Equity Investment

Another theory is that the investment industry plays a critical role in the economy, as the conduit through which money moves from savers to businesses. Financial reporting is important information for investors. See Box 3.1.

Box 3.1 US, UK and Major European stock exchanges

US	**UK**	**Europe**
New York Stock Exchange NASDAQ	London Stock Exchange AIM AIM (Alternative Investment Market) a sub-market of the London Stock Exchange	Euronext NV[1] Deutsche Börse SIX Swiss Exchange Nasdaq Nordic BME Spanish Exchanges

We feel that one of the most useful purpose for the investment industry is in supporting long-term investment and productivity requires effective dialogue between investors and companies. This refers to what John Kay identified as the primary function of finance intermediaries (such as asset managers) now that the provision of new capital is no longer is important. The primary function is to monitor the managers of companies to ensure that they are efficient and not self-serving.

The Economist commented[2]:

> Since a peak in 1996 the number of publicly traded companies in America has fallen by nearly half. The experience of Uber and Lyft, a smaller competitor whose share price has fallen by even more since it floated in March [2019], will have done nothing to make IPOs[3] more appealing.

It may be that the Chinese stock exchanges will become more important in the future. The Shanghai and Hong Kong stock markets are well established, However, the newer STAR market (tech focused and competitor to and modelled on NASDAQ) will benefit from China-US tensions.

[1] Merging Paris Bourse with Amsterdam, Lisbon and Brussels exchanges in September 2000.
[2] NOIPO? Uber's listing and a new stock exchange may herald change, The Economist, 19 May 2019.
Available at:
https://www.economist.com/finance-and-economics/2019/05/16/ubers-listing-and-a-new-stock-exchange-may-herald-change
Accessed June 2019.
[3] Initial Public Offerings. A company is offering its shares for sale to the public for the first time.

IPOs

IPOs are all about making the founders of a firm rich and not so much about financing industry. The Economist claims that[4]:

> The nadir in America was the dotcom boom in 1999-2000, when deliberately under-priced IPOs rocketed on their first day of trading, bankers doled out "hot" ipos to executives in exchange for underwriting business, and new shares were "spun" and "flipped" for profit. This year the ipo process is under fire again. WeWork, an office-rental firm, cancelled a listing that bankers once valued as high as $104bn. Now SoftBank, its main backer, will throw it a $9.5bn lifeline that values the firm's equity at a puny $8bn. Shares of Uber and Lyft, two ride-hailing companies, have slumped since their ipos, a sure sign of overpricing. Meanwhile Beyond Meat, a trendy vegan foodmaker, soared by 163% on day one, suggesting the reverse.
>
> In Silicon Valley venture capitalists are livid—even though they are as much to blame for mispricing the unicorns as Wall Street. But investment banks like Goldman and Morgan Stanley are contrite and asking themselves whether the traditional ipo, however lucrative for them, remains the best means to bring tech firms to market. This is healthy. Scrutiny of ipos is long overdue. To critics, they are a classic case of cronyism. Even fans, such as Ann Sherman of DePaul University in Chicago, call them "legalised bribery". The challenge, though, is to find anything better.

The traditional techniques in the US are to build the book. A roadshow to catch the attention of investors and elicit orders from them.

> For the underwriter, the trick is to find an IPO price that satisfies the company but also stimulates buying—providing a "pop" on the first day of trading. The trouble with the "pop", though, is that it represents money left on the table that should by rights belong to the company's sellers, not its buyers[5].

The other methods are auctioning shares to the highest bidders, as Google did in 2004, or selling shares directly without underwriters, a route taken recently by Spotify and Slack. Auctioning has not proved to be popular anywhere in the world – usually met with some sort of failure. Airbnb is considering a direct listing in 2020.

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[4] Economist, IPOs are a racket. But try finding something better, *Economist*, 24 October 2019. Available at: https://www.economist.com/business/2019/10/24/ipos-are-a-racket-but-try-finding-something-better Accessed October 2019.

