How We Approach Governance of Public Versus Private Companies

Unique aspects of private investments require different level of stewardship.

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KEY INSIGHTS

- Investing in private companies offers exposure to innovative businesses that can compound wealth as they potentially move from fledgling to durable growth companies.
- When we invest in a private company, our responsibilities as an investor are, in most respects, the same as for any publicly traded investment.
- However, some unique aspects of private company investments require a different level of stewardship activity and oversight.

Given that T. Rowe Price is a significant investor in private companies, we often receive questions from our clients about how our investing approach differs for privately held companies versus those that are publicly owned. To answer this, it is necessary to understand the evolving life cycle of a private company and the stewardship responsibilities that we undertake once we have invested.

Why Invest in Private Companies?

When considering private company investments, our aim is to identify innovative businesses that can compound wealth as they transition from fledgling to durable growth companies. An allocation to early-stage, dynamic, private companies offers the potential for above-average returns compared with public company investments. Investing in private companies also offers other possible benefits, such as providing insights into potential industry disrupters, as well as the opportunity to assess companies before they go public.

However, investing in private companies that may still be years from going public is always challenging. These securities are more illiquid and carry greater risk than investments in more established, publicly traded companies with longer track records.

The Life Cycle of a Private Investment

Sourcing: T. Rowe Price has been participating selectively in private-equity investments for 30 years. We have gradually been increasing, and broadening, our stake in private investments over the past decade in order to take advantage of a growing array of opportunities. As a result of our experience investing in this space, we have earned a reputation among the

The Life Cycle of a Private Investment

There are five distinct phases of a private-equity investment

founders of, and advisers to, emerging growth companies as a preferred provider of capital funding. In turn, the network of entrepreneurs and private company directors that T. Rowe Price has established over time is our primary source of introduction to new private investment opportunities today.

Due Diligence: T. Rowe Price portfolios strictly adhere to the firm's private investment oversight process, which requires that all such investments be approved by either a director of equity research or the appropriate regional head of equity. A T. Rowe Price investment analyst is assigned to analyze the prospective investment and, if we ultimately make a capital commitment, to follow the company's progress and performance from that point forward.

Purchase: Upon purchasing a stake in a private company, T. Rowe Price prioritizes establishing clear lines of communication with the company management. Unlike investments in publicly listed securities, private companies are not required to make periodic financial disclosures. Accordingly, we have established a system of secure communications that allow our analysts and valuation specialists necessary access to company updates and financials.

Monitoring and Maintenance: T. Rowe Price typically holds private company investments for a period of at least several quarters up to several years. During this time, our responsibilities as an investor in the company are, in most respects, similar to any publicly traded investment. Our analysts closely monitor the company's progress against expectations, and they receive periodic updates from management about how the business is performing and how effectively the strategy is being implemented. In some other respects, however, ownership of a private investment entails a different level of responsibility for investors, particularly in relation to corporate governance.

Liquidity Event: Typically, the final phase of the cycle occurs when a private company decides to offer securities in the public markets via an initial public offering (IPO). In almost all cases, T. Rowe Price remains an investor in the company after the IPO, often purchasing more shares in the offering. In some cases, the company is purchased by a strategic buyer while still privately owned, and so it does not proceed to an IPO. In a few instances during our long period of investing in private companies, the business model has proven not to be economically viable and the enterprise has been shut down, with investors receiving no return of capital.

In the next section of this article, we will focus specifically on the monitoring and maintenance phase of private company investments.

> Private companies do not hold annual general meetings of shareholders, nor do they offer proxy voting.

Company Monitoring and Maintenance: A Deeper Dive

When T. Rowe Price invests in a private company, our responsibilities as an investor are, in most respects, the same as for any publicly traded investment. We have a duty to our clients to carefully monitor the company's performance and strategy. Being an active and constructive owner of the company's securities over the long term is an extension of our strategic investing approach.

Accordingly, we expect our investee companies to provide a reasonable and reliable level of transparency into their financial and operating performance. We expect companies to be overseen by a board of competent, experienced directors, of whom a reasonable number should be independent of management. We expect companies to employ a sensible framework for executive compensation, aligned with investors' interests but tailored to their stage of development and performance. Finally, we expect companies to operate with integrity and to meet their obligations under applicable laws and regulations. These universal principles apply to all of our investments, both public and private.

However, in some other respects, ownership of a private investment involves a different level of responsibility for investors, particularly in relation to corporate governance.

