# WHY PRIVATE COMPANIES MATTER MORE

Interview with Peter Singlehurst

MB Malcolm Borthwick

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MB Hello, and welcome, thanks for joining us. I'm Malcolm Borthwick, editor of Intellectual Capital at Baillie Gifford.

In 1996, there were over 8,000 companies listed on US stock markets. 20 years later, that number had almost halved. So more companies are choosing to stay private, and for longer.

Baillie Gifford has over $10 billion of assets invested in private companies, and a further $20bn off assets in public companies that we first invested in when they were private. Our investments in private companies includes SpaceX, the advanced rockets and spacecraft firm founded by Elon Musk, Epic Games, which is behind the hit video game Fortnite, and ByteDance, owners of TikTok, which was the most downloaded app in 2021. So given the growth in private companies, it's no surprise that more investment managers are focusing in on this area.

So what's Baillie Gifford's edge? To discuss this, I'm joined by Peter Singlehurst, who is head of Baillie Gifford's Private Companies team.

But before we start the conversation, some important information. Please remember that, as with all investments, your capital is at risk and your income is not guaranteed, and the risk of investing in private companies could be higher, as these assets may be more difficult to buy or sell, so changes in their prices may be greater. And we're recording this podcast during Covid-19, so Peter and I are both at home, as opposed to in the usual Edinburgh studio.

Peter, welcome to the podcast. In the introduction we talked about why we're seeing more companies moving into this space, more investment management companies. What's Baillie Gifford's edge when it comes to investing in private companies?

PS I think in many ways it's quite simple. I think it's that we meet the needs of mid and late-stage high-growth private companies in a way that others aren't able to. And I think within that there are two components. One is a degree of patience and long-termism, and that's both philosophical but also structural.

It's philosophical in the sense that that is how we've always invested at Baillie Gifford, with a long-term mindset, being patient, trying to find exceptional companies that can compound over many, many years, but that philosophical patience is backed up by structures which enable it.

Most of the venture capital industry invest from ten-year limited-life funds. Even with the longest-term philosophy, if you don't have a long-term vehicle, you're not going to be able to genuinely practise that long-termism.

And so starting off investing in private companies within Scottish Mortgage was, I think, actually crucial because it meant that we could come at these investments with an approach that enabled us to be aligned with the time horizons of many of the founders that we were backing, a time horizon which is much longer than your traditional ten-year, limited life fund.

So that long-term approach, that alignment with founders on time horizons, and that ability to provide continuity of ownership for companies as they transition into the public markets, I think, is one part of our advantage, and a need that we meet for companies.

The second part is that we can and do support companies with additional capital over the lifetime of our holding. Now, of course, that provision of additional capital is always dependent upon the availability of upside, it's dependent upon the execution, and it's dependent upon valuation, and it's dependent upon us continuing to be able to make money for our clients.

But where those things are all there, we can become much larger owners of businesses over time, both through the provision of additional capital in the private markets but also as companies transition into the public markets and start that journey as public companies.

And I think that contrasts to many investors out there who view an IPO as an exit, and they'll look to sell after a lock-up expires. And there are all sorts of reasons as to why they do that, but to our thinking, and I think to many of the companies that we back, that sort of arbitrary decision to sell once companies become public is a strange decision because it's driven by factors that have got nothing to do with the ability to continue to make exceptional returns for your clients.

MB You talk about supporting companies through the provision of long-term, patient capital, Peter, but what other types of support do we provide to private companies? I guess what I'm thinking here is a lot of other venture capitalist firms may push for a place on the board or something like that, but I think our approach is somewhat different?

PS Yes, that's right. I think we're as clear about what we can help with as we are about what we can't help with. We don't get operationally involved with companies. We don't take board seats. We will sometimes take board observer seats but we're not investors that can help early-stage companies build out a sales strategy or form the company in the way that good early-stage venture capitalists can do.

However, there are things that we can do for mid and later-stage companies that I think are helpful and that our position, as public-market investors, makes us well-placed to help with. If companies are starting to think about becoming public, I think that we are reasonably well-placed to be able to help those companies think about their governance structures as they enter the public markets. Or we can help them with things like dual-class share structures.

There was a recent example with Allbirds, one of our private-market holdings that today is a public business. We were asked by the company to help them pull together a new framework for evidencing their ESG credentials as they came to the public market. We were part of an advisory committee that helped them do this, and we were the only investor on that group.

