Finance

Staying Private, Going Public: An Overview of Startup Finance

Key Takeaways

- An unintended consequence of regulatory changes over the past few decades is that initial public offerings (IPOs) happen less frequently. IPOs also occur later in young companies' lives, as founders increasingly elect to tap private markets instead.

- This shift may suggest the need for different regulatory and policy frameworks around private markets as they see more capital inflows.

- The shift also raises questions about how to structure equity arrangements for early-stage employees and investors, many of whom would rather have options to cash out more easily than private markets usually allow.

Adapted from "Private or Public Equity? The Evolving Entrepreneurial Finance Landscape," by Michael Ewens of Columbia Business School and Joan Farre-Mensa of the University of Illinois Chicago.

A paper from Columbia Business School, "Private or Public Equity? The Evolving Entrepreneurial Finance Landscape," explores the interplay between public and private markets and the impact of company founders raising capital via one vehicle versus the other. The study was co-authored by Michael Ewens of Columbia Business School and Joan Farre-Mensa of the University of Illinois Chicago.

Research

The process of financing young startups has changed over the past two decades, with founders waiting longer to tap the capital markets and increasingly turning to private investors when they do.

As an example, in 2002, the aggregate amount of private equity invested in venture capital-backed startups raising later-stage capital was $14.2 billion. In 2019, it was $80 billion. In 2002, the median VC-backed startup was 3.83 years old at the time of its initial public offering. By 2019, it was 6.3 years old.

This shift in capital supply comes with trade-offs. In the United States, founders may pay more to access private capital markets – for both equity and debt – than public ones, which are broader and much more liquid. But public market access comes with an increased regulatory and reporting burden.

Meanwhile, even as an increased reliance on private markets may be advantageous for company founders, it makes it harder for early employees to convert company equity into cash and exit the firm if they wish.

From the perspective of investors, the shift may seem even bigger. It has shrunk the options for investors in public markets, which are far more accessible and transparent. Still, as institutional investors, including public pensions and higher education endowments, continue to allocate funds to private equity, investors may be more exposed to those companies than they realize.

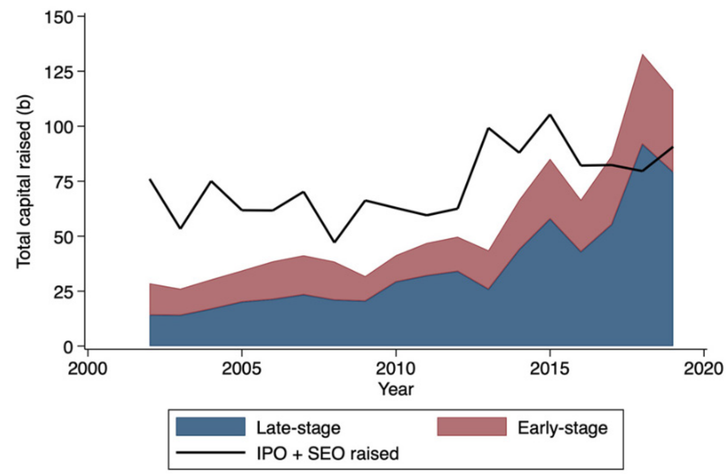
Research

Finally, private markets are not just less transparent and accessible than public ones; they're also more lightly regulated, requiring fewer disclosures, for example.

This evolution in the startup finance marketplace may suggest a need for more regulation of private markets, the research paper notes. But more important, it suggests that policymakers, regulators, and even some large investors should take into account the landscape as a whole, not just pieces of it.

It also raises questions for further research, including investigations into the nature of the types of companies founded and whether there are shared characteristics among those that stay private longer versus going public.

Late- and early-stage financing and public firm capital



Conclusion

The past two decades have seen major changes to the ways entrepreneurs access capital for their young companies. The paper provides an "intellectual framework to think through these changes," according to the authors, who add that "more research is needed to establish strong causal relationships between these shifts and the new equilibrium outcomes."

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