Private Investment Stewardship

Diligent and attentive stewardship of our clients' capital is a pillar of our investment philosophy and process. This applies to all asset classes and to both public and private investments. There are some unique aspects of private company investments, however, that require a slightly different approach regarding our stewardship activity and oversight.

The composition of a private company's board is a good example of a governance issue that evolves as the company moves from the private capital markets toward a public listing.

During the company's early stages, its board tends to be made up of a small number of its own executives, venture capital investors, and other key business partners. This is an appropriate composition while the company is still primarily focused on operational matters: building scale, growing market share, research, and development.

However, as the company moves closer to a public listing, and its investor base expands, the board has a fiduciary duty to a much larger group of stakeholders and so must dedicate the necessary level of attention and oversight. This shift requires independent director representation on the board, free of any transactional or familial ties to the company, and ideally with previous experience leading companies through similar early growth phases.

For public companies, we believe it is important to have a majority of independent directors on the board. However, for newly public companies, we think it is reasonable to achieve this independence standard within two years after the IPO.

Proxy Voting Versus Written Consent for Private Companies

Private companies do not hold annual general meetings of shareholders, nor do they offer proxy voting. Instead, these companies use a mechanism called written consent to seek shareholder approval of corporate matters, such as director elections and equity compensation plans.

Under written consent, the company selectively notifies investors, asking them to approve the item or items in question. These items do not have to be shared with all stockholders, nor is any advance notification required. Companies can simply ask for the consent of certain investors, one by one, until they achieve the 50% needed for approval. The remaining stockholders are then informed of the event after the fact.

> We do not consent to any practices at private companies that we would not approve at public companies.

Privately Owned Companies Are Less Beholden to Outside Influences

There are some key differences in governance between privately owned and publicly listed companies.

Privately Owned Companies	Publicly Listed Companies
Owned by founders	Owned by shareholders
Written consent	Proxy voting
No annual shareholders meeting	Annual shareholders meeting

This process is very different from a public company shareholder meeting, which requires advance notice to be provided to all stockholders, publicly, and weeks ahead of the meeting date. All stockholders are informed at the same time of the items up for vote, and all have the chance to express their view.

Written consent clearly reduces the complexity and costs of holding a shareholder meeting, which is important for private companies that need to receive stockholder approval quickly and efficiently. However, it also reduces transparency for those investors whose consent is not sought by the company.

On occasion, our clients observe that private companies owned in T. Rowe Price portfolios proceed to IPO with unusual or onerous corporate governance provisions. These might include dual-class stock structures with superior voting rights for founders, allowing them to maintain control of the company. Or it might relate to unusual compensation packages where large IPO bonuses are embedded within. Understandably, our clients question us about why we support such provisions for private companies but vote against them for public companies.

It is important to make clear that T. Rowe Price does not apply different standards to private and public companies. We do not consent to any practices at private companies that we would not approve at public companies.

Unfortunately, our ability to affect change at private companies is limited by the written consent mechanism, given that they can easily obtain the consent needed from other investors or company insiders.

Evolution of Governance

For certain governance structures we see as problematic, we feel it is important to register our concerns with management of private companies in our portfolios and their outside advisers. We do this by declining to consent to such structures and discussing our concerns directly with company management.

However, a far more common scenario is that T. Rowe Price serves as an informal adviser to private companies on matters of corporate governance, capital allocation, investor relations, and business strategy. For example, we might provide guidance on the need for a company's governance to evolve over time. The governance provisions, takeover defenses, and board structures of a company in the first year after its IPO are likely to be very different from its needs after five or 10 years.

A Potential Turning Point

Looking ahead, we believe that 2020 could prove to be a turning point in the private company ecosystem.

The past decade has been characterized by an abundance of capital flowing into private companies, from both venture capital funds and traditional public investors like T. Rowe Price. This enormous demand for promising growth investments caused a shift in power—away from the providers of capital and toward company founders. This has made it difficult for investors to negotiate protective provisions or shareholder rights that safeguard their interests, as company founders could simply move on to the next investor in the line of eagerly waiting capital providers.

However, there are signs that this power imbalance has started to shift. In just the past few quarters, there have been some important developments involving major investors/capital providers demanding more stringent requirements from companies seeking capital funding. The onset of the coronavirus crisis in early 2020 and the subsequent economic dislocation have only accelerated this trend as private companies scramble to secure funding in the current environment.

WHAT WE'RE WATCHING NEXT

If our prediction is correct and 2020 proves to be a turning point in the private company ecosystem, we could see a healthier and more balanced dynamic emerge in the market for growth-oriented private companies. We will continue to monitor developments closely.

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