

# STILL STRONG

The origin of the public company reveals its advantages.



BY JOHN ILKIW

Global leveraged buyouts reached a staggering \$458 billion in 2006. That's an almost sixfold increase over the \$79 billion just

three years earlier. The deals are getting ever larger, with nine of the 10 biggest buyouts occurring since 2005. This unprecedented growth—fuelled in part by low interest rates and large chunks of cash from the world's mega pension funds—has resurrected the 1989 Michael Jensen forecast in the *Harvard Business Review* that privately financed businesses have become the preferred organizational structure for marshalling and allocating investment capital. In his “Eclipse of the Public Corporation,” Jensen argues that highly focused institutional investors with large and well-aligned financial contracts have resolved the central and inherent weakness of the public corporation—the conflict between owners and managers over the control and use of corporate resources. In other words, because they manage agency risk better, private corporations outperform public corporations.

A brief examination of how publicly traded companies developed suggests they may not be easily overshadowed. The public company, which has its origins in feudal Europe, is characterized by easily transferable shares of ownership. For example, mining enterprises in 13th century Siena relied on share financing, as did manufacturing ventures in other cities. However, it was the emergence of joint-stock companies in England in 1600 that crystallized the advantages of the public corporation, in particular the East India Company.

Transferable share financing proved to have a host of material benefits. Large amounts of capital could be raised and invested for long time horizons because the initial investors could subsequently sell part or all of their claims on the company profits to other parties at low transaction costs. In contrast, selling all or part of a private company involved

complex and expensive legal documents, and usually the agreement of other private shareholders. In the extreme, selling shares in a private company could force liquidation.

By concentrating a vast amount of capital in a single enterprise, public companies could achieve and exploit previously unattainable economies of scale, scope and informational advantages. With size and expertise came market power and the ability to negotiate advantageous contracts with both buyers and sellers. Leading joint-stock companies also diversified organizational risk by moving into complementary business lines across different geographical regions and countries—a precursor to today's global public corporations.

Of particular note, the most successful public joint-stock companies improved profitability by reducing agency costs. Management and reporting systems were developed that coordinated and controlled far-flung business operations to minimize losses from agent incompetence or opportunism. The comparative advantage attributed to private equity firms today was a clear focus of the original public corporations. With their large equity base and the relaxation of usury laws, joint-stock companies raised additional long-term capital by borrowing funds to leverage their diversified profit margins. This is now a taken-for-granted financing strategy used by both private and public companies.

Have private equity investors, as Jensen contends, earned superior returns, thus signalling the eclipse of the public corporation? According to the empirical findings published by Steven Kaplan and Antoinette Schoar in the *Journal of Finance* in August 2005, no. Net of fees, the average return earned by the limited partners of private equity partnerships approximately equalled the S&P500, and under-performed the benchmark on a risk-adjusted basis. It seems that the reports of the eclipse of the public corporation have been exaggerated. ■

John Ilkiw is senior vice-president, portfolio design and risk management at the Canada Pension Plan Investment Board.