[5] Ibid

The problem is that valuing companies will always be problematic. The underwriting method, still the most common route. Some IPOS will be undervalued such as Royal Mail on its IPO in 2013. (But has since performed poorly as letter volumes have declined as electronic mail usurped post). Recent unicorns such as Uber have been over-valued at IPO and have performed badly since s profits continue to evaporate. We Work withdrew its share offering when at one point it valued the IPO at $47 billion[6]. Though at one point the eccentric cofounder, Adam Neumann talked about a company worth $100 billion or more. As the Business Insider put it[7]:

> With its stratospheric $47 billion valuation and preposterously ambitious cofounder and CEO, Adam Neumann — his goal wasn't merely to make money or rent office space, he claimed, but to "change the world" — WeWork had become a glaring symbol of Silicon Valley's boundless audacity and self-professed exemption from the laws of economics.
>
> In the early-morning light, thousands of investors and journalists would get their first real peek at the company's financial condition and be able to judge for themselves whether WeWork was really, as its founder claimed, on a path toward galactic dominance and unimaginable profit.
>
> Almost immediately, all hell broke loose. A steady stream of rapid-fire headlines detailed Neumann's self-dealing, mismanagement, and bizarre behavior. Within 33 days the offering was scuttled, WeWork's valuation plummeted 70% or more, and Neumann, who believed he would become the world's first trillionaire, was ousted as CEO. What was supposed to be Neumann's coronation as a visionary became one of the most catastrophically bungled attempted debuts in business history.

In our earlier book, *Financial Failures & Scandals: From Enron to Carillion*[8], we examined the case of Theranos where the charismatic CEO manged to defraud he government and other institutions. So investors, reporters, and analysts, drew upon which was the experience of Theranos revealed as a massive fraud and watching Uber fail to live up to expectations, did not want to let another visionary founder 'pull the wool over their eyes'.

As the Economist put it: "However much anyone re-engineers the process, valuing companies will always be a shot in the dark". Value is something inherent in financial reporting and as intangibles grow in company balance sheets, their value will always be a shot in the dark. We examine the possibility of reducing that often extreme uncertainty.

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[6] Campbell, D., How WeWork spiraled from a $47 billion valuation to talk of bankruptcy in just 6 weeks, *Business Insider*, 28 September 2019.
Available at:
https://www.businessinsider.com/weworks-nightmare-ipo?r=US&IR=T
Accessed October 2019.
[7] Ibid.
[8] Bhaskar, K., and Flower, J. , *Financial Failures & Scandals: From Enron to Carillion*, Routledge, 2019.

PIE's and the top 1,000 listed companies

The Big Four accounting/auditing firms PwC, EY, Deloitte and KPMG who have now branched out into consultancy but still have a stranglehold over the external audits of the FTSE 350[9] the UK's largest 350 companies by market capitalisation. Public interest entities (PIEs) include most of the FTSE 350 and some private and other companies. The definition of what is or is not a PIE is complex but usually all large listed companies are (see Deloitte's guide)[10]. PwC do have a list of companies that were classified as PIEs[11] - though out of date as companies move in and out of the top listed companies quite quickly. The external audit is supposed to be the final check and balance on financial reporting.

PIEs are subject to greater reporting requirements and auditing procedures and control - enshrined within the now UK's but formerly the EU's Audit Reform Regulations (ARD). The relevant watchdog both for reporting requirements and for auditing, is the FRC/ARGA, the new widened and expanded audit regulator. Though, as already explained in Chapter 1, politics may intervene and a low regulated Brexit may see the part of the original Kingman concept of ARGA rolled back.

PIEs are mostly the listed companies banking and credit institutions also most financials services companies plus insurance firms. The biggest element of which are the listed companies. We have referred to the top FTSE 350 companies. Who are these and what are the companies. In Appendix 3.03.2 we show all the 350 FTSE companies and most of the listed companies.

There are a list of all the FTSE 350, most of the AIM, most of the smaller companies listed on the FTSE and some other companies which are important to the UK for example the Bank of Santander.

