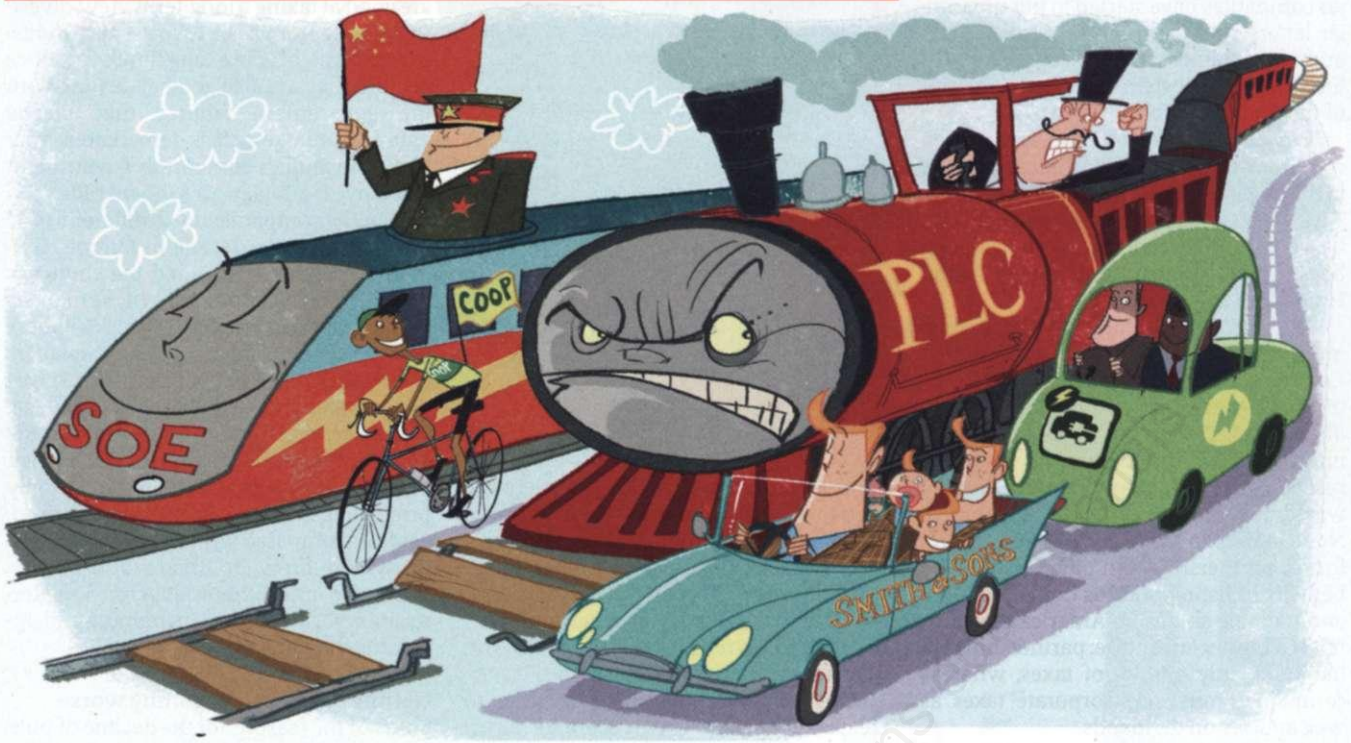


The big engine that couldn't

Public companies have had a difficult decade, battered by scandals, tied up by regulations and challenged by alternative corporate forms

PUBLIC companies have been the locomotives of capitalism since they were invented in the mid-19th century. They have installed themselves at the heart of the world's largest economy, the United States. In the 1990s they looked as if they would spread round the world, shunting aside older forms of corporate organisation such as partnerships, and newer rivals such as state-owned enterprises (SOEs). China's former president, Jiang Zemin, described NASDAQ as "the crown jewel of all that is great about America". Russia rejected five-year plans in favour of stock-market listings and Wall Street banks abandoned cosy partnerships in favour of public equity: Goldman Sachs, the last big holdout, went public as the decade came to an end.

Public companies triumphed because they provided three things that make for durable success: limited liability, which encourages the public to invest, professional management, which boosts productivity, and "corporate personhood", which means businesses can survive the removal of a founder. In 1997 the number of American companies reached an all-time high of 7,888 (see chart 1 on next page). Even now, American listed companies are as profitable as than they have been for 60 years.

