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The Blurred Lines of Public and Private Equity

Disruptive Forces in Investing **November 2, 2021**

Anu Rajakumar: Global capital markets are always evolving, and today both public and private markets play a vital role in our economy. In recent years it's been said that the line between public and private markets are beginning to blur. Between traditional IPOs, SPACs and direct listings, there's more than one way for a private company to exit. Today we'll look at the pre-IPO market which is generally defined as a private fundraising round of $100 million or more. As an example, the high-profile SpaceX raise more than one billion dollars in the first half of 2021 alone[1] and has left its investors hanging on edge for a possible IPO. But what might the benefits be of staying private for longer and what's involved behind the scenes of investing in a company ahead of a potential public offering? My name is Anu Rajakumar and today I'm joined by Marc Regenbaum, portfolio manager of long-short and US equity strategies and Gabe Cahill, portfolio manager for pre-IPO strategies, to provide their views on how these creative investment strategies in the grey area of investing can operate. Gentlemen, thank you very much for joining me today.

Marc Regenbaum: Great be here.

Gabe Cahill: Thanks for having us.

Anu Rajakumar: So to start us off I think it'll be helpful to share an overview of the ways that late-stage private companies can go public today. What are the main paths for getting to an IPO and what are the characteristics of each of those methods that investors might want to keep in mind?

Marc Regenbaum: Great. I'll kick it off, Anu. First I think this is a really exciting and dynamic market opportunity, and it really starts with the fact that many companies are remaining private for longer. Just if you look over the last decade alone, there has been a nearly three-fold increase of the average age of a company upon IPO. But at the same time these companies are still seeking growth capital and more long-term holders ahead of an IPO. They want shareholders that can partner with management teams to best position themselves in the eyes of public shareholders. So if you look at 2020 alone, nearly three quarters of companies that filed for an IPO had previously raised a cross-over fundraising round. And this overall activity has really accelerated in recent years. In fact, by 2020 the number of deals had a total value of approximately $60 billion, which was more than a six-times increase of number of deals and a 30-fold increase in the total deal value versus the prior decade.

Gabe Cahill: Yes. And to add to that I think that, you know, strategically it's important for those management teams – as they approach an IPO, they're, to Marc's point, looking for those partners that will be with them for the subsequent decade. And as their VCs in growth equity funds solely look to move on or their funds start to mature, it's that next set of public investors as their partners into the distant future. And there's be a number of interesting developments on the IPO side just in terms of the methods that they go public. Whether it's a traditional IPO that we're all accustomed to, but SPACs really certainly hit the scene over the course over the last 18 months. Um, direct listings have evolved over time in a manner that's much more company friendly for the right companies, and we've also seen some other hybrid versions of both. But when you think about the traditional IPO, it's really well suited for a lot of companies that are able to achieve what they need to go public, whether it's a good amount of scale, the right trajectory of growth or be able to captivate the attention of institutional investors that would like to participate in that transaction. The SPAC has certainly provided an alternative means to go public.

It often times provides more capital to businesses that have hi-, traditional IPO, um, involves a sponsor that can provide a layer of expertise, and then also helps transition the company into the public markets, albeit a slightly different route. Um, and a direct listing is reserved for essentially the select few. Those that have grown their business to such a place where, you know, it is essentially a name-brand name, it has notoriety, it has the public's attention and the attention of institutional investors such that there isn't a formal offering per se. They just list directly, and it creates a little bit more of a democratic

[1] https://www.reuters.com/technology/spacex-raises-116-bln-equity-financing-2021-04-14/

version of an IPO such that, uh, really anybody can participate in that transaction. There isn't really an allocation procedure which, for some companies, is a really unique and interesting opportunity, to choose.

Anu Rajakumar: I think Warby Parker did direct listing pretty recently. That was one of the most notorious ones I've seen anyway.

Marc Regenbaum: Exactly. I'd echo Gabe's sentiments, which is I think you can almost summarize all of it with regard to IPO paths is that not one size fits all. Right? Different companies will be looking for different partners, different solutions, serving different stakeholders. So it each has its advantages and disadvantages, but again it's incumbent upon the company itself to work through the various options to see their ultimate path and optimal path going forward.

Anu Rajakumar: Yeah. You know, on that point – not one size fits all, let's transition to your role as portfolio managers. How do you both go about identifying private companies that you think might be planning to go public in the intermediate future? And are there sectors that you find particularly attractive right now in the space? Uh, maybe, Gabe, starting with you.

