Marketing material
for professional investors and advisers only

Perspective

What are the merits of a public-private equity investment approach?

February 2022

A public-private equity investment approach is one that combines public equity and private equity investments within the same portfolio. In recent years this has grown in scale globally, with several billion dollars raised for new and existing offerings; we believe there is much more to come. In this paper we describe what we believe to be the attractions of a hybrid approach that invests in both public and private equities.


Tim Creed
Head of Private
Equity Investments

Uzo Ekwue
UK Small & Mid Cap Analyst,
Public Equities

The authors are part of a team involved in the management of Schroders' public-private equity strategies.

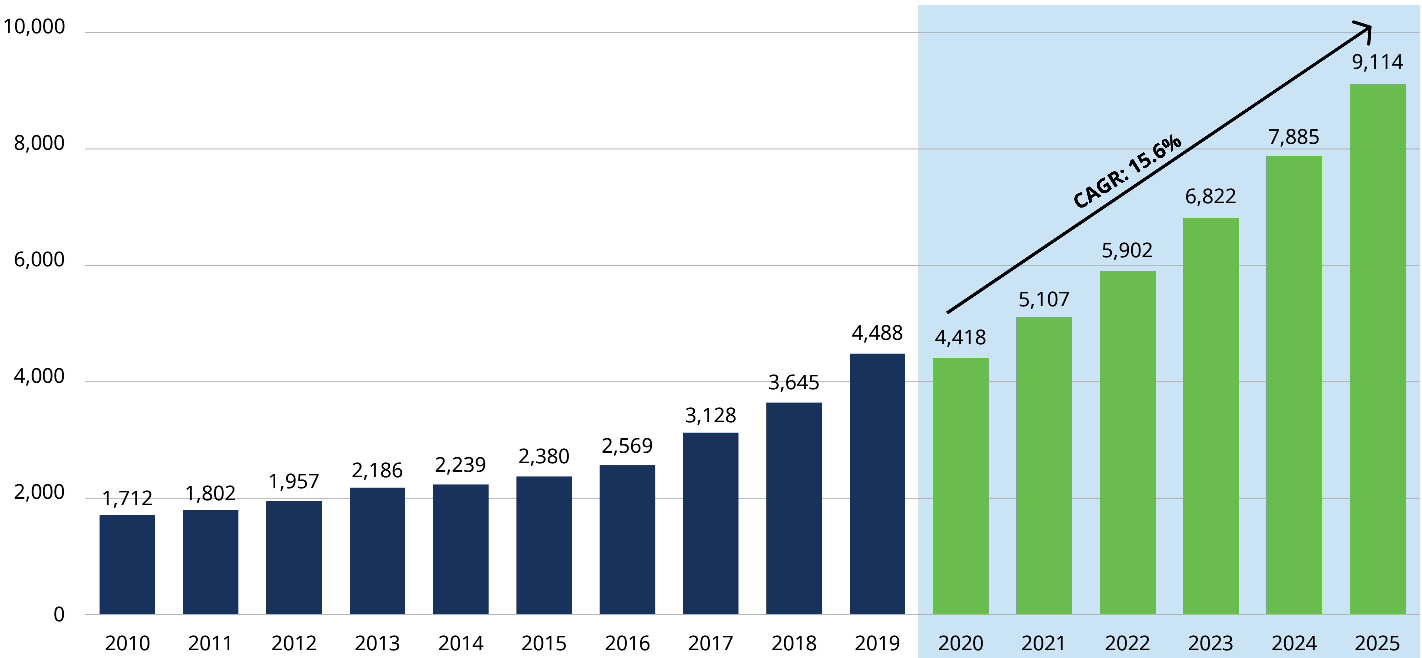
Investor interest in private equity is growing...

Global assets under management ('AUM') in alternatives (e.g. private equity, infrastructure and other types of private assets) is expected to increase 1.6x from 2020 levels by the end of 2025 to $17.2tn. Within this, the private equity asset class is expected to grow the most at a CAGR of 15.6% between 2020 and 2025 (Exhibit 1) vs. a growth rate of 5% or less for all other asset classes.

