What are the myths of private company investing?

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Ben James (BJ): Hello, and welcome to this next film in the series on investing in private companies at Baillie Gifford. This film is about myth-busting and we're going to bust three big myths about investing in private companies. The first one, Rachael, is we invest in really early-stage, high-risk, seed capital companies. Do we do that?

Rachael Callaghan (RC): I think it's worth setting the scene a little bit. Back in 2008, there were only 18 companies that had a valuation of a billion dollars or more, so-called the unicorns. In today's world, there is over 1,200 of these companies. These companies are established businesses with clear revenues or pathways to revenues, profitability or, again, pathways to profitability. They are looking for additional capital to really help grow or unlock that next stage of transformational growth.

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BJ: I think it's really important for context to give the audience an idea of some of our largest companies. Let's look at the largest five private companies we invest in. SpaceX, the rocket company, ByteDance, the owner of TikTok, Epic Games, which essentially runs the engine for the likes of Fortnite, Northvolt, the European battery maker, and Stripe, the payments company. Let's look at those. SpaceX and ByteDance, they are both valued well north of $100 billion. They are generating cash.

And then if you bought anything online recently and paid for it, it's likely that Stripe will have powered that. If your kids play on Fortnite or if indeed you play on Fortnite, James, no judgement here, it'll have been powered by Epic Games. And Northvolt has $60 billion of orders on its orderbook. And if they were public companies, they'd be in the FTSE 100. They'd be big enough to be in the FTSE 100.

RC: Yes.

James Yuill (JY): Exactly.

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RC: It is important to recognise that that inflection point does change per company. For some companies, it might be $150 billion and they're looking for the next stage of investment. Some of these companies are extremely capital-intensive. They need multiple rounds of support. And for some companies, they might be pre-revenue and they're just looking for that next stage of investment for certain R&D, research and development projects. And they might need capital too. It just depends per company.

If you look at the dollar failure rate for a series A company, that's slightly earlier on in the journey, it's north of 16 per cent. Whereas when you get to series D, E and F, where Baillie Gifford tends to participate, you're into the low single digits then for failure rate. But a lot of the upside, a lot of the growth still remains for these companies because of the kind of companies that we invest in that are changing industries or creating new ones entirely.

BJ: That leads me on to myth number two, investing in private companies means you need to have a seat on the board, you need hundreds of people going in and helping them set up their processes or shifting or pivoting the business model. And we don't do that, James?

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JY: No, that's right. Often, private equity can mean going and taking a majority stake trying to turn around a business. Whereas what we're trying to do, we're stage-appropriate investors. We're taking minority positions in these companies, in companies that we believe in the management that's there and the ideas that they're fostering. We're not taking on that risk. We're not trying to turn them around and change what they're doing. We support the ideas that they already have.

BJ: They're pretty mature companies that essentially need a different skill set, whether that be supporting them on the road to IPO and beyond or connecting them with other people. But they don't need us to change their business. They're already well-functioning businesses?

JY: Exactly. And I think the important part there as well is we're not pressuring them to list as well. We’re about supporting the ideas and developing their business. As and when they do list, we'll be there to support them. But because we can be agnostic about that means we don't need to pressure them.

RC: I think a big part of the role that Baillie Gifford plays is the continuity of capital and the well-aligned shareholder, the well-aligned supportive voice that we provide to the management team. Because we have this institutional understanding that we talked about in our earlier video, we know what it takes to be a great growth business. And that doesn't happen overnight. These companies need that support. They don't necessarily need us to come in and change things. They just need capital to execute on the ideas that they already have.

BJ: Myth number three, private company valuations are stale. We don't think ours are, but can you just give us a bit of a colour on that, James?

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JY: I think historically, the reporting frequency when it comes to the private equity space is lesser. And that can lead to this notion that valuations are left untouched for long periods.

BJ: How often would a traditional private equity fund revalue their companies?

JY: They tend to report quarterly. But what they're more focused on will be the annual.

BJ: Maybe once a year, they change the value?

JY: In times gone by, I think that that's certainly been the case. And that impression is still there. Whereas we don't have that luxury where we hold these assets and vehicles, like Scottish Mortgage, that are pricing daily. We need to be on top of our valuations. The way we deal with valuations looks to almost mark to market to be able to react and look at what's happening in the broader markets, whether that's company-specific or volatility in the broader markets and what that might mean for private companies.

BJ: We're pretty confident that we have amongst the most robust and diligent valuation processes for private companies in the business, but I think that's a whole film in itself. If you want to watch that film, please check out the other films in this series, including the one on valuations.

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