Gabe Cahill: Sure. So we have the pleasure and the benefit of meeting a lot of different companies in a lot of different spaces with a lot of very unique business models and technologies. What we generally tend to look for are companies that are benefitting from a secular theme, oftentimes have a disruptive technology that is helping drive that secular change. And that secular theme, is something that we can generally underwrite as is the company's, ability to not only continue to generate revenues but grow those revenues well into the distant future. Those companies are the ones that we find most interesting, at least from an investment perspective and often look to partner. And when we do partner, it's a phenomenal opportunity to try to help that management team business., the resources of a firm like ours, extend into many different aspects of many different, sectors, industries, verticals, et cetera, or even in financing. And so we try to bring the firm in a holistic approach to the partnership, uh, and specifically with those companies and sectors that are resonating, at least a-according to our investment thesis, which – oftentimes when people think of technology, you know, you gotta think of your software names, your different hardware names. You can move into different subtypes, software as a service, but that also permeates other areas. Cloud storage has really dramatically improved the ability for companies to scale in a way that they haven't been able to do before, and that's led us to a number of – I'd almost call them tech-infused genomics companies that are one the cutting edge of personalized medicine. So it really varies, but those are some of the key themes that often resonate with us.

Anu Rajakumar: And maybe, Gabe, just follow-up question there – at what stage of maturity do you typically begin a dialogue with a company? What sort of series are they in their maturity? Or if you can quantify w-when you might begin a relationship?

Gabe Cahill: Sure. When we begin a relationship is completely independent to when we might invest. So we might be helping a company from, uh, a relatively early stage. And they know it's too early for us to invest, but we stay engaged with the company, the business and management team and oftentimes with the board to help them along the way whenever we can be helpful. When they do get to that scale, when they're generating revenues north of – generally speaking, 50 million. You know, there're exceptions where they might be a little bit lower and certainly there are exceptions where we're north of 200 million. Um, we're – uh, at that particular point in time, that's where the fund would look to get engaged and ultimately make an investment and grow the partnership into a financial relationship as well.

Anu Rajakumar: And, Marc, same question to you.

Marc Regenbaum: Yeah. I think this is called Disruptive Forces in Investing, and I think it's fair to say we love to invest in disruptive companies that have competitive edges. And these are some of the most exciting companies out there. They are changing the game in various industries, some are consumer-facing, some are business-oriented, many, like Gabe said, have technological leads or brands that resonate with the consumer, scalable platforms and just nimble business models for changing economic backdrops. For us though, it is more about the companies than the sectors themselves. So common attributes, when you drill down, may include the secular growth dynamics. We love market share gainers and of course terrific management teams that know how to allocate capital appropriately to make sure that they are really sustaining that business moat over time and having sustainable cash-flows. So it's a really exciting time. When think about it all, if you boiled it down from a company perspective, we love to call them "beyond privileged and resilient" because they characterize many of, those elements that we just described before.

Anu Rajakumar: Great, thanks so much for that. I'd love to hear a little bit more about how you typically engage with a company, what that relationship looks like and any anecdotes that you could share. Maybe, Marc, starting with you.

Marc Regenbaum: Yeah, when you think about this, there's a very large difference between being just a capital provider and a partner. There's no shortage of capital out there for companies, but what we would debate is the value add that comes along with that particular investment. And so what I think you're hearing myself and Gabe discuss is that we have this buy-to-own mindset. It's an ability to tap into robust global resources of our firm – when we talk about crossover investing – that can really help our companies with elements such as data science, ESG capabilities and a broader network of industry relationships. Management teams want to embrace those investors that can provide the tangible credibility; and being viewed favorably by the market as a future public company. So, again, on the value-add side, we love to help a company during its journey to the public markets. We love talking about what we call our four key pillars – those four key pillars revolve around making great companies, great stocks, and they really focus in on financial communication, capital allocation, corporate governance and helping the company manage their overall incentive scheme for their employees. We've done this with a bunch of our different investments to date. This includes helping with C Suite relationships in some of our business services companies. It's been helping to craft public market narratives with some of our consumer-facing investments and even engaging on capital structure ESG topics across the entire platform.

Anu Rajakumar: Terrific. Gabe, any examples you can share?