...and the concept of investing in a company throughout its multiple growth stages is increasing in familiarity.

While we see the private equity class as an attractive investment opportunity on a standalone basis, and one that is suitable for some clients, we note that at some point after the initial public offer ('IPO') of a portfolio company, private equity funds are usually forced sellers. In this context, these funds are not able to invest across a company's lifecycle. In contrast, 'lifecycle investing' occurs when investors are shareholders of a company throughout multiple stages of the company's life, and where an IPO is not viewed as an opportunity to exit.

Exhibit 1: Private Equity Assets under management ($bn)[1]



Source: Preqin, 2020 figure is annualised based on date to October. 2021–2025 are Preqin's forecasts.

Schroders

A similar concept that has risen in prominence is 'crossover investing', where investors usually become shareholders at the private round that just precedes a company's public market listing (the round may occur 6-18 months before), with the intention to remain investors thereafter.

The advantages of the integrated public-private equity model over a segregated approach

Some may argue it is possible for asset allocators or other investors to achieve a public-private equity exposure by investing separately in distinct wholly-private equity and wholly-public equity vehicles. We take the view that such an approach contains an important disadvantage in that it removes the opportunity for a centralised point of governance.

Centralising the governance function means the capital allocation decision is then made by a single fund management team in such a way that synergies are created, investment returns are maximised, consistency in active stewardship is maintained and appropriate sector diversification is achieved. In addition, centralising the governance function allows the investment team to use the wider perspective gained by investing across public and private asset classes to create what it believes to be the best possible portfolio. We discuss these points further in the rest of this document.

How public-private equity investing can widen an investor's perspective and create a competitive edge

Public companies are subject to strict reporting rules and at times also choose to limit the amount of information they provide to the market for competitive reasons. In both cases this results in reduced disclosure to public market investors. In contrast, private companies provide their investors with more information, and in the case where a public company has decided to reduce or avoid disclosure for a particular division, a private company competing in the same sub-industry can potentially provide further insights around the industry landscape such as competition and demand trends. This can also be particularly useful when assessing the attractiveness (or otherwise) of niche or undercapitalised areas of the market.

To put it explicitly, having sight of companies operating in both the public and private markets can be useful in increasing investment conviction. A single fund management team that works together on the same investment approach can use this wider knowledge base to select what it views as the best companies operating in any given industry. In contrast, anyone investing in separate wholly-public and wholly-private equity vehicles in an attempt to create a synthetic public-private equity exposure does not benefit from such a centralised knowledge function, nor the competitive edge.

