
SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 24

Why private companies matter more

MB Malcolm Borthwick

PS Peter Singlehurst

MB Hello, and welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. I'm Malcolm Borthwick, editor of Intellectual Capital at Baillie Gifford.

In 1996, there were over 8,000 companies listed on US stock markets. 20 years later, that number had almost halved. So, more companies are choosing to stay private, and for longer.

Baillie Gifford has invested over \$10bn in private companies, and has a further \$20bn of assets in public companies that we first invested in when they were private. Most of Baillie Gifford's private company investments are held in investment trusts.

These include SpaceX, the advanced rockets and spacecraft firm founded by Elon Musk, Epic Games, which is behind the hit video game Fortnite, and ByteDance, owners of TikTok, which was the most downloaded app in 2021. It was also the most downloaded app in 2020.

To discuss why companies are staying private for longer, I'm joined by Peter Singlehurst, who is head of Baillie Gifford's Private Companies Team.

But before we start the conversation, some important information. Please remember that, as with all investments, your capital is at risk and your income is not guaranteed, and the risk of investing in private companies could be higher, as these assets may be more difficult to buy and sell, so changes in their prices may be greater.

And we're recording this podcast during Covid-19, so Peter and I are both at home, as opposed to in the usual Edinburgh studio.

Peter, welcome to *Short Briefings on Long Term Thinking*. Thanks for joining us. So why are companies staying private for longer?



PS I think there are a few different factors at play here. There are some very hard and tangible factors, particularly regulation. Over the last 20 years or so, there have been regulatory changes which have, at the same time, made it more burdensome to be public but also made it easier for companies to stay private.

In addition to the availability of the capital in the mid and later stages of the high-growth private markets, I would categorise those as the hard factors, which are pushing companies to stay private for longer. But I actually don't think those are the most significant factors.

I think that the more significant, and perhaps less appreciated, factors come down to the cultural perception of founders of the value of staying private versus going public. I think that what founders today increasingly realise is that, by staying private for longer, they derive focus, and from focus they get competitive advantage. Everything else being equal, they are able to build better businesses by staying private longer.

And the reason for that is they don't have to worry about having thousands of public market shareholders who may well be owning shares for reasons that are completely misaligned with what the founders are trying to achieve.

They can maintain a small, concentrated, aligned group of shareholders, focused on the operations of what they are doing and the long-term vision, and we think, as a result, build better businesses with higher probabilities of success. And I think that this softer factor is in fact the most important reason as to why companies are choosing to stay private longer.

MB Are you seeing this change as something that is cyclical or is it a long-term trend?

PS I think we had this question ourselves back in 2012, 2013, 2014. I think it was, at that point, an open question as to whether this was a cyclical change or structural. I think that it's becoming increasingly clear to us that this is a structural change, which has happened.

We are not going back to the world of the best high-growth private companies choosing to go public with a market cap of a few hundred million dollars. Companies will today continue to stay private, in many cases, for as long as they can. And going back to the previous question, I think that many of those reasons are structural.

MB And how did it all start? Because Baillie Gifford has been investing in private companies for some time now.

PS Yes, it all started with an investment that we made in Alibaba in 2012. We made that investment from within the Scottish Mortgage Investment Trust, a client of ours for the last 112, 113 years.

We made a few more investments over the course of 2013-2014, and I think at that time we didn't yet know whether these were going to be a series of one-off investments, almost anomalies of businesses that were staying private longer, or



whether this was the start of something that was going to be a more profound change in the way in which companies were capitalising themselves.

But I think what we learnt over the rest of the last decade was that in fact that was the start of this big change of companies staying private longer. And I think that we were, in many ways, fortunate to get off to a good start through the investment in Alibaba, and that was the start of what has gone on to become a meaningful area of investment for our clients, but also a very important way in which we start to get to know the next generation of companies that are increasingly forming the backbone of many of our public market mandates as well.

MB At what stage does a private company, from your perspective, become interesting or scalable to invest in?

PS There are two criteria that we use here, and we try to think about it philosophically rather than quantitatively. The two questions we ask ourselves are, firstly, do we have the analytical skill set to be able to tell whether or not this is a good business?

And I think that you can perhaps elucidate that by thinking about extremes. So if you think about a very early-stage business, where there are a couple of people with a dog working on something in the garage, we don't have the skill set to be able to tell whether or not that's going to be a good investment.