Gabe Cahill: Sure. I mean it's very common for us to meet and engage with companies as I, as I referenced earlier, independent of a financing round, um, really to get to know them, understand their business. Uh, it's very common for us to go out and visit a company's headquarters and spend a good amount of time with them. When they're private, when there isn't an opportunity to necessarily get involved as an investor in the business, but it helps us build that rapport, help open doors – and, I'll get into that in a little bit – and hopefully be there at the right time when they do, uh, and ultimately look for a financial investor. So, you know, one comes to mind right off the bat. It's a company we had known for, goodness gracious, uh, 18 months before their first ever private round.

We had been out to visit their facilities in Arizona, we had met with the founder on multiple occasions, we had met with the chief scientific officer on multiple occasions to not only understand the business but understand how it was gonna grow, understand how we could be helpful, et cetera. When it came time for them to raise their first round, we were their first call. They wanted to understand how a public market thought about that private round, uh, in relation to the IPO, uh, the valuations, uh, for each and what that progression would look like, as well as what they needed to accomplish with the capital they were about to raise to best position their IPO.

We ultimately did make that investment in the middle of the pandemic. So we were in a position to be supportive where it was very difficult for others to be supportive. Uh, it was great to be there for them then, um, because it certainly helped pay dividends. It's enabled them to finish some of the facilities that we believe will bring one of the most exciting, um, advancements in personalized medicine to market early next year.

But it continued to progress: the company's fundamentals continued to improve and, you know, we utilized some of the resources of the firm. Like, we could work with our healthcare team in Research, for example, to introduce them to some large publicly- traded prospective clients that were difficult for them to get into. And, you know, it's part of a partnership. It's-it goes beyond, just the financial relationship. But, you know, when the question came up, SPAC versus IPO, we were one of their first calls.

When they wanted to evaluate the direct listing versus the IPO, they wanted that third-party, public market investor sounding board to help provide some perspective at least in terms of how institutional public market investors would view those decisions, um, as they go. And so we're pretty excited. We do expect an IPO from this company early next year, and we're excited to continue to partner with them for an extended period of time.

Anu Rajakumar: Terrific. OK. Well, that's very helpful. Appreciate both of your perspectives there. Um, you know, most strategic asset allocations certainly for institutional investors typically have a clear division between the public market allocations and private market allocations. And of course these strategies that we're speaking about were blurring the lines between public and private. So how should end investors really be thinking about, where pre-IPO strategies fit into their asset allocation models, given some of the risk and return characteristics?

Gabe Cahill: Yeah. I think you-you kind of addressed it, in an interesting fashion. I think the crossover space is a space that continues to develop and expands between private and public or two separate boxes that most allocators have, or different investment teams focused on each box. [Laughing] And often many investment teams in, within each box focusing on different asset classes within those boxes, if I don't have everybody confused yet–

Anu Rajakumar: I think I need to draw a Venn diagram first. [Laughing]

Gabe Cahill: [Laughing] But really the-the way to think about it – uh, I'd say private equity investors are one category where this certainly fits. As they think about a private investment, the liquidity profile when it's private and ultimately the transition to the IPO. Public market investors also, um, have interest in this given how quickly the company goes from private to public in a crossover round.

And then there's the opportunistic bucket that allocators have which is structured and set up just for something that doesn't fit into a box at a particular allocator. But most private equity teams find the strategy to be really interesting, um, simply because they're used to, like, a 10-year fund life with a typical private equity fund or sometimes 15 years of venture capital, where in crossover equity the fund life is anywhere from five to seven, so it's roughly half the time. And that creates the ability to get their capital back and/or redeploy it, it provides much more flexibility, but it also provides somewhat of a margin of safety given how quickly the companies ultimately do become liquid and the stage at which we're making those investments. You know, most venture capital funds are dominated by just a few investments. From those later stage crossover investments, most of those are ultimately going to go public and the returns generated by those funds are made up of most of the investments the fund ultimately makes. So the risk is much more diversified and something that they often find to be, uh, quite unique and differentiated both in terms of the duration of the fund, the lack of correlation to the rest of their portfolio and the quick return of capital.

On the public equity side, it's a little bit of a different value proposition. Um, these investors are used to dealing with correlation to the S&P 500, um, trying to be an index or a benchmark that is out there. Uh, they're always looking for uncorrelated streams of alpha, and that's really where this fits in. And then there's the opportunistic bucket again reserved for those strategies that might straddle the lines between two different boxes than a typical allocator, and oftentimes this is a fantastic fit for that, for that box as well.