A wider perspective is crucial at the time of an IPO

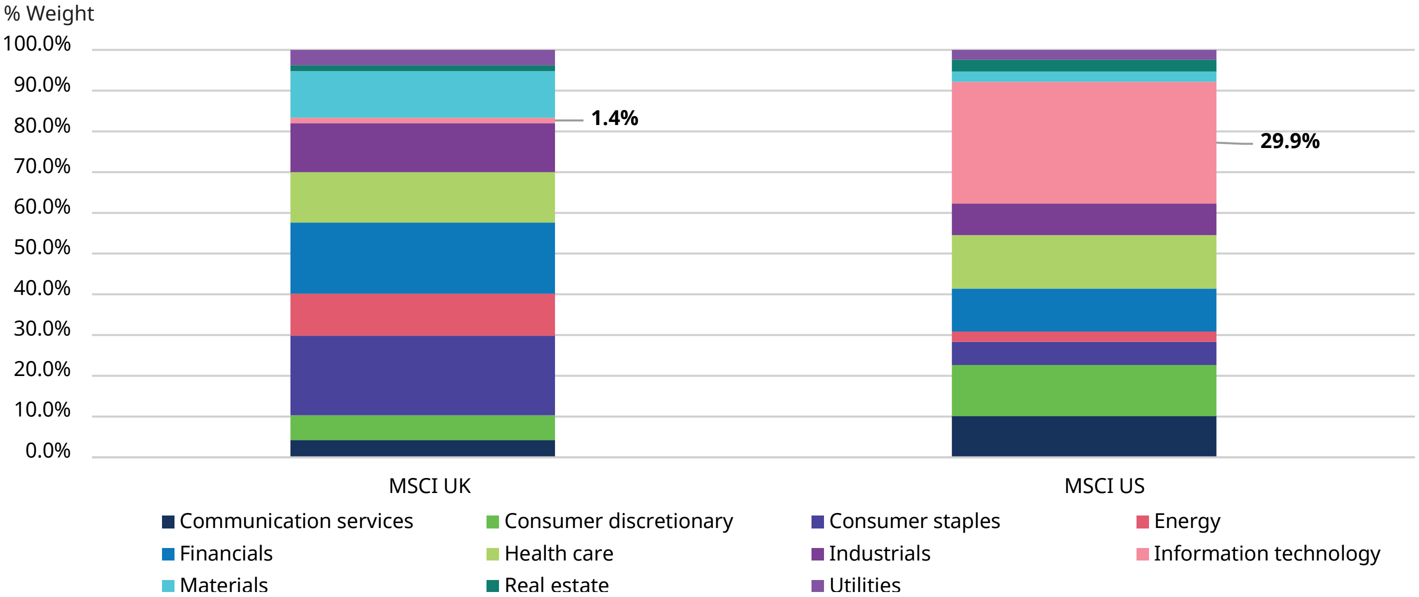
A number of institutional investors shy away from taking part in the IPO process for several reasons. One is the belief that they have not obtained sufficient information to appraise the investment, particularly within the short time frame available (in the UK approximately three weeks from the publication of the 'Intention To Float' document to the flotation itself. Although there can be 'Early Look' stages, where companies seeking to IPO meet investors three to six months before the issue of the Intention To Float document, these are typically only reserved for a select few investors).

There are two ways to narrow the knowledge gap, in our view. The first is to invest prior to the IPO when the company is still private; such private funding rounds present investors with due diligence information that can be used to make better decisions, with processes lasting up to several weeks or months. For institutional investors that are also concerned about receiving low allocations in a traditional IPO round, investing prior to listing can avoid this.

The second way to close the information gap is to consult in-depth with colleagues specialising in the private markets who have previous knowledge of the company, its competitors and/or the industry it operates in (as long as material non-public information is not exchanged of course).

A combined public-private equity investment approach can utilise both methods, which we believe may be useful when involved in an IPO process.

Exhibit 2: Index sector weightings in UK & US



Source: Bloomberg, as at 31 December 2021.

Combining public equity and private equity investments widens an investor's opportunity set

Bringing together both public and private equities in the same investment approach also allows investment managers to access the widest possible set of opportunities. The degree of sector diversification across a number of global indices varies depending on country. For instance, the tech sector in the UK is equal to only 1.4% of the market capitalisation of the overall index, whilst in the US this is 29.9% (Exhibit 2). As at the time of writing, there are only a few payment companies listed on the London Stock Exchange; this means that UK-focussed public equity investors interested in fintech businesses are denied an opportunity to invest in fast growing, non-listed UK businesses. The wider opportunity set allows public-private equity investors to consider the best investments whether they be public or private, which again supports the need for the earlier mentioned centralised governance function. Furthermore, it also ensures that the appropriate level of sector diversification is achieved.

Investing earlier could enhance portfolio returns

One attraction of combining private equity and public equity holdings in a single investment approach is the ability to potentially generate higher returns. Exhibit 3 illustrates that in the decade ending 2020, private equity and venture capital strategies returned a CAGR of 14.4% and 14.1% respectively, whilst public equities generated 10.5%.

