DECEMBER 2020

THE PRIVATE OPPORTUNITY

BY ROBERT NATZLER

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide to future returns.

We may be on the cusp of a once-in-a-century change in how rapidly growing companies access capital. Many are staying private for longer, approaching late-stage venture capital rounds with altogether different intentions than they had even two decades ago.

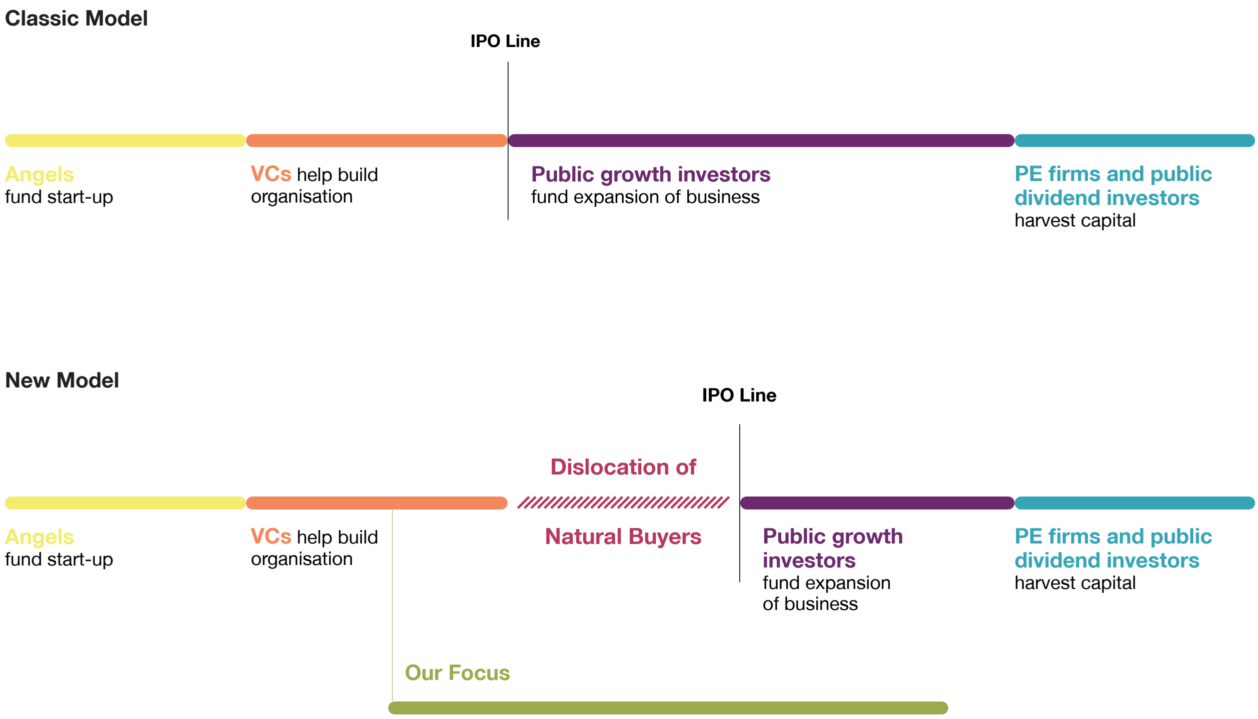
This is not the first time the classic finance textbook story of how companies grow has been challenged. We believe that it is by understanding *how* we ended up with the current system of company financing, that we can best understand the new, evolved system emerging in front of us today.

THIS PAPER IS INTENDED SOLELY FOR THE USE OF PROFESSIONAL INVESTORS AND SHOULD NOT BE RELIED UPON BY ANY OTHER PERSON. IT IS NOT INTENDED FOR USE BY RETAIL CLIENTS.

HOW WE GOT HERE

The classic textbook story about a company's lifecycle tends to start with an entrepreneur raising capital from friends and relatives then possibly giving some equity to a knowledgeable angel investor or taking out a bank loan. As the business grows, the company may turn to venture capitalists (VCs), who will provide larger amounts of funds as well as useful expertise around recruiting, marketing and legal support.