Now, good earlier-stage venture capital investors do, and that's what they specialise in, and we need those early-stage investors to be mentoring those businesses at those very early stages of development. So that's too early for us.

But if you can start to have a meaningful conversation about a company's business model, about the management team's track record in executing, if you can talk about a business's competitive advantage and the scale of their addressable market, these are the factors that we've been analysing for 100 years as an organisation, and so we think we do have the analytical skill set to be able to determine whether businesses that are beginning to exhibit those characteristics can be good investments for our clients. So that's the first criteria.

The second criteria, in many ways, turns the question back on ourselves and says, are we the right partner for this company at the given stage of development that it is at? So again, thinking about those different stages, very early-stage companies need lots of help and guidance and operational support from their early-stage investors. We can't, and we don't, and we don't aspire to be able to, do that.

But what we can do is help steward companies in the mid and later stages, we can help them make that transition to the public markets, and we can provide that continuity of capital at a period of time when much of their cap table will be looking for an exit. And if a company needs those things from investors, well then maybe it tells us that we can be the right partner for the right company at the right stage of its development.

MB And there's a perception amongst many investors that private companies are more risky to invest in, is that fair?



PS I don't think there's anything about a company being private, per se, that makes them more or less risky. Yes, arguably, if you're talking about a very early-stage business that has an unproven product, those companies probably are more risky, but the stage that we're investing at, where you have companies that are normally generating substantial revenues, many of the companies that we invest in today are profitable, that are growing very quickly, that have got proven product-market fit, I don't think there is anything that is more risky about those companies than many public businesses.

And I think that you can see that in our return profiles over the years, not just in the upside but in the downside. We've made about 100 investments over the course of the last ten years, and we have had one bankruptcy within our portfolio over that period of time. If you compare that to typical loss rates within earlier-stage venture funds, where you can be looking at anything from 20% to 30% loss rates, frankly when we first started off on this journey, I think we thought we were going to have higher loss rates than we have done.

MD So do you think too much is made of the difference between private and public companies and, at the end of the day, you're just looking for great long-term opportunities?

PS Yes, I think that's exactly right. I think that it's to the detriment of companies, it's to the detriment of end asset owners, that the financial world pretends that there is a meaningful difference between private and public companies. I really don't believe that there are meaningful differences.

There are differences in terms of how you source businesses, there are differences in terms of the relationships that you can have with companies which are often much closer when companies are private, but I don't think there's any difference in terms of the qualities of companies and the abilities to create returns for your clients.

So, the journey that we've been on for the last ten years has been about trying to break down this artificial divide between private and public companies, because we believe that that is in the interest of our clients, and we think that it's in the interest of the companies that we're backing as well.

MB And most of our private company investments are in investment trusts. Why is the closed-ended vehicle more attractive than the open-ended vehicle in this situation?

PS I think the long-term capital within investment trusts is attractive to us, but it's also really attractive to the companies that we back. It's attractive to us because it means that you can really practise this long-term investment philosophy, and where you find a business that can compound over 20 years, you can continue to own those businesses over that period of time.

But for the founders we back, it means they know that provided they're executing and providing the growth and the upside remains, they will have a partner within Baillie Gifford that can stay the course, because of the longevity of the capital in



these investment trusts that we manage on behalf of our clients.

MB So what's the problem with investing in private companies if you're an investment manager of an OEIC or an open-ended fund?

PS There are some regulatory reasons that make it very difficult to invest in private companies from open-ended structures. And in many ways, I think that those regulations are right. You are investing in a highly-illiquid asset class when you invest in a private company, and you need to have a structure that is appropriate for that, but you also need to have an audience that really understands that.

OIECs are open-ended structures, and so you have this mismatch between the liquidity of the instrument you own, which is completely illiquid, and the open-ended nature of the vehicle, which is open-ended and liquid. And I think that mixing those two, it's just not appropriate. Which is why we've always used investment trust structures and other structures that are suitable for the realities of the liquidity of private companies.

MB So the problem can be, within an open-ended fund, that you become a forced seller but you can't always sell because of liquidity?