But during the past decade, the title of a 1989 essay, "Eclipse of the Public Corporation", by Michael Jensen of Harvard Business School, has turned out to be prescient. In 2001-02 some of America's most prominent public companies imploded. They included Enron, Tyco, WorldCom and Global Crossing, which, before their demise, were admired. Six years later Lehman Brothers collapsed and Citigroup and General Motors turned to the government for salvation. Meanwhile, SOEs were growing in emerging markets, challenging the idea that public companies are the biggest fishes in the sea. Private-equity firms flourished in the West, challenging the idea that public companies are the best managed. And the rise of the Asian economies, with their legions of family-owned conglomerates, challenged the idea that they are best equipped to advance capitalism's geographical frontier.

So, even though public companies are flush with cash (American firms are sitting on $2.23 trillion, see Free Exchange) and even though the world's most talked-about entrepreneur, Facebook's Mark Zuckerberg, is due to take his company public on May 18th, the signs of health are misleading. Public companies are in danger of becoming like a fading London club. Their membership is falling. They spend their time fussing over club rules. And, as they peer out of the window, they see the bright young things heading elsewhere.

The number of public companies has dropped dramatically in the Anglo-Saxon world-by 38% since 1997 in America and by 48% in Britain's main markets. The number of initial public offerings (IPOS) in America dropped from an average of 311 a year in 1980-2000 to just 81 in 2011 (chart 2 on next page).

Going public no longer has the glamour it once had. Entrepreneurs have to wait longer-an average of ten years for companies backed by venture capital, compared with four in 1985-and must jump through more hoops. Lawyers and accountants are increasingly specialised and expensive; bankers are less willing to take them public; qualified directors are harder to find, since even "non-execs" can go to prison if they sign false accounts.

The great IPO famine

Even when their firms do go public, the most successful technology entrepreneurs manage to preserve a lot of personal control. Google introduced a third class of non-voting shares despite the fact that its three bosses, Eric Schmidt, Sergey Brin and Larry Page owned 60% of voting shares. Mr Zuckerberg put off taking Facebook public until he had little choice (you have to publish quarterly accounts like a public company once you have more than 500 private shareholders); he will control more than half of Facebook's voting stock.

The IPO crisis has coincided with a boom in other corporate life forms. Famil-

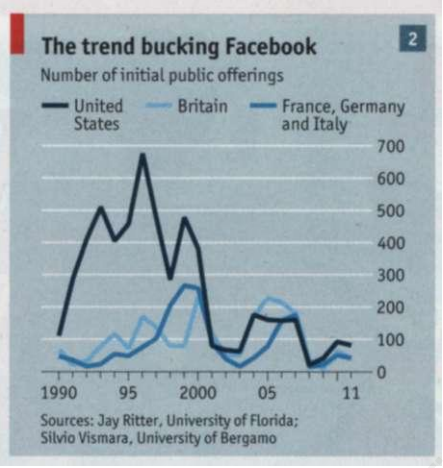
• iar companies have started to put unfamiliar letters after their names: Chrysler **L L C** and Sears Brands **L L C** . The University of Illinois's Larry Ribstein called this "the rise of the uncorporation".

Private-equity companies have taken some of the most familiar names on the high street private, including Boots, J.Crew, Toys "R" Us, and Burger King. They also bagged some of the biggest stockmarket beasts: in **2007** Blackstone bought Hilton Hotels for **$25.8** billion.

Partnerships, too, are thriving, reversing a decline that began in the era of Charles Dickens's "Dombey and Son" **(1848).** Partnerships provided unlimited liability to the partners but limited their number. This meant partners could be ruined if their company failed (as Dombey was) but could not expand if it boomed. Now, thanks to three decades of legal reforms, partnerships can offer most of the benefits of listing, such as limited liability and tradable shares. In America they also boast a big tax advantage: partnerships are liable for only one lot of taxes, whereas companies must pay corporate taxes as well as taxes on dividends.

The result has been a revolution: one-third of America's tax-reporting businesses now classify themselves as partnerships. They have adopted exotic forms of corporate organisation, such as Limited Liability Limited Partnerships (LLLPS), Publicly Traded Partnerships (PTPS) and Real Estate Investment Trusts (REITS). Private-equity firms are typically organised as private partnerships. The individual funds through which they raise money are limited partnerships. And they treat their managers more like partners than employees, rewarding them accordingly. The former **C E O** of the Gap retail chain made **$300m** running J.Crew, a clothing firm, on behalf of Texas Pacific.

Policymakers have embraced alternatives to the public company, too. Britain's Conservative prime minister, David Cameron, is happier praising employee-owned John Lewis than your average **P L C** (public limited company). American corporate reformers regularly cite a private firm, W.L.



Gore, as a model; the maker of the eponymous Gore-Tex employs **9,500** "associates" and "sponsors" (not workers and bosses). Such companies use shares to motivate their employees but shield themselves from the capital markets. Employees become co-owners when they join and may not sell their shares when they leave.