If everything goes well, the company then 'graduates' into public markets via an initial public offering (IPO). The shares will pass into the hands of public market investors, who will be looking for different specific characteristics – perhaps the ability to reinvest and grow even larger, or perhaps a clear framework for paying profits back out in the form of dividends. After a period of time, as the business ages, it may pass into the hands of private equity (PE) buyout funds, which would look to start the process of either rejuvenating the business under new management, or else beginning to close the business down and release its resources for deployment in other businesses elsewhere.



Such is the classic model, drawn from the experience of the second half of the 20th century. As well as describing how companies access capital, it shapes how pension funds and other investors think about allocating it.

What's important to realise is that this model *didn't* apply for much of the 19th century. Until the railways appeared, Wall Street's purpose was to help governments raise debt. In London, a few hundred companies were traded on exchanges by public shareholders, but these were the exception, not the rule. Most companies around the world achieved scale entirely off the back of private capital, gathered from retained earnings, local banking networks or inter-family alliances.

The railways challenged this model because of the enormous amounts of money they needed to spend up-front in order to buy land and lay track. No family network alone could support such an effort, and so companies were forced to go to Wall Street. Once these railways were built, companies were able to sell their products to a much wider market, forcing their rivals to gain scale or be put out of business. The public markets were born as these local manufacturers raised capital on Wall Street to fund mergers in pursuit of national dominance.

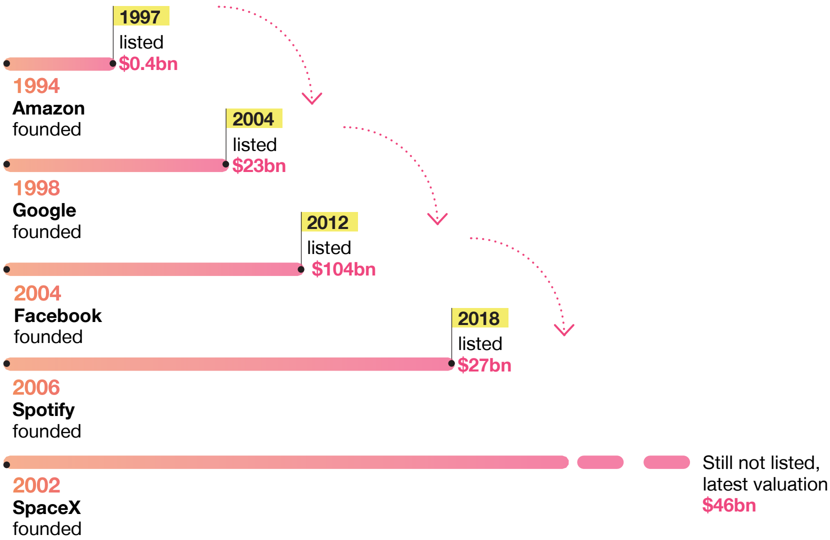
Ron Chernow's 1990 history, *House of Morgan*, describes in detail how the classic Wall Street banks were slow to recognise these changes. They left space for new challengers, banks such as Goldman Sachs and Lehman Brothers, which rose to prominence by specialising in financing businesses and factories. The incumbents were left behind because they failed to learn the different financial analysis skills needed for anything that wasn't a railroad or government.

And the public markets didn't stop there. The new industries of the 20th century – in autos, petrochemicals and mass manufacturing – proved incredibly capital hungry at early stages. Before products could reach customers, entrepreneurs needed to raise huge amounts of money to build factories and distribution systems. With founders ever more dependent on venture capital support to get their ideas off the ground, companies were increasingly likely to IPO into public markets when the venture capitalists wanted to get their money back. And so it was that the 20th century textbook model, described above, took shape.

WHAT WE SEE TODAY

At Baillie Gifford, we see signs that this system is evolving once again. Fewer companies are listing at IPO, and the ones that do are doing so significantly later in their lives than they were previously. The average age of a US company at listing now stands at 12 years, up 50 per cent since the start of the millennium. The aggregate valuation of late-stage private companies has also exploded. In 2006, there was a little under $10bn of value in 'unicorn' companies – private businesses with a value of over $1bn. As of 2019, there was more than $1.8tn of value in these businesses. *Something* is clearly going on!

Time to IPO and Market Capitalisation at IPO Illustrative Examples:



Source: Baillie Gifford. SpaceX valuation as of August 2020.

