firms.

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- VC and PE funds increase the number of LP they raise from.
- Size of VC and PE funds increases.
- Other types of investors (hedge funds, investment banks) increase funding to startups.

Aggregate Results

All together, changes in private market incentives has an effect on supply and demand of financing for startups.

- The evidence presented so far points to the emergence of a new equilibrium in the U.S. entrepreneurial finance market, where late-stage startups are able to raise large sums of private capital (both from traditional and new startup investors) to fund their growth while remaining private.
- Blue sky laws created frictions that prevented optimal flow of capital within the US.

Discussion and Extensions

Why do entrepreneurs prefer to stay private longer?

- Want to retain control on timing and mode of exit strategy (Ewens and Farre-Mensa 2020)
- Private markets allow companies to grow without fear of hostile takeovers.

Discussion and Extensions

The case of Google

When Google filed for its IPO in 2004, investors were surprised to learn how profitable the company was (e.g., Delaney and Sidel 2004). If Google's VC investors had had to disclose the value of their investment in Google on a semiannual basis between 1999 (when it raised its first VC round) and 2004, Google's competitors would have learned about its profitability much earlier than they did, potentially harming the company's competitive position.

Google's founders recognized this in the company's S-1 filing: "As a smaller private company, Google kept business information closely held, and we believe this helped us against competitors" (Google 2004, iv).

Discussion and Extensions

Value of opacity is consistent with:

- Rise of private markets.
- Decline of public markets (IPOs) for small companies (Doidge, Karolyi and Stulz 2013).
- Evidence of killer acquisitions (Cunningham, Ederer and Ma 2021)