Governments have made it easier to create such alternative corporate structures. Seven American states have passed laws to allow companies to register as " **B** " corporations which explicitly subordinate profits to social benefits. The British government has established a class of Community Interest Companies which issue shares and dividends but exist to promote social purposes. It has also handed over the management of hospitals to "trusts"-public-private hybrids.

The rise of new economic powers has further changed corporate organisation. In the **1990s** it seemed that emerging-market companies would take the Western public company as their model. In fact they have embraced two slightly different corporate forms: SOES and family conglomerates. These companies list on the stockmarket but do little to constrain the power of the state or of family shareholders.

In June **2011** SOES accounted for **80%** of the value of China's market, **62%** of Russia's and **38%** of Brazil's. They include some of the world's most important concerns: the **13** largest oil companies, the biggest gas company (Gazprom), the biggest mobile-phone company (China Mobile), the biggest ports operator (Dubai Ports).

The most serious challenge to SOES comes from family-controlled conglomerates. Family businesses account for about half of listed companies in the Asia-Pacific region and two-thirds in India. Families exercise tight control of their empires—and limit the power of other shareholders-through a variety of mechanisms such as family-controlled trusts (which have more power than boards), appointing family members to managerial positions and attaching different voting rights to different classes of stock. Diversified family firms are good at taking a long-term view, diverting money from cash cows to new industries that might take a long time to produce results. They are also good at dealing with the government failures that plague emerging markets. It is remarkable how fast even India's lumbering government can move if a Tata or an Ambani calls.

Family companies of a different type have had a good decade in Europe. German family firms have led the country's export boom by dominating niche markets such as printing presses (Koenig & Bauer), licence plates (UTSCH) and fly swatters (Aeroxon). These firms pride themselves on a professional approach to management: Nicholas Bloom and John Van Reneen, of the London School of Economics, point out that only **10%** of German family firms choose their CEOS through primogeniture compared with two-thirds of family-owned firms in Britain and France. They also pride themselves on long-termism, investing heavily in training and upgrading their machinery.

Getting better versus getting worse

Some of the reasons for the decline of public companies and the success of alternatives may prove temporary. The fall in the number of listed firms owes something to the dotcom bust, a one-off event. The private-equity boom was fuelled by cheap debt, SOES have been turbocharged by the rise in the price of oil and other commodities. The next decade may not be as easy for the emerging-world's family conglomerates as the past decade. But there is also something more fundamental going on: these various corporate forms have all learned how to manage their problems better than public companies have, while continuing to exploit their advantages.

The biggest advantage of SOES is political: ties with governments can protect them from unwelcome competition. That, of course, is also their problem: they can easily become bloated and lazy. So state-capitalist governments, particularly the Chinese, have turned to overseas listings to force staid monopolies to become nimbler, capable of responding to market demands, as well as government fiat.

The big advantage for family firms is their capacity for long-termism. The drawbacks are family feuds and a lack of professionalism in the second or third generations. So, like state-capitalist governments, family companies are turning to market mechanisms: professional managers, private-equity firms and private markets such as SecondMarket and SharesPost, which allow private firms to trade shares without public scrutiny.

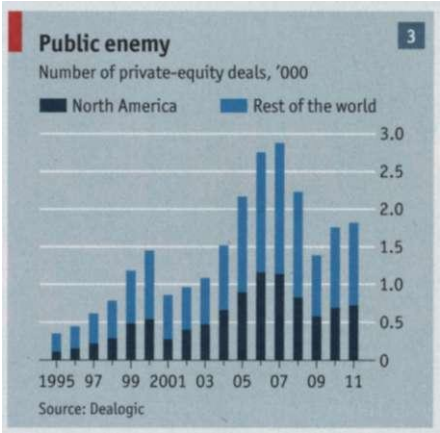
In contrast, public companies have got worse at managing their problems, three in particular. Mr Jensen argues that their biggest drawback is what economists call the principal-agent problem: the split between

• the people who own the company (principals) and those who run it (agents). Agents have a nasty habit of trying to feather their own nests. Dennis Kozlowski, Tyco's former boss, even spent company money throwing a $2.1m birthday bash for his wife that featured a Manneken-Pis-like replica of Michelangelo's David dispensing vodka. But, as the current "shareholder spring" attests, principals have been bad at monitoring their agents.

Mr Jensen's solution was to give managers "skin in the game"—that is, make their pay reflect company performance so they act like owners. This has backfired: some bosses manipulated their companies' share prices to enrich themselves and most have seen their pay outpace company performance. The total remuneration of FTSE 100 chief executives rose by an annual average of 10% in 1999-2010, whereas returns on the FTSE 100 rose by an annual 1.9%.

