PUBLIC VS. PRIVATE CAPITAL

The roles of public and private equity in energy finance are complementary.

ARTICLE BY
JOHN J. MOON

ILLUSTRATION BY
VON GLITSCHKA

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4545 Post Oak Place
Suite 210
Houston, TX 77027
(713) 993-9320

Therein lies the paradox of public capital: it's most readily available when a company may not need it and least available when it does.

Many executives may dismiss private equity as simply "expensive" money while public equity is considered relatively "cheap." The logic seems obvious enough: private-equity returns have been higher than public-equity returns so, the former must be costlier.

The reality is more complex. One gets what one pays for: public equity is not as cheap as it may seem and private equity is not as costly. Only by appreciating the costs and benefits of each, can an executive make sound, value-maximizing decisions.

Public equity

Most executives recognize the direct expenses of raising public equity—underwriters, attorneys, etc.—are typically 3% to 5% of an offering, depending on size among other factors. Compliance and investor-relations presentations are additional ongoing—and with the introduction of Sarbanes-Oxley, growing—costs of being public.

However, as large as these direct costs are, an even larger cost often goes overlooked: the adverse stock-price reaction associated with a public offering. Studies find that stock prices fall on average -3% to -10% after an equity offering.

The most widely cited academic study was written by Paul Asquith and David Mullins from Harvard (at the time). They showed that the average stock-price reaction to equity offerings for unregulated companies was -3%. While this may not seem so bad at first blush, unlike other costs, this cost affects all shares of the company.

The loss of value from a public offering can dwarf any of the direct costs. In the Asquith and Mullins study, the typical primary offering represented 12.5% of the pre-money equity value of the company. The -3% decline in equity value represented 31% of the value of the equity offering itself. In other words, a $1-billion-market-cap company suffered more than $30 million of loss to raise $125 million.

In theory anyway, stock prices should not react negatively to equity offerings. In practice, public investors are skeptical providers of capital as studies demonstrate, and the more complex the business plan, the more difficult it becomes to raise public capital.

Investment bankers insist that the public markets are sometimes even "closed" to some companies. At these times, public equity is impossible to raise—at any price.

These issues are particularly pertinent to energy companies. Many energy executives believe that the highly cyclical energy industry presents its most profitable opportunities during industry downturns

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when project costs are lower and competition for opportunities are less intense because competitors—even public companies—find themselves capital constrained. However, these periods are precisely when the public markets are costly to tap or even closed.

Therein lies the paradox of public capital: it's most readily available when a company may not need it and least available when it does. It is "cheapest" when a company already enjoys a high cash flow, and it is expensive in downturns when investment may be highly attractive. In difficult times, public investors are not able to discern these opportunities and provide capital reluctantly, if at all. If financial flexibility is the key to capitalizing on opportunities in the long run, public capital may come up short.

Private equity

The manner in which the private-equity market operates represents a stark contrast. These differences can often make private equity a superior choice for many companies, even public companies.

Liquidity regardless of market conditions. Private-equity funds are typically limited partnerships whose investors have committed to fund upon some short notice period, irrespective of market conditions. Therefore, while the limited partners of a fund, typically pension funds, endowments, etc., hold a highly illiquid investment when they invest in private equity, their pooled (illiquid) commitments are precisely what provide the enhanced liquidity of private equity even through difficult industry and market conditions.

In fact, private-equity investors are often contrarian by strategy, investing more aggressively when public market appeal for an industry is low. As principals of Morgan Stanley Capital Partners, which was recently spun-off into an independent private-equity business called Metalmark Capital, our experience has been that providing liquidity to companies in out-of-favor industries has proven to be a particularly effective strategy.

An information-based model of investing. While public offerings are undertaken through an SEC registration process and marketed to the universe of potential investors, the private-equity process begins with targeting a small group of investors. This smaller group is afforded significantly more information than what is typically disclosed in an SEC filing, and these investors are selected for their expertise and ability to understand a company's operating plan and specific business issues.

Rather than analyzing and acting solely on a proscribed, one-size-fits-all set of public filings, private-equity investors interact deeply with the companies they evaluate. This process involves due diligence of a business, financial and legal nature.

For E&P companies with oil and gas reserves, it means an independent review of the engineering for those reserves. For other companies, it would typically include an inspection of the physical assets of the business.

While this process may seem burdensome, the rewards are clear. The investors are better informed, and therefore, more confident to commit capital—a well-informed investor is a willing investor. To the management team that can credibly communicate its vision, it can be the difference between a successful capital-raise, which enhances equity value for existing investors (and management), and a highly dilutive offering.

Private-equity investors are better able to recognize and reward management performance despite difficult industry conditions.

Greater incentives for management. The due diligence allows for a candid discussion about the business plan. As a key part of the investment process, incentive plans are structured or enhanced to provide significant sharing of the value created by the management team. Alignment of management and shareholder interests is fundamental to the private-equity investment philosophy.

