THE MONEY GUY

WHAT'S UP WITH THE STOCK MARKET?

by Harold Montgomery

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Have you been watching the stock market lately? There have been some important changes in the last decade that any independent businessperson ought to notice and think about because it affect us all. I'm not talking about the market's recent run-up in anticipation of an economic recovery – a run-up that's put the Dow over 12,000 for the first time since 2008. Rather, I am talking about changes that may be subtle, but are very important (and not good) long-term trends for businesses in the U.S.

For example, the number of public companies listed on the three major U.S. exchanges (NYSE, NASDAQ and AMEX) has declined 20% in the last 10 years. In 2000, there were 8,361 public companies on these exchanges. By 2010, there were 6,693, a drop of 1,668 companies. Companies left the public markets due to natural causes such as buy-outs, going out of business, acquisitions and other reasons. But, the more important trend was the lack of new listings to overcome natural attrition and grow the number of public companies. Companies just aren't going public as much or as easily anymore. In fact, given the recent examples of private share sales

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from Facebook, Groupon and other high-tech wonders, it's beginning to look like being public is every growing company's last choice of financing options.

Why is that? There are three main reasons: cost, intrusiveness and liability. First, it costs millions to go public and millions more per year to stay public. Today's regulations governing public companies are so restrictive that the company has to have auditors on-site virtually daily to review quarterly and annual results. Further, companies have legal teams on staff to oversee any moves under consideration and vet any disclosures.

Public companies have to report any material events or agreements within 4 business days of their occurrence. These disclosures require that the company publish all relevant information about whatever commitments they make. There are no secrets in today's public company world. That makes some companies nervous because it borders on releasing sensitive information about what companies are doing that might be useful to their competitors. Private companies have no such burden and can make their plans in secret. It's an uneven playing field designed to protect the investing public but puts public companies at a disadvantage.

The liability profile of a public company is also higher than that of a private company. Sarbanes-Oxley legislation makes the CEO and CFO personally liable for any mistakes the staff might make with the company's numbers. This concentration of liability on two officers of a complex corporation reveals a poor understanding of how modern businesses work and how responsibility is shared within them. No wonder no one wants to be a public company CEO. Fear of making a mistake limits the pool of talent willing to take on these important jobs.

So, what has the public market become? It's now the preserve of large corporations that have no other options. There have been 24 Initial Public Offerings in the U.S. in 2011 so far, raising a total of $8 billion. That's an average of $333 million each. Take out the two largest, and the average was still $158 million per offering. That's an historically large number. Time was, companies could go public and raise $10-$30 million to fund research and development, product development or growth. For a company to make an offering over $100 million means the company has to have a total capitalized value of at least $300 million. That's hardly the size of a small business or even a young, growth-stage company. In fact, the average age of the companies that went public in 2011 was 16 years.

The average total market capitalization of pubic companies in the U.S. in 2000 was $1.92 billion. Today, it's $2.4 billion, up 20% in 10 years. In general, these companies are bigger, less innovative, less flexible, more heavily regulated and motivated more by minimization of liability than risk taking and growth. It's harder to be public today than ever before.

What does this mean for small business? It's not good since financing through the public market has been one of the great sources of American growth innovation and wealth in the last century. It's one of the great American inventions that fueled innovation and growth making the U.S. the leading economy in the world after WWII. Restraining it with burdensome regulations and liabilities is hampering this engine of growth. We're choking off an important way of getting capital in the hands of job-creating entrepreneurs.

Why does this all matter to a small businessperson? In a word: valuation. Every businessperson should be thinking about the value of the business and the eventual need to maximize that value. Public companies buying out private ones has long been the ideal value maximization technique for private firms. The public market values a dollar of earnings higher than any other buyer, so public companies can pay more for an acquisition. Furthermore, sellers taking stock in the public company can ride the stock value and often get preferential tax treatment as well. All things considered, becoming part of a public company is a great way to go. But large public companies with multi-billion dollar market capitalizations aren't going to be interested in acquiring small businesses and cashing out the owners. Acquisitions of that size won't make a difference to them. That means fewer buyers for small businesses and therefore lower prices.

A private business can't specify the time when a value maximizing opportunity might present itself. Given how fast the economy changes these days, if you see your chance, take it. They're likely to be fewer and fewer in the years ahead. ■