Whilst we recognise that greater returns have historically been generated in the private markets, to reiterate observations made earlier, there are limitations to sole private equity strategies that mean they may not be suitable for all clients. Furthermore, we would expect that an investment team that has full view of the public and private equity landscape may be able to generate additional alpha for its clients. As such, for clients that seek to enhance their public equity returns, we believe a public-private equity investment approach could be considered.

Investing earlier may be financially beneficial to both public-private equity investors and prospective IPO candidates

As discussed earlier, investing in a company prior to its IPO is one way to close the knowledge gap and ensure a sizeable allocation at the IPO. In addition, this ability to 'lifecycle invest' from the venture or growth capital stage may provide public-private equity investors with an opportunity to enter at a lower valuation to the IPO price, thus potentially providing such investors with a superior ability to outperform relative to other public equity investors that enter at a higher price.

What's more, we have found that IPO candidates seek out long term financial partners early on, with a mutual understanding that these partners may act as cornerstone investors for the listing. In particular, our experience is that companies with an end goal to IPO are more likely to select investment firms that have internal capacity to invest in the public equity markets. Building a relationship in earlier funding rounds is an important competitive advantage that lifecycle investors have relative to non-lifecycle investors, as it also puts the former in good stead to potentially receive greater allocations in follow-on public equity raisings.

A single point of governance can be a powerful driver of companies' progress in ESG

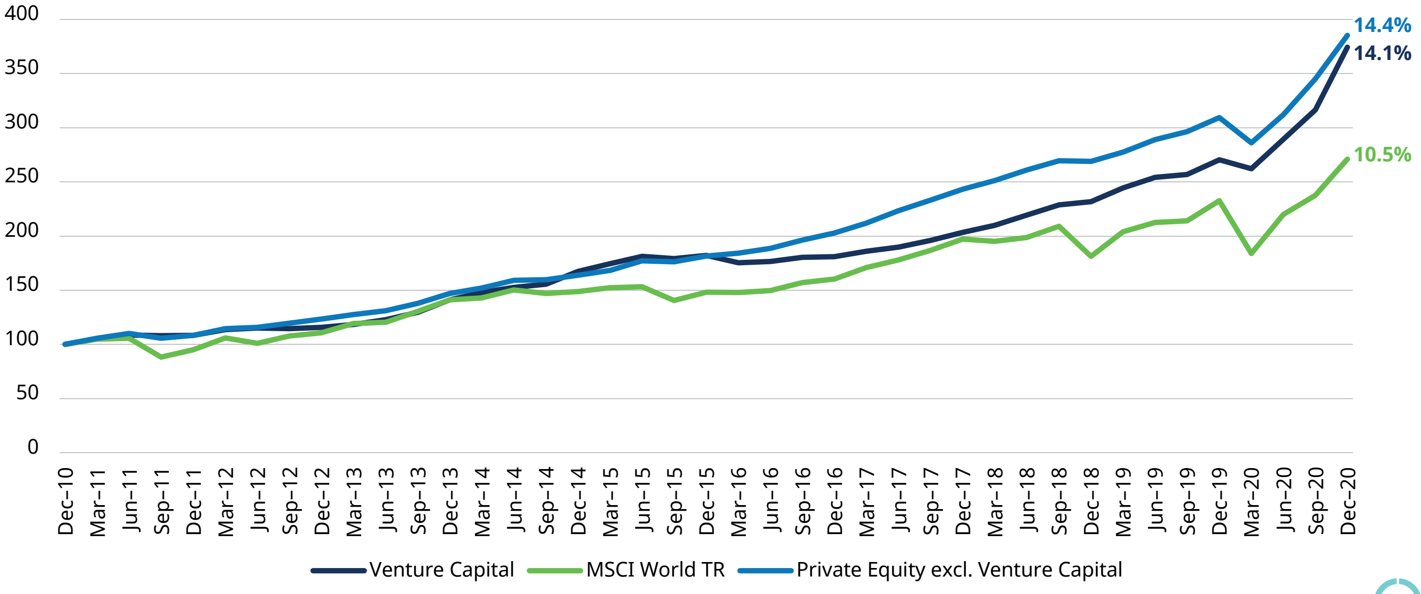
By investing in companies when they have may have limited sustainability infrastructure and before they reach the public markets, lifecycle investors have the opportunity to drive significant change through partnership on ESG issues. This can include implementing diversity & inclusion and environmental practices at an early stage, and recommending an appropriate board structure. As such the magnitude of the impact that lifecycle investors (and to a lesser extent crossover investors) are likely to have should be greater than those investing at, or after, the IPO stage.