In Appendix 3.03.2 you will find a list of up to 1,300 companies (though this is as it was in 2018 and many changes have occurred). The information includes:

- The EPIC code
- The name of the company or group
- Which index it is (e.g. FTSE 250 (the next biggest 250 companies after the FTSE 100)
- Whether it has an integrated report as defined by the <IR>,

[9] The top 350 companies listed on the FTSE, the Financial Times Stock Exchange 350 index – that is the top 350 companies by market capitalisation. Most of these are classified by as Public Interest Entities which means they have the highest level of reporting and external audit requirements. The FTSE 100 is the top 100 listed companies. The FTSE 250 is the 101st to the 350th top listed company.

[10] Deloitte, 2015, 'Public interest entity: Definition and scope', *Deloitte*, November 2015. Available at: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Audit/gx-audit-public-Interest-entity.pdf Accessed July 2018.

[11] PwC, 2014, 'List of public interest entities', *PwC* June 2014. Available at: https://www.pwc.co.uk/assets/pdf/public-interest-entities-fy14.pdf Accessed July 2018.

- Whether it is a UK concern or joint with another country or whether it is in another country and just listed in the London
- The primary industry
- The share price as of March 2018
- The market capitalisation.as of March 2018

FTSE 100 analysis (as at March 2018)

These were the top 100 companies by market capitalisation listed on the London Stock Exchange (LSE). Current 100 is also shown in a separate tab on the Excel sheet.. The criteria are based on market capitalisation. At the moment the criteria for inclusion is around the £5 billion mark but it is the top 100 that determines the cut-off point. You might want to add the top AIM Company, ASOS, which is fast growing online fashion retailer with a current market capitalisation of over £6 billion and will at some point switch from AIM to London Stock Exchange.

Of course there will be some takeovers, such as Melrose on GKN and this reduces the number of companies. In general about 5 to 10 companies drop out and the same number drop in the FTSE 100. This movement has accelerated in recent years. Recently joined are Auto Trader, Aveva, HIKMA (about to be demoted), JD Sports, Meggitt, Melrose, Ocado, Phoenix, Polymetal, Rightmove, and Spirax-Sarco. Those that have left the Appendix list includes Direct Line, DS Smith, Fresnillo, GKN (taken over by Melrose), Marks & Spencer, Mediclinic, Micor Focus, Old Mutual, Royal Mail, Shire (taken over by Takeda) and Sky.

Of these only around 80 are proper UK-based companies. That includes Unsilver which is moving to Rotterdam in the Netherlands,, and Melrose Industries (which we feel might move to or be based more in Switzerland). There are also several companies which should probably be classified as overseas – examples are Rio Tinto (Australia), AstraZenica (Sweden), Carnival (US), and others.

Long-Term thinking
So the main conventional stock exchanges see to concentrate on short-termism. Thus recent failures could give a boost to fresh thinking on how fast-growing start-ups should go public:

> The Long-Term Stock Exchange (LTSE) is based in San Francisco and backed by Silicon Valley luminaries including Marc Andreessen, Reid Hoffman and Peter Thiel. They are animated by the weaknesses of conventional exchanges when it comes to startups. Things such as quarterly results, short-sellers and high-frequency trading distract from building businesses for the long term, says Eric Ries, the LTSE's boss and the author of "The Lean Startup".
> ….
> The LTSE wants to give entrepreneurs stability and smaller investors more of the upside. It aims for listing requirements that will encourage long-term thinking. One idea is to give longer-term share- holders more voting power. Instead of charging for transactions or data, as most stock exchanges do (though some offer re-bates), it will charge for add-ons that appeal to startups, says Mr Ries, such as soft-ware enabling them to track which shareholders are "tourists" moving in and out and which are "citizens of the republic"[12].