The second problem is regulation. Public companies have always had to put up with more regulation than private ones because they encourage ordinary people to risk their capital. But the regulatory burden has become heavier, especially after the 2007-08 financial crisis. America has introduced a raft of new rules, from the 2002 Sarbanes-Oxley legislation on accounting to the Dodd-Frank financial regulations of 2010. According to one calculation, Sarbanes-Oxley increased the annual cost of complying with securities law from $1.1m per company to roughly $2.8m. But that is nothing compared with the costs of distraction. In 2007 Oaktree Capital Management, a hedge-fund advisory firm, chose to raise $880m in a private placement rather than an IPO because, as the founders put it, "they were happy to sacrifice a little public market liquidity, and even take a slightly lower valuation, in return for a less onerous regulatory environment and the benefits of remaining private."

The third problem is growing short-termism. The capital markets have increased their power dramatically with the rise of huge institutional investors and the intensification of shareholder activism. Mutual funds count their money in trillions rather than billions. Data providers such as Risk Metrics arm shareholder activists with plenty of ammunition. And hedge funds are not afraid to take on corporate Goliaths such as McDonald's and Time Warner if they think they are failing. And as capital markets have flourished, corporate life has become riskier. The average life expectancy of public companies shrank from 65 years in the 1920s to less than ten in the 1990s. So has the life expectancy of CEOs. The average job tenure of the CEO fell from 8.1 years in 2000 to 6.3 years in 2009, according to Booz & Co, a consultancy. Leo Apotheker lasted just nine months as head of SAP and ten as head of Hewlett-Packard.



Sometimes, investors are right to kick out managers (they own the firm, after all). Companies must strike a balance between the short and long term, satisfying the market's demand for profits today, while planning for the future. The worry is that regulators and owners both seem to be making it harder for bosses to look beyond quarterly earnings. Boards are devoting less time to strategy and more to enforcing regulations. Leo Strine, a judge with expertise in corporate law, accuses institutional investors of "gerbil-like" activity as they move money from one company to another. Standard Life Investors complains that the noise generated by quarterly earnings has become an "unwelcome distraction" from thinking about the long term.

Public company as public good

What should one make of the public company's travails? There is every reason to celebrate the fact that businesses have more corporate forms to choose from. Indeed, the menu should be lengthened by inventing new arrangements or revisiting old ones. France's "SCAS" or *Sociétés en* Commandite par Actions have two tiers of partners: general ones jointly and severally liable for a company's debts, and limited partners who are ordinary shareholders with little power and who can lose only what they invest. This might provide a model for investment banks.

But there are reasons to worry that the downgrading might go too far. Can the private-equity industry function properly if private investors cannot easily cash out through IPOs? Can SOEs avoid stagnation if conventional multinationals are struggling? Public companies are parts of an ecosystem of innovation and job creation. IPOs give venture capitalists and entrepreneurs a chance to make fortunes if they spot a game-changing idea. They also provide new companies with capital. The Kauffman Foundation has shown that one reason America has been better at generating jobs than Europe is its skill at creating innovative companies such as Amazon, eBay and Google. These companies took off when they went public.

William Draper, one of Silicon Valley's most successful investors, speaks for many when he argues that this ecosystem may be drying up. Venture capitalists are recouping their investment by selling new companies to established ones rather than preparing them for independent life. In 2010 five large companies gobbled up 134 start-ups-more than the entire crop of American IPOs that year. Two of the most talked-about start-ups of recent years-Skype and Zappos-chose to sell themselves to giant firms (Microsoft and Amazon respectively). This may not be good for the start-ups. Imagine if Microsoft or Apple had sold themselves to IBM in the 1980s and you get a sense of the problem.

Public companies produce annual reports, hold shareholder meetings and explain themselves to analysts. Private companies by comparison operate behind a veil of secrecy. The danger is that regulators are creating a corporate version of the dual labour market. By shining a spotlight on public companies, they are encouraging businesses to take refuge in the shade of the private sector.

Public companies also foster popular capitalism. The 20th century saw shareholding broadened thanks to privatisations in the 1980s and the rise of mutual funds. Today shareholding is in danger of narrowing again. The reduction in the number of IPOs is making it harder for ordinary people to put money into a future Google. The rise of the private-equity industry and the proliferation of private markets such as SecondMarket gives more power to a magic circle of company founders and experienced investors.

Public companies have shown an extraordinary resilience. They have survived the Depression, the fashion for nationalisation, and the buy-out revolution of the 1980s. But the challenge to them looks unusually strong at the moment, and the auguries for the future grim. ■

Fonte: The Economist, London, v. 403, n. 8785, p. 27-30, 19-25 May 2012.