And I think the reason Allbirds asked us to help with that is because governance and ESG of public-market companies is something that we have a reasonable amount of experience with, and it's also something that we care about. Because we, in all likelihood, will continue to be a partner with Allbirds for many years to come, at a time when many of their earlier-stage investors probably won't be.

MB And how do you incorporate ESG, or Environmental, Social and Governance, issues into your research with private companies?

PS We believe that there is no fundamental difference between ESG factors around businesses and fundamental business factors around companies. And that's because when you invest with a long-term view, these things converge. And so over the years, we've not invested in many companies because we believe that they are doing something that is deleterious to the society that they operate in, which over time will lead to them losing their social licence to operate.

And there are many examples, over the years, of such companies that we've decided not to invest in because maybe, in one sense, they don't look good from an ESG criteria but actually, really for us, it's that those factors mean they are potentially less attractive investments because the probability-adjusted upside of high returns for our clients is lower.

On the other side, many of the companies that we invest in, I think, are unambiguously doing some pretty good things for the world. But we're not investing in them because they're doing good things for the world, we're investing in them because we think they can be great businesses, and it's the societal changes that they are part of which are going to be the drivers for real change.

So, to give you some examples, we've been longstanding shareholders in Northvolt, which of course is to be one of Europe's largest battery manufacturers providing lithium-ion batteries to automotive manufacturers as they make that transition away from internal combustion engines.

You could say, well, that's a company that ticks a lot of ESG boxes. We look at it and say, well, yes, it does all that but actually what this really means is that this can be an absolutely fantastic business because you have real demand from consumers for electric vehicles, you have a whole industry that is starting to make that change, and you just don't have enough supply.

And Northvolt is bringing on that supply in a way that we think will really be one of the big facilitators of that shift. And so I think when you have this longer-term view, there is this convergence between what's good for businesses and what's good for society at large.

MB At what stage does a private company, from your perspective, become interesting or scalable to invest in?

PS There are two criteria that we use here, and we try to think about it philosophically rather than quantitatively. The two questions we ask ourselves are, firstly, do we have the analytical skill set to be able to tell whether or not this is a good business?

And I think that you can perhaps elucidate that by thinking about extremes. So if you think about a very early-stage business, where there are a couple of people with a dog working on something in the garage, we don't have the skill set to be able to tell whether or not that's going to be a good investment.

Now, good earlier-stage venture capital investors do, and that's what they specialise in, and we need those early-stage investors to be mentoring those businesses at those very early stages of development. So that's too early for us.

But if you can start to have a meaningful conversation about a company's business model, about the management team's track record in executing, if you can talk about a business's competitive advantage and the scale of their addressable market, these are the factors that we've been analysing for 100 years as an organisation, and so we think we do have the analytical skill set to be able to determine whether businesses that are beginning to exhibit those characteristics can be good investments for our clients. So that's the first criteria.

The second criteria, in many ways, turns the question back on ourselves and says, are we the right partner for this company at the given stage of development that it is at? So again, thinking about those different stages, very early-stage companies need lots of help and guidance and operational support from their early-stage investors. We can't, and we don't, and we don't aspire to be able to, do that.

But what we can do is help steward companies in the mid and later stages, we can help them make that transition to the public markets, and we can provide that continuity of capital at a period of time when much of their cap table will be looking for an exit. And if a company needs those things from investors, well then maybe it tells us that we can be the right partner for the right company at the right stage of its development.

MB When a company does decide to list and go from the private market to the public market, typically how do you work with the company on that, and what's your response in terms of whether or not to stay invested or exit?

PS When companies come and say they're thinking about going public, the first thing we normally ask them is are you sure you want to do that? It's a one-way value. Once you've become public, it's very difficult to not be public, and there are all sorts of pressures and burdens on public companies that are not necessarily conducive to building the best companies.

So we normally challenge companies as to why they're thinking about going public. And there are good reasons for going public, and we want to make sure that it's the right reasons that are underpinning that decision, rather than for the wrong reasons.

As they start that journey, in many cases we'll engage with them on some of the topics that I was just talking about, but there will also be a process whereby we, as the private markets team, working alongside our public market colleagues, help our public market colleagues get to know these companies and build their own understanding of the companies, leverage the relationships that we'll have with the founders and management teams, so that our public market strategies can come to their own informed decisions about whether or not they're going to invest in the companies as they transition to the public markets.