[12] Op. Cit. *The Economist* 16 May 2019

Types of shareholders
Of course, the shareholders have become entrenched in different types with very different goals and objectives. Unfortunate, we believe, the majority focus is on the short-run and not long-term. The Japanese, China and other Asian countries have traditionally been far more concerned with long term than the west. So we have provided a very rough categorisation of shareholders and their power groups for the UK/US and some of Europe:

a) Small-private shareholder – mixed goals but usually not short-term.
b) Institutional shareholder and pension funds – can be long term but with a short-term constraint.
c) Distress purchase and recovery shareholders – buying companies to recover and grow or break-up and sell – short to medium term
d) Hedge funds[13] and other similar shareholders who want short-term gains.
e) Vulture funds[14] – short term
f) Algorithmic and gaming shareholders including some of the private dark pool owners- inevitably extremely short-term (seconds, minutes, hours and a day can be a long time).
g) Individuals and firms betting on options etc – usually short-term (one month or so).
h) Proxy firms/advisers[15] command much clout but rarely owns shares but advise the larger institutional shareholders.
i) Private equity – the role of which is discussed below.

The goals and objectives of these groups can be and are very different.

[13] Defined as an (often) offshore investment fund that engages in speculation using credit or borrowed capital.
[14] A vulture fund invests in shares considered to be very weak. The fund profits by buying shares or debt at a discounted price often on a secondary market and then using numerous methods to gain a larger amount than the purchasing price.
[15] A proxy firm (also a proxy advisor, proxy adviser, proxy voting agency, vote service provider or shareholder voting research provider) provides advice and services to shareholders (in most cases an institutional investor of some type) and sometimes also vote their shares at shareholder meetings of quoted companies.

Private Equity – bad for the economy?
Private equity is not always good and some consider to be mainly bad for the companies taken over – especially the impact of high gearing when boom times end. Oliver Shah commented in the Sunday Times on Debenhams'[16]:

> CVC, Merrill Lynch and TPG — working with the veteran dealmakers John Lovering and Rob Templeman — gave Debenhams the full boom-era treatment. They cut investment, got cashflow gushing by discounting and sold and leased back stores.
> It produced amazing short-term results — the trio made back more than three times their initial £600m outlay in three years — but it loaded Debenhams with heavy debts and an unwieldy property portfolio.

Similarly, the FT commented[17] of the fashion icon J Crew, that the litany of retailers bought and wrecked by private equity owners has gained a new name. J Crew. The holes in its balance sheet proved too big to mend a heavy debt load induced by a private equity take-over scuppered the business. This crippling debt load was a legacy in part of a 2010 $3bn leveraged buyout by TPG Capital and Leonard Green & Partners, J Crew was struggling long before the coronavirus outbreak forced the closure of its near-500 stores. In the US, Fairway, Toys R Us, Gymboree, and Payless ShoeSource and Neiman Marcus are among the many other private equity-backed retailers that have filed for bankruptcy in recent years.

The Sunday Times columnist and retailer Peter Williams agrees as to the negative effect of the growing private equity sector on the UK economy. He puts this elegantly as[18]

> The structural make-up of the entire private equity industry is geared to making a quick buck. Get in cheap and get out fast, for the maximum price.
> Private equity firms raise cash from wealthy individuals, family offices and pension managers to put into funds that have a fixed lifespan — often 10 years. The private equity firms charge investors a fee to run the funds and then take a share of the profits, usually 20%.
> It is reasonably undisputed that the root causes of many of our challenges stem in some way from low productivity. As Germany has productivity rates close to the highest in the world, there has to be some merit in looking at its ownership structures and time horizons for investing for clues as to where they are going right — and where we have been going wrong.
> Few believe that a highly flexible workforce and a short investment time horizon — three to five years, say — will generate soaring levels of productivity. The long-term,

[16] Shah, O., Private equity's part in Debenhams' downfall, **The Sunday Times**, 31 March 2019.
Available at:
https://www.thetimes.co.uk/article/private-equitys-part-in-debenhams-downfall-z2w6fnrk5
Accessed June 2019
[17] Lex, J Crew: abandon ship, Financial Times, 4 May 2020.
Available at:
https://twitter.com/FTLex/status/1257358001750622208
Accessed May 2020.
[18] Williams, P., Private equity's quick-buck ways are hollowing out our companies, *The Sunday Times*, 9 June 2019. Note: Peter Williams is the founder of clothing and lifestyle brand Jack Wills
Available at:
https://www.thetimes.co.uk/article/private-equitys-quick-buck-ways-are-hollowing-out-our-companies-6kkplxjgh
Accessed June 2019

> often multigenerational, family ownership structures of many of Germany's companies mean they invest for decades rather than the "hold" period more typical of private equity. Quite simply, if you intend to own a company for only three years, it is irrational to make big capital investments to deliver increases in labour productivity that won't be felt for perhaps a decade or more.