While not every investment within a public-private equity portfolio may be a private company seeking to list, we believe that a public-private equity investor's ESG reporting as a whole is likely to show greater demonstrable active stewardship improvements than that of non public-private equity funds. In addition, the consistency in stewardship created by a singular team across both asset classes is preferential to asset allocators selecting and investing in distinctly separate public equity and private equity vehicles.

Not all companies IPO: a multi-layered approach to public-private equity investing

Although it is generally IPOs that grab the headlines, our research suggests that only c.10% of private companies actually seek a stock market listing, thus implying that most private equity transactions are trade sales either to other private equity firms or corporates. As such, investment managers that have exposure to private companies seeking all types of exit routes not only widens the universe of investment prospects in the private market, but it also means such an investment approach is not wholly dependent on whether or not an IPO process is successful.

Exhibit 3: Performance of venture capital and private equity strategies vs. public equities: December 2010 – December 2020



Past performance is not a guide to future performance and may not be repeated.
Source: Preqin.

Schroders' approach to public-private equity investing comprises the following:

- Private companies where we intend to exit our investment via trade sale to another private equity firm or corporate;
- 'Lifecycle investments' – i.e. earlier investments made in private companies that plan to eventually list on a stock exchange. We intend to continue to be shareholders post-IPO; and
- Companies that are already publicly listed, where the due diligence that we have gained from our public and private market expertise helps to provide a well-informed view of the overall industry, competitive landscape and investment opportunity

In our view, this three-pronged approach allows us to implement the attributes of public-private equity investing on a multi-layered basis.

Conclusion

We believe there are several attractions of a combined public and private investment portfolio. Most critically, a central point of governance means that each part of a portfolio can be managed with reference to the other. This enables monitoring of diversification – by sector or geography - and of other underlying exposures – such as correlations. It also means an overall portfolio can be aligned to a single set of overarching risk, return and impact objectives.

In our view, bringing together public and private equity also widens the investment team's perspective, creating an edge when it comes to in-depth understanding of particular industries, especially those where there may be few publicly-listed companies for comparison.

Note to readers/viewers in Indonesia: Issued by PT Schroder Investment Management Indonesia Indonesia Stock Exchange Building Tower 1, 30th Floor, Jalan Jend. Sudirman Kav 52-53 Jakarta 12190 Indonesia PT Schroder Investment Management Indonesia is licensed as an Investment Manager and regulated by the Indonesian Financial Services Authority (OJK).This material has not been reviewed by the OJK.

For readers/viewers in Israel: Note regarding the Marketing material for Qualified Clients or Sophisticated Investors only. This communication has been prepared by certain personnel of Schroder Investment Management (Europe) S.A (Registered No. B 37.799) or its subsidiaries or affiliates (collectively, 'SIM'). Such personnel are not licensed by the Israeli Securities Authority. Such personnel may provide investment marketing, to the extent permitted and in accordance with the Regulation of Investment Advice, Investment Marketing and Investment Portfolio Management Law, 1995 (the 'Investment Advice Law'). This communication is directed at persons (i) who are Sophisticated Investors (ii) Qualified Clients ('Lakoach Kashir') as such term is defined in the Investment Advice Law; and (iii) other persons to whom it may otherwise lawfully be communicated. No other person should act on the contents or access the products or transactions discussed in this communication. In particular, this communication is not intended for retail clients and SIM will not make such products or transactions available to retail clients.