The average age of a US company at listing now stands at 12 years, up 50 per cent since the start of the millennium

I think there are three big factors at work. The fundamental economics of starting a business are changing. Government rules have changed. And, never to be discounted, cultural norms among founders are changing. Let me touch on each in turn.

Economics first. There has been a sharp change in the levels of capital investment most companies need before they're ready to enter their chosen markets. Historically, an entrepreneur might have to build a factory, set up bricks-and-mortar outlets to achieve national coverage and invest heavily in servers to run IT. Today, it's possible to rent Chinese manufacturing capacity through Alibaba, hire digital targeted advertising from Facebook and Alphabet, and access the exact amount of required computing capacity through the cloud services of giants such as Amazon Web Services (AWS). The result is that many companies can scale for a much longer time before the founders have their ownership stakes diluted by outside capital providers, whose limited-life vehicles made them historically impatient for an IPO 'exit' event.

On top of this, there's been a revolution in staff count. The biggest employers today have far fewer employees than juggernauts of yesteryear such as GE or Ford. In the 1930s, Ford's River Rouge Complex in Michigan employed more than 100,000 workers on just a single site. Today, tech companies such as TransferWise are generating hundreds of millions in revenue with barely 2,000 staff members.

Facebook CEO Mark Zuckerberg Rings Nasdaq Opening Be, ©Bloomberg/Getty Images.

Where hierarchies are needed, modern management software lets them be more flexible than ever before. Effective business systems are easier, cheaper and less reliant on the expertise of senior chiefs from large organisations. The result is that founding teams of talented engineers can run their organisations for much longer before they need to lure in bosses from large corporations with promises of big pay-outs and a company listing.

These fundamental changes in the economics of building and running firms means that founders have more control of their organisations and have it for longer. With these outside pressures to list removed, many are taking the option to stay private for longer, selling down a bit more of their ownership stake rather than rushing into IPO.

Along the way, there have also been helpful changes in government rules. The 2002 Sarbanes-Oxley Act made IPO conditions significantly more stringent, while subsequent regulatory actions have substantially increased the reporting burden on public companies. Some chief financial officers have gone as far as claiming that the cost of being public has risen more than five-fold since 2010 alone! On the other side, the tax changes enshrined in the US JOBS Act of 2017 have made it easier for emerging growth companies to share rewards with employees while remaining private, removing one more historic source of pressure to IPO.

Take that combination of regulatory change and increased founder power, and it's not surprising that we see another great driver of this trend. Norms are shifting within the founder community. For companies such as Facebook, ringing the stock exchange bell at IPO was a prestigious coming-of-age moment. But as more and more large and famous companies – Airbnb, SpaceX, Stripe, ByteDance (owners of TikTok) – have stayed private, the association between being listed and being successful has weakened. Talking to founders today, we are struck by how many view public markets with distaste, noting the arms-length mistrustful relationships that develop between managers and often all too short-term shareholders.

THE WORLD AHEAD

These changing trends of business economics, government rules and corporate norms have resulted in a late-stage private market containing increasingly valuable and large companies. That combination points to a 21st century where the classic finance textbook's neat account seems ever more out of date.

The simple truth is that the kind of companies that are staying private for longer are very different from the young and immature operations that talented early stage VCs specialise in finding and helping. These are not companies that require investor help in making key hires, writing HR policies or designing marketing plans. Far from desiring it, the last thing many of these founders want is one more investor telling them how to run their already highly successful and expanding business.

This matters, as private markets have never just been about access to capital. Management teams get to choose their investors, determining the terms and prices at which they offer stakes in their company. Any investor can write a cheque; but it's the investor the company wants that gets the chance to write that cheque at an attractive valuation. This is why the best early-stage venture capitalists have specialised for so long on the support areas outlined above; and why it's so important for us to understand what it takes to be a natural buyer in the rapidly growing late-stage private market.

At Baillie Gifford, we believe that we are natural buyers for these businesses. This began as a tentative hypothesis but has strengthened over the last decade into a core belief. We review it with the help of two key reference points.

Any investor can write a cheque; but it's the investor the company wants that gets the chance to write that cheque at an attractive valuation.