PS Yes, I think that's broadly right. But it works the other way as well, because you can't build the positions. If your open-ended fund grows, you can deploy fresh capital equally across the public assets, but you can't readily just deploy into the private companies. You can only invest in private companies when they're raising capital or if there happens to be some secondary liquidity.

And so, the process of bringing new capital into an open-ended fund where you have private companies is dilutive, and if the client base of the OIEC doesn't understand that, then that's not in the interests of the existing clients because you're diluting their holdings of those private holdings.

MB And something that we haven't discussed so far is the conical mountain in Perth and Kinross, and also a fund that invests in private companies. Where does Schiehallion fit into things, Peter?

PS Schiehallion was the first dedicated fund that we launched for investing in private companies. We went down the route of using an evergreen structure again, and that was very important to us, when we launched Schiehallion, that it would be not only long-term but that it would also be low-cost. So, the fees for Schiehallion are much, much lower than your traditional fund for investing in these sorts of companies.

We launched that fund in 2019, and we did an additional capital raise within the fund springtime last year, and that's a portfolio that's pretty substantially deployed now, the Schiehallion fund, in aggregate. And we've started to see some of our holdings enter the public markets, and many of those companies we remain shareholders in.

It's a public company in its own right, it's listed on the specialist fund segment of



the London Stock Exchange, and that was the first dedicated fund that we launch for private companies.

MB And who's it mainly targeted at?

PS The Schiehallion Fund, initially we only marketed it to our existing longstanding institutional investors. We went a little bit broader when we did the C share raise, to many UK financial intermediaries. But by virtue of being listed on the specialist fund segment of the London Stock Exchange, it's a vehicle that's for institutional investors who really understand the dynamics of investing in private companies.

MB And as I was saying, also a conical Mountain in Perth and Kinross. Have you climbed it?

PS Shamefully, I haven't, actually, which is terrible, isn't it?

MB Maybe a New Year's resolution.

PS Had it not been for Covid, we would have had a team trip to go and climb it, but hopefully on the other side of Covid, if there ever is the other side of Covid, we'll get a team trip to go and summit it.

MB And speaking of the pandemic, what has the pandemic changed your mind about, Peter?

PS I'll talk about two things, if that's okay. One internal and one external. I think the internal one is just the effectiveness of remote working. I think that's something that I had a very different view of going into the pandemic than I do now. As a team, we've been able to work incredibly productively and efficiently over the course of the last two years, but I think that's largely because we had very good social and personal bonds within the team, and we had a very aligned view of what we were trying to do as a team. So that's the internal one.

The external one, I guess, around companies and investing, would be around healthcare. And I wouldn't say this is so much a change of mind, more a confirmation of a hypothesis that we had for many years that I think that the pandemic has really proven.

Over the last few years, we've been talking internally about the changes in healthcare and how some of the developments and the understanding of biology and new therapeutic modalities is leading biology to become much more predictable, programmable.

mRNA and vaccines are, I guess, the poster child of that development, but if you look at other companies that we've invested in privately, over the years, that are today public businesses, like Vir Biotechnology, they've had incredible success developing antibody therapies against Covid as well.

So, I think that a confirmation around that hypothesis, that biology is becoming more predictable, more programmable, and that perhaps in the future the probabilities of success in developing new therapies, not just against infectious



disease but more broadly, is going to go up. And I think that could lead to some very attractive opportunities for our clients.

MB Peter, progress in healthcare is a very optimistic note to end on. Thank you very much for joining us on the podcast.

PS Thank you, Malcolm.

MB And thanks for investing your time in *Short Briefings on Long Term Thinking*. You can find our podcast at bailliegifford.com/podcasts, or subscribe at Apple podcasts, Spotify or on TuneIn.

And do check out previous conversations we've had on the podcast, such as how the messenger RNA vaccine is transforming biotech, something that Peter was talking about earlier in this podcast, why investing in some ESG funds could do more harm than good, and have you ever wondered why we are so pessimistic about progress? Well, find out by listening to our back catalogue.

And if you're listening at home, you're listening in the car, wherever you're listening, stay well and we look forward to bringing you more insights in our next podcast.

Important Information

The Schiehallion Fund has a significant investment in private companies. The Fund's risk could be increased as these assets may be more difficult to sell, so changes in their prices may be greater

Investments with exposure to overseas securities can be affected by changing stock market conditions and currency rates.

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