Marc Regenbaum: And if I might add just one thing, which is – it's always important not to forget the actual individual investment risk reward with crossover investing. Part of the attractiveness that often gets overlooked is the potential opportunity to be involved in structured deals that can help created a symmetric risk return profiles for our investors. So there [are] always options, potentially, to have enhanced deal structures that may include structurally advantage preferred stock, it may include IPO participation rights, it could have liquidation preference or even consent rights. All this can be structured in an extremely valuable manner for our underlying investors, which again could cross different universes depending on their broader asset allocation.

Anu Rajakumar: Yeah, I think that's an important nuance. That's Marc for that. Um, as we start to wrap up here it'd be great to get both of your final thoughts about what you think makes this space particularly exciting or anything else that you'd want to share with someone trying to learn a bit more about the pre-IPO space. So, Marc, maybe starting with you.

Marc Regenbaum: What gets me really excited is I think we live in a time where the speed of change is upon us. Everything happens faster nowadays. With ever-improving technology, greater transparency and tremendous information flow, the trends we all see are emerging quicker and more powerful than ever. And so against that you're having market share shifts that used to take a decade or two are being done in potentially months and years now. And that's again that understanding – this blurring of the lines that we've talked about on this episode is effectively – you have to understand both the public and private markets when you're doing any form investing. They cross over to one another. And to give specific examples, for instance, in the COVID environment that we all lived through there were consumer Internet companies that had business plans to reach total addressable markets in four years that did it in four months. And perhaps the most amazing and impressive was we had the development of vaccines that took months instead of years. It's truly an amazing time of innovation, and some of the late-stage private companies are clearly leading the charge and that's the attractiveness of jumping into this space as it continues to grow.

Gabe Cahill: Yes. I would completely agree. There are absolutely fascinating opportunities to partner with really dynamic companies, companies that we expect to grow long into the future both up into their IPO and well beyond their IPO. And the ability to be a partner to that company, especially when it reaches an age where that IPO and that next transition is really starting to form. And to be a partner and helping making that become a reality. I think it puts us in a position to-to interact with some of the more exciting companies that are out there, some of the most fascinating, um, [Chuckles], growth trajectories that are out there. But it's unique to get a pure play in that space and to be able to have that type of access. And so, I agree with Marc. I think that things continue to accelerate, company formation continues to accelerate, and the ability for companies to do unique and novel things, um, that could help create or drive secular change, um, is also set to accelerate.

Anu Rajakumar: Thank you very much. And for a bonus question today, you know, in my introduction we talked a little bit about SpaceX for just a moment. Uh, so my question for you is just a-a simple yes/no, but love any additional color. Um, would you go on to one of the-the rockets to go up into space? Uh, any hesitations that you might have? Marc? [Chuckles]

Marc Regenbaum: Well, I'm a quick hard no on that one.

Anu Rajakumar: [Laughing] OK.

Marc Regenbaum: Um, I can't even do rollercoasters, so, uh, that one I-I-I'll take the pass and watch from the spectator seats. Yeah.

Anu Rajakumar: Sounds fair. What about you, Gabe?

Gabe Cahill: Yes. After a few years of testing just to validate, um, you know, the-the success rates versus the failure rates, I'm fascinated, and I'd absolutely love to explore space at some point in the not-too-distant future.

Anu Rajakumar: [Laughing] Well, Marc and I will be holding the handbags, watching everyone. Thank you very much.

Marc Regenbaum: Perfect.

Anu Rajakumar: Well, you know, from this conversation I think what I have certainly learned is that pre-IPO investing in this time really is the epitome of disruption, so very on brand for this podcast. Um, and, you know, Marc, to some of your-your points here, you know, everything is happening faster. You know, Gabe, I think you mentioned that lots of people can provide capital, but to be a partner that can drive value, be the third- party sounding board to provide guidance, that's-that's a source of real value add. Thank you very much for-for enlightening our listeners about this very interesting space and the blurring of the lines between public and private. Um, this has been terrific. Thank you very much for joining me today.

Marc Regenbaum: It's been a pleasure.

Gabe Cahill: Thank you.

Anu Rajakumar: And to our listeners – as always, if you enjoyed this episode of Disruptive Forces, I encourage you to subscribe via Apple Podcasts, Google Podcast or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.

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