First, we look at our ability to source proprietary deals. We can access investment opportunities through our own relationships and reputation, rather than through just joining in on bank-promoted rounds. Over the last two years, over 75 per cent of the deals we've made have come through these proprietary channels. Second, we look to the frequency with which we receive our full allocations in private funding rounds. In 2019, we received our full allocations more than 95 per cent of the time. For 2020, the figure is standing at a little over 97 per cent. We know this is an exceptionally high level relative to many other participants.

So why do founders choose to partner with Baillie Gifford? For us, this comes down to three points. We are long-term in our approach and understanding, with a proven record of supporting growth businesses both at scale and globally. We use vehicles and structures that let us offer continuous support, walking with the founders through multiple private funding rounds and then staying with them long into the public markets. Using the insight this gives us means we can be aligned with the management as the company grows. Let me take each point in turn.

At Baillie Gifford, long-termism has never just been a punchline. In public markets globally, the average investor has a holding period measured in months. At Baillie Gifford, our average holding period is above seven years. For the flagship strategy that began our private market practice in 2012, that period is nearer 12 years. We've always focused much more on the long-term strategic opportunities in front of businesses than on worrying about every potential short-term tactical misstep; and we've always been very upfront in sharing our perspectives with boards and fellow investors whenever management have needed our support.

We've brought this perspective with us to private markets. The companies we invest in know that we're in no rush to push them into an IPO. We support them in many cases through multiple private rounds before they seek a listing. And when they do seek that listing, we have the firepower to support them, and then continue to stand by them. At the time of writing, Baillie Gifford clients have almost $5bn deployed into private companies around the world – and around another $40bn deployed into public companies that we first invested in when they were private. This behaviour, in both public and private markets, in turn goes to build our reputation among board members and management teams, helping us secure further introductions to other private opportunities.

Second, the way in which we approach this means that we can offer continuous support. Not for us the seven- or 10-year limited life fund timelines that have been typical of VCs. The vast majority of our private investments have been made from permanent capital vehicles – closed-ended investment companies whose shares are available for trading on stock exchanges. Our clients can buy and sell shares in these vehicles, allowing us to promise companies that we will never pressure them into timing a financing event simply to provide us with liquidity. These vehicles also have the ability to hold companies into public markets. Rather than just passing holdings as an introduction to a separate team, we can then continue to support them as they progress to public markets over many years from within the same team and vehicle that first invested.

This continuity point applies at a broader level too. There is no firewall at Baillie Gifford between our private company specialists and the public market teams. Indeed, our core team of seven private investment specialists is joined by over 30 other Baillie Gifford investment managers who split their time between private and public investing. Each of those 30 has individually led a private investment within Baillie Gifford. The research that this group generates is then shared within our central research hub, which it is accessible to all the 120-plus Baillie Gifford investors, wherever they are based in the world. The result is that Baillie Gifford has a seamless relationship with the management of private holdings when the companies eventually move into public markets. This lets us forge deep relationships and thus understanding of them while they are private – and reassures founders that in Baillie Gifford they have a potential public market investor who truly knows them.

Finally, these relationships allow us to work closely with founders and their management teams. As one of the few investors in the world that walks with companies through multiple private rounds with the intention of being a long-term public markets holder, we stand out as an obvious source of advice on how to prepare for listing. Whether it is engaging on individual corporate governance policies or discussing how to behave at IPO to attract good long-term public markets funds, we frequently find ourselves engaging with the companies we invest in to help them think about their future on a multi-year time period. We continue to work hard at improving this offering, doubling down on making sure we remain the investor of choice for long-term oriented private company founders.

We believe that the world of capital provision is changing in ways that have not been seen since the early 20th century. With over $1.8tn of value now found in private company unicorns, we believe that late stage private companies can no longer be considered as an afterthought. This is a new space, and it requires a new kind of private investor.

At Baillie Gifford, we are striving to be that investor.

RISK FACTORS

The views expressed in this article are those of Robert Natzler and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect personal opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This communication was produced and approved in December 2020 and has not been updated subsequently. It represents views held at the time of writing and may not reflect current thinking.

Stock Examples

Any stock examples and images used in this article are not intended to represent recommendations to buy or sell, neither is it implied that they will prove profitable in the future. It is not known whether they will feature in any future portfolio produced by us. Any individual examples will represent only a small part of the overall portfolio and are inserted purely to help illustrate our investment style.