In essence, short-termism has led to cost cutting and prevented productivity growth through the lack of investment (and innovation). Not so good for the UK economy.

The Economist[19] claims that:

> Worldwide, pools of private capital, including private equity and private debt, as well as unlisted real-estate and hedge-fund assets, grew by 44% in the five years to the end of 2019, according to JPMorgan Chase. A different way to capture the scale of the private party is to look at the quartet of Wall Street firms that specialise in managing private investments for clients—Apollo, Blackstone, Carlyle and KKR. Their total managed assets have risen by 76% in the past five years, to $1.3trn. They have long specialised in buy-outs and property. More recently they have grown in private-debt markets, too—in total their funds' credit holdings have hit $470bn.

The reason

> The flood of capital into private markets ultimately rests on the belief that they will outperform public ones. There is evidence for this—in the past the best-run private-capital managers have beaten the returns from public markets, even after generous fees. And there are grounds to believe that this was no statistical fluke. Private capital, say its boosters, reduces "agency costs". These arise wherever somebody (the principal) delegates a task to somebody else (the agent) and their interests conflict. Consider the public markets—no one has a big enough stake to make it worthwhile to monitor firms, which as a result get complacent or indulge in short-term earnings management to the detriment of the long term. Private capital, which is closely held in a few hands, is supposed to get around such agency problems.
>
> Yet every investment craze is liable to overreach, blindness to risk and misallocated capital. Recent converts to the private world, dazzled by the historical returns, may not fully appreciate the hazards. The capital washing into San Francisco's venture-capital industry has bloated both the value of pre-IPO companies and the egos of founder-managers. The big concern is that a shift from public to private capital merely swaps one set of agency conflicts (shareholders v company managers) for another (shareholders v private-asset managers).

Guy Hands, the buyout pioneer argued in an opinion piece in the FT that private equity has become too focused on money and its culture is no longer fit for purpose[20].

D Private equity and a circle of money benefitting private equity

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20 Wiggins, K., and Smith, R., Private equity became too focused on money, says Guy Hands, *Financial Times*, 5 February 2020.
Available at:
https://www.ft.com/content/f6c59ffe-482a-11ea-aeb3-955839e06441
Accessed February 2020.

An example of this is an old case involving the purchase of Comet, an electrical retailer, going back to 2011 when a group of private investors structured a deal to buy Comet – which was in dire state. Private equity bought the company through an off-shore company vehicle set up for this purpose. This company then borrows money and re-lends that money to Comet at high interest rates in return for preferential charge of all Comet's assets meaning it ranked above all other creditors in the vent of insolvency. Comet then went bust less than a year later – one theory is that was always the intention of the private equity companies. The price paid to acquire Comet was £2. The cots to the UK taxpayer for Comet's collapse was £50m. The private equity companies made at least £100m without putting a pound of their own money at risk[21]:

> The only sanction was levied this month: a fine of £1m for Comet's administrators, Deloitte, which had earned £15m in fees for work unwinding the company but was found to have failed in a duty to be independent and objective because of its close relationship with the retailer's acquirers.
> "The demise of Comet is a tale of how cynical corporate greed was aided and abetted by some of the UK's leading professional services firms," said one person involved in the inquiry by the ICAEW, which levied the fine. "The private equity firms stitched up a structure that guaranteed a huge profit from insolvency, which went unchallenged by the administrators."

Of course not all private equity deals are devised in the same vain. Some are more beneficial to the company being taken over than other private equity deals.