Note to readers/viewers in Japan: Issued by Schroder Investment Management (Japan) Limited 21st Floor, Marunouchi Trust Tower Main, 1-8-3 Marunouchi, Chiyoda-Ku, Tokyo 100-0005, Japan Registered as a Financial Instruments Business Operator regulated by the Financial Services Agency of Japan ("FSA"). Kanto Local Finance Bureau (FIBO) No. 90 This material has not been reviewed by the FSA.

Note to readers/viewers in Singapore: For Accredited and or Institutional Clients only, where appropriate Issued by Schroder Investment Management (Singapore) Ltd (Co. Reg. No. 199201080H) 138 Market Street #23-01 CapitaGreen, Singapore 048946 This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.

Note to readers/viewers in South Korea: Issued by Schroders Korea Limitedn26th Floor, 136, Sejong-daero, (Taepyeongno 1-ga, Seoul Finance Center), Jung-gu, Seoul 100-768, South Korea . Registered and regulated by Financial Supervisory Service of Korea ("FSS")This material has not been reviewed by the FSS.

For readers/viewers in Switzerland: Marketing material for professional clients and qualified investors only. This document has been issued by Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zurich, Switzerland a fund management company authorised and supervised by the Swiss Financial Market Supervisory Authority FINMA, Laupenstrasse 27, CH-3003 Bern.

Note to readers/viewers in Taiwan: Issued by Schroder Investment Management (Taiwan) Limited 9F., No. 108, Sec. 5, Xinyi Road, Xinyi District, Taipei 11047, Taiwan. Tel +886 2 2722-1868 Schroder Investment Management (Taiwan) Limited is independently operated. This material has not been reviewed by the regulators.

Note to readers/viewers in Thailand: This presentation has not been approved by the Securities and Exchange Commission which takes no responsibility for its contents. No offer to the public to purchase any fund will be made in Thailand and this presentation is intended to be read for information only and must not be passed to, issued to, or shown to the public generally. Schroder Investment Management (Singapore) Ltd does not have any intention to solicit you for any investment or subscription in any fund and any such solicitation or marketing will be made by an entity permitted by applicable laws and regulations.

Note to readers/viewers in Malaysia: This presentation has not been approved by the Securities Commission Malaysia which takes no responsibility for its contents. No offer to the public to purchase any fund will be made in Malaysia and this presentation is intended to be read for information only and must not be passed to, issued to, or shown to the public generally. Schroder Investment Management (Singapore) Ltd does not have any intention to solicit you for any investment or subscription in any fund and any such solicitation or marketing will be made by an entity permitted by applicable laws and regulations.

For readers/viewers in the People's Republic of China: Issued by Schroder Investment Management (Shanghai) Co., Ltd. Unit 33T52A, 33F Shanghai World Financial Center, 100 Century Avenue, Pudong New Area, Shanghai, China, AMAC registration NO. P1066560. Regulated by Asset Management Association of China ("AMAC") This material has not been reviewed by the AMAC.

For readers/viewers in the United Arab Emirates: Schroder Investment Management Limited, located on 1st Floor, Gate Village Six, Dubai International Financial Centre, PO Box 506612 Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority. This document is not subject to any form of regulation or approval by the DFSA. The DFSA has no responsibility for reviewing or verifying any Prospectus or other documents in connection with this Fund. Accordingly, the DFSA has not approved any associated documents nor taken any steps to verify the information set out in the Prospectus for the fund, and has no responsibility for it. This document is intended to be for information purposes only and it is not intended as promotional material in any respect. This document is intended for professional investors only as defined by the DFSA rules which can be accessed from their website www.dfsa.ae.

For readers/viewers in the United Kingdom: Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy or on request should you not have access to this webpage. Issued by Schroder Investment Management Limited, 1 London Wall Place, London EC2Y 5AU. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

Issued by Schroder Investment Management Limited, 1 London Wall Place, London, EC2Y 5AU. Registered No. 1893220 England. Authorised and regulated by the Financial Conduct Authority.

603182