This article contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

The images used in this article are for illustrative purposes only.

IMPORTANT INFORMATION

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018 and is authorised by the Central Bank of Ireland. Through its MiFID passport, it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions (“FinIA”). It does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. It is the intention to ask for the authorisation by the Swiss Financial Market Supervisory Authority (FINMA) to maintain this representative office of a foreign asset manager of collective assets in Switzerland pursuant to the applicable transitional provisions of FinIA. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co.

Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is wholly owned by Baillie Gifford Overseas Limited and may provide investment research to the Baillie Gifford Group pursuant to applicable laws. Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is incorporated in Shanghai in the People’s Republic of China (PRC) as a wholly foreign-owned limited liability company under the Company Law of the PRC, the Foreign Investment Law of the PRC and its implementing rules, and other relevant laws and regulations of the PRC. Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is registered with the Shanghai Municipal Administration for Market Regulation, with a unified social credit code of 91310000MA1FL6KQ30, with its registered office at Unit 4203-04, One Museum Place, 669 Xin Zha Road, Jing An District, Shanghai 200041, China. Baillie Gifford Investment Management (Shanghai) Limited 柏基投资管理(上海)有限公司 is a registered Private Fund Manager with the Asset Management Association of China and manages private security investment fund in the PRC, with a registration code of P1071226.

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 and a Type 2 licence from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford’s range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Room 3009-3010, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong. Telephone +852 3756 5700.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

IMPORTANT INFORMATION

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited (‘MUBGAM’) is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

This material is provided on the basis that you are a wholesale client as defined within s761G of the Corporations Act 2001 (Cth). Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth). It is exempt from the requirement to hold an Australian Financial Services License under the Corporations Act 2001 (Cth) in respect of these financial services provided to Australian wholesale clients. Baillie Gifford Overseas Limited is authorised and regulated by the Financial Conduct Authority under UK laws which differ from those applicable in Australia.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission. Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited (‘BGE’) relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Oman

Baillie Gifford Overseas Limited (“BGO”) neither has a registered business presence nor a representative office in Oman and does not undertake banking business or provide financial services in Oman. Consequently, BGO is not regulated by either the Central Bank of Oman or Oman’s Capital Market Authority. No authorization, licence or approval has been received from the Capital Market Authority of Oman or any other regulatory authority in Oman, to provide such advice or service within Oman. BGO does not solicit business in Oman and does not market, offer, sell or distribute any financial or investment products or services in Oman and no subscription to any securities, products or financial services may or will be consummated within Oman. The recipient of this document represents that it is a financial institution or a sophisticated investor (as described in Article 139 of the Executive Regulations of the Capital Market Law) and that its officers/employees have such experience in business and financial matters that they are capable of evaluating the merits and risks of investments.

Qatar

This strategy is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved. This does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents, or consultants in connection with the addressee’s consideration thereof). Baillie Gifford Overseas Limited has not been and will not be registered with Qatar Central Bank or under any laws of the State of Qatar. No transactions will be concluded in your jurisdiction and any inquiries regarding the strategy should be made to Baillie Gifford.

Israel

Baillie Gifford Overseas is not licensed under Israel’s Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This document is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

ROBERT NATZLER

Investment Manager

Robert is a member of the Private Companies Team at Baillie Gifford.

He joined the firm in 2015 and worked on our Emerging Markets and UK Equity Teams before moving to Long Term Global Growth. There he focused on finding stocks for a set of highly concentrated long-term international growth portfolios. He also began working on private companies, in the context of both private founding rounds and existing holdings approaching IPO.

In 2018 he moved to our Private Companies Team to work full-time on identifying high growth late-stage private companies. He has led research on private companies including Tanium, Niantic, Sana, Flixbus and Away, as well as doing follow-up work on pre-existing portfolio holdings. He is working to develop a best-in-class research culture and company support strategy on the team.

Robert graduated with a BA (Hons) in Philosophy, Politics and Economics from the University of Oxford in 2014.

BAILLIE GIFFORD

Copyright © Baillie Gifford & Co 2015. Authorised and regulated by the Financial Conduct Authority.

Private Co Op 50416 1220
Ref: 50416 ALL AR 0161