These management plans offer significantly greater opportunity for wealth creation than in a public context. Certainly, the link between pay and performance is significantly greater. Studies show that CEOs of public companies have little at stake in the companies they lead.

The best known of the academic studies to examine management incentives is a Harvard study by Michael Jensen and Kevin Murphy that showed that the average public-company CEO earned $3.25 for every $1,000 of shareholder value created. CEOs of private-equity-backed companies would typically have gain-sharing arrangements that can offer 10 times that amount.

Furthermore, private-equity gain-sharing arrangements are considerably more flexible, and for example, can be structured to provide additional incentives for exceptional performance by a management team, or under certain circumstances, to deliver returns taxed as capital gains as opposed to income. These incentive plans are essential to facilitating frank and open discussion between management and investors and serve as the foundation for effective boards of directors.

Superior governance structure. Better-informed investors working with more highly motivated executives interact in a closer working relationship and more open discussion at the board level. Large public investors typically eschew board membership because being an insider restricts their ability to trade shares freely, and public investors put a high premium on the liquidity of their investment.

In contrast, private-equity investors actively seek out board representation. In monitoring investments, private-equity investors work with management teams to execute business plans for rapidly changing businesses, providing useful business contacts, ongoing advice, and of course, additional capital.

Interaction always extends beyond periodic board meetings to ad hoc conversations to discuss ideas and build upon the company's network of relationships and managerial capital. This dynamic is in stark contrast to the typical public company's board of directors. Public boards are usually not comprised of direct representatives (i.e., employees) of the key investors and are generally larger, and hence, at risk of being more bureaucratic.

David Yermack of New York University confirms an inverse correlation between firm value and board size, surprisingly even for boards that are small by public-company standards. He found that as much firm value is lost as a company's board grows from six to 12 members as a board that grows from 12 to 24 members. The median board was comprised of 12 members in his sample of public companies.

Interestingly, a board of 12 would be regarded as large for a private-equity-sponsored company. Leaner boards allow for less politics and more efficient decision-making.

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PIPES

Interestingly, the benefits of private equity are not limited to private companies. Indeed, private investments in public-equity securities (PIPES) represent an interesting phenomenon in the expensive private-equity-versus-cheap-public-equity debate.

Why do public companies with access to public equity take private equity? Interestingly, unlike public-equity offerings, stock-price reactions to PIPES transactions are on average positive and statistically significant for issuing companies. Studies have measured an average price response on the order of +10% to PIPES transactions. The favorable market reaction belies the belief that public capital is always cheap and private equity is simply expensive capital.

It is likely that the certification role of the private-equity investors—representing well-informed or so-called "smart" money—plays some role in the positive reaction. The improvement in corporate governance through board participation by a private-equity investor may also play a role in explaining the favorable stock-price reaction.

Complementary roles

What these facts highlight is a need for executives to shed preconceived and simplistic notions of public and private equity and reevaluate the proper roles of each. The importance of public capital, particularly for larger companies, should be duly recognized.

The Treasury Department estimated that private-equity investments totaled $400 billion at the end of 1999, which remains small relative to the $17 trillion of public-equity value that same year. Active and liquid public-equity markets are critical for capital formation and economic development.

Indeed, there is evidence to suggest that public capital markets support the development of the private-equity markets, rather than replace them. Cross-country comparisons show that countries with well-developed public markets also have the most dynamic private-equity markets, suggesting the two pools of capital are complementary.

Bernard Black of Columbia Law School and Ronald Gilson of Stanford Law School have posited that public markets support venture capital by serving as a means of exit for these investors. For some businesses, complex business plans may develop into transparent companies ready for the public markets.

For companies with a well-understood and credible plan, public equity will serve as the lowest-cost and largest pool of equity capital. The master limited partnership market in the United States and the income trust market in Canada are good examples of this low-cost capital at work for energy companies with transparent business plans, both midstream and even upstream.

For those businesses, the public markets represent a logical alternative, but most energy companies do not start off ready for the public markets. Some companies, by virtue of their very complex or niche strategies, may never be suitable for public status. As discussed, even companies that have already gone public may benefit from private equity as an attractive capital source.

When public markets are as vibrant as they are today, it is easy to overlook private equity as an alternative. The public markets may be directly accessible for some, and the publicly traded companies are very willing to commit capital in creative partnerships.

However, history has shown that conditions change, often rapidly. Maintaining private-equity relationships today may be the key to securing the financial flexibility and the resources necessary to capitalize on opportunities tomorrow and secure long-term success. □

John J. Moon, Ph.D., is a founding partner and managing director of Metalmark Capital LLC, an independent private-equity firm established by principals of Morgan Stanley Capital Partners to manage the existing Morgan Stanley Capital Partners' funds, comprising more than $3 billion of private-equity capital, and to make private-equity investments in a broad range of industries including energy. Moon is also an adjunct professor of finance at the Columbia Business School.