[21] Kinder, T., Hailey's Comet: how Deloitte helped funds win a distressed bet, Financial Times, 13 February 2020.
Available at:
https://www.ft.com/content/329317ae-48cc-11ea-aeb3-955839e06441
Accessed February 2020.

Growth of private equity

The issue is that private equity is growing and investment in publicly listed markets are being switched to private markets which have now grown into vast empires[22]:

> This passive boom has spawned its antithesis—niche, run by humans, secretive, thinly traded and high-fee. Institutional investors are rushing headlong into private markets, especially into venture capital, private equity and private debt. The signs are everywhere. A large and growing share of assets allocated by big pension funds, endowments and sovereign-wealth funds is going into private markets—for a panel of ten of the world's largest funds examined by The Economist, the median share has reached 23% (see chart 1).
>
> Worldwide, pools of private capital, including private equity and private debt, as well as unlisted real-estate and hedge-fund assets, grew by 44% in the five years to the end of 2019, according to JPMorgan Chase. A different way to capture the scale of the private party is to look at the quartet of Wall Street firms that specialise in managing private investments for clients—Apollo, Blackstone, Carlyle and KKR. Their total managed assets have risen by 76% in the past five years, to $1.3trn. They have long specialised in buy-outs and property. More recently they have grown in private-debt markets, too—in total their funds' credit holdings have hit $470bn.

The move of capital into private markets probably rests on the belief that they will outperform public ones. In the past the best-run private-capital managers have beaten the returns from public markets, even allowing for generous fees. In public markets, no one has a big enough stake to make it worthwhile to monitor firms, which as a result get complacent or indulge in short-term earnings management to the detriment of the long term. Private capital, which is closely held in a few hands, is supposed to get around such problems.

The growth in passive investing has made public markets less attractive:

1. Midsized companies are not big or liquid enough to be in baskets of leading stocks, such as the S&P 500 or the FTSE 100, that are tracked by giant low-cost index funds.
2. Regulation based on legislation from the mid-1990s made it easier to set up large pools of private capital in America and more recently in the UK with increasing regulations such as the ARD and increased nervousness of shareholders in the major markets. The costs of being a public company have grown. After the financial crisis of 2007-09 new rules made it costlier for banks to lend.
3. The large fund managers such as life-insurance funds, university endowments and sovereign-wealth funds have obligations far into the future, they can take a long-term view. They can sacrifice the liquidity of public markets for the better returns promised in private markets—where data are hard to come by; where assets are complex and value is hard to appraise; and where finding the right opportunities takes patience.
4. Private-equity funds can pile on more leverage in order to boost returns. Some pension schemes and insurers are forced to sell public shares at the wrong time, when

[22] Finance and Economic, Privacy and its limits: Everyone now believes that private markets are better than public ones, *The Economist*, 30 January 2020.
Available at:
https://www.economist.com/finance-and-economics/2020/01/30/everyone-now-believes-that-private-markets-are-better-than-public-ones
Accessed February 2020.

markets tank, either to comply with solvency rules or because trustees panic. That is not possible when your money is locked up in private funds with lifespans of a decade.

5. Proxy advisers, shorter and companies such as Muddy Waters LLC can be irksome for listed companies. Private companies avoid such scrutiny.

The private-investment boom shows little sign of stopping. Low interest rates mean that a global hunt is on for higher returns.

Now whatever one thinks of the stock exchanges, and private equity firms and the financing/investment industry, their original role has changed. They do help people who have money increase their wealth. However, they are also a conduit for a large number of pensions used by companies, organisations, government, unions, universities, and other governmental or non-governmental organisations.

Impact of black swan events

The impact of GFC led to greater regulation and major changes to reporting and the final seal of approval – the audit. The 2020 pandemic will lead to even more profound changes. Changes to auditing are already in progress in the UK. As the UK makes its way pro-Brexit, it is difficult to see what type of regulatory framework will be unleashed in the future. The only definite it that change will occur whatever the events or proposed policies. Large-scale borrowing by the UK and other governments is also bound to have an impact on financial markets.