And that was always one of the reasons for doing this. By this I mean investing in private companies. We believed, very much from the outset, that by investing in high-growth private companies, we could be better public market investors as well, because rather than having a couple of weeks to decide about an IPO of a company you'd never heard of, we would be able to build an understanding of these companies over a period of years, before they came to the public markets.

And as a result, we would be able to make better and more informed decisions for our wider client base. So helping our public market colleagues understand these companies as they make that transition as well is an important part of what we do as a team.

The decision as to whether we put more capital in from within the portfolios that we manage is driven by the ability to continue to make money for our clients. So the key question that we always ask ourselves whenever we make a new investment, but also when we make any follow-on investments, be that in a private financing round or an IPO or after an IPO, is can we see a path to making a '5X' return for our clients?

And if the answer to that question is 'yes', then we will put more capital in, we will support companies with additional primary capital which they will be able to use to invest in their businesses and systematically twist the odds of success in the company's and our clients' favour. And it really is that availability of upside that will drive the decision to invest and to continue to own.

Now, where we don't see a path towards a '5X' return, that's when we will either not participate or when we will consider moving on. But the questions really are not informed by whether the companies are private or public. I don't think there's much information in how a company's shares are traded, which is, after all, really the only difference between a company being public or private, that informs whether or not you should continue to own the shares of a business.

And yet, much of the financial market seems to think that there is information in how a company's shares are traded that should determine whether you should continue to own those shares, because that is how financial universes are divided up. And we don't think that's in the best interest of our clients, hence why we tried to break down these boundaries between private and public businesses.

MD So do you think too much is made of the difference between private and public companies and, at the end of the day, you're just looking for great long-term opportunities?

PS Yes, I think that's exactly right. I think it's to the detriment of companies, it's to the detriment of end asset owners, that the financial world pretends that there is a meaningful difference between private and public companies. I really don't believe that there are meaningful differences.

There are differences in terms of how you source businesses, there are differences in terms of the relationships that you can have with companies which are often much closer when companies are private, but I don't think there's any difference in terms of the qualities of companies and the abilities to create returns for your clients.

So the journey that we've been on for the last ten years has been about trying to break down this artificial divide between private and public companies, because we believe that that is in the interest of our clients, and we think that it's in the interest of the companies that we're backing as well.

MB And where do you see the most exciting opportunities at the moment?

PS We're very fortunate to have a global remit, we're fortunate to be able to invest across sectors, so we get to see a lot of different companies doing a lot of different things in a lot of different geographies. The companies that I'm the most excited about are ones that are taking technological development from certain fields and applying them to surprising and different fields.

So to give you an example, we led a round in a business based in Houston this year called Solugen. Solugen is, in one sense, a chemicals company. A chemicals company based in Houston is probably not the bread and butter of your Silicon Valley VC firms. The company was introduced to us by a founder of another portfolio company.

What Solugen has done is found a way to make base chemicals, such as hydrogen peroxide, using enzymatic catalysts, which are much more efficient than the metal catalysts, which are traditionally used in the industry. And the benefit of that efficiency is that you can use much less heat, which would normally come from burning fossil fuels, and you can use different feedstocks. You can use organic feedstocks rather than petrochemical feedstocks.

The consequence of this is that you can make chemicals such as hydrogen peroxide in a way that is much cheaper. You can make a much better product and you can do it in a way that is carbon-negative rather than heavily carbon emitting, as much of the petrochemicals industry is today.

But the interesting thing about Solugen is that the core insight and understanding that they leveraged to create the enzymes that they use in these processes comes from healthcare. One of the founders was an oncologist, and he discovered these enzymes in pancreatic cancer cells which make hydrogen peroxide.

So there was the discovery that came from medicine, the scaling up and the making of those enzymes was made possible by advances in industrial synthetic biology over the last ten years, which itself has its links and its heritage to developments within the biotech industry over the last 30 years, and here you have a business taking advances and developments and insights that have their ancestry within healthcare, and they are using those technologies to create chemicals that are used in things like water purification that are traditionally made in very carbon-intensive ways.

And so I think it's the intersections of these different industries where I see so much opportunity and where I get particularly excited about businesses. And I think it's where having a broad geographic and a generalist remit is a particular strength of the approach that we take.

MB Peter, that's an optimistic note to end on. Thanks very much for joining us on the podcast.

PS Thank you, Malcolm.

MB And thanks for investing your time in listening to this podcast. And if you're listening at home, you're listening in the car, wherever you're listening, stay well and we look forward to bringing you more insights in our next podcast.

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