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Government Pension Fund Global – Access to invest in unlisted companies seeking a listing

The Management Mandate for the Government Pension Fund Global (GPFG) permits the fund to be invested in “unlisted companies where the board has expressed an intention to seek a listing on a regulated or recognised market place”. This provision was added to the mandate on 1 January 2011. In Report to the Storting No. 15 (2010-2011), the Ministry explained that this was to enable the Bank to exploit the fund’s characteristics and help ensure efficient execution of the fund’s management.

In its letter of 27 March 2019, the Ministry asks the Bank to report on its experience of investing in unlisted companies where the board has expressed an intention to seek a listing and consider whether the current regulation needs to be amended. The Ministry asks the Bank to report specifically on the extent to which the fund currently participates in initial public offerings and whether the Bank believes that access to invest the fund in companies at an earlier stage contributes to more efficient execution of the fund’s management. The Bank’s report follows in this letter. We begin by looking at a number of general trends relevant to investments in companies seeking a listing.

Trends

We have observed a decrease in the number of new listings since the early 2000s, and more companies are being delisted for various reasons.[1] The companies coming to

[1] This applies particularly in the US, where the number of listed companies has dropped almost 50 percent since the fund began investing in equities in 1998. The average number of companies coming to market each year was 218 in the period from 1980 to 2018, but 118 in the period from 2010 to 2018 (for further information, see Ritter (2019) “Initial Public Offerings: Updated Statistics”). Developments in the US are important because this market accounted for about 54 percent of FTSE Russell’s float-adjusted global stock index at the end of 2018.

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market are older and larger than before. Many have put this trend down to presumed benefits of remaining in private ownership. Companies may prefer to stay private in order to retain control over decisions and ownership. Regulatory changes have also meant that the costs of being listed have increased.[2] These costs impact more on small companies.

Parallel with this, we have seen a trend in recent years for private companies being able to raise capital on a scale previously only available to listed companies.[3] One explanation may be the emergence of alternative providers of long-term risk capital, such as sovereign wealth funds, large institutional investors, private equity funds and other large companies.[4] Another explanation may be technological advances that have made it easier for private companies and investors to find one another, including the emergence of a secondary market for shares in private companies.[5] A third explanation is that more types of investor are able to invest in private assets than in the past.[6]

The increased availability of capital for private companies means that raising capital is no longer necessarily the main aim of going public. An initial public offering (IPO) is also an opportunity for founders, employees and other shareholders to realise their assets. This was clearly illustrated by the listing of Spotify in April 2018 and Slack in June 2019. Both opted for a "direct" listing, and both raised capital from institutional investors less than a year before the IPO.

The key difference between an ordinary listing and a direct listing is that the companies do not issue any new shares as part of the process. This allows existing shareholders to sell their shares straight away to give the stock the necessary liquidity. With an ordinary listing, shareholders will normally be subject to a lock-up period. Another difference is that the costs may be lower than for an ordinary listing. With a direct listing, the company can, in principle, be included in the fund's benchmark index for equities within days. Since no new shares are issued, index investors have to buy the shares they need in the secondary market.

Experience of investing in unlisted companies where the board has expressed an intention to seek a listing

The Ministry has asked the Bank to report on its experience of investing in unlisted companies where the board has expressed an intention to seek a listing. The Bank's review is to include the framework established in different parts of the Bank's governance structure, including any restrictions, the risk management framework and due diligence processes.

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[2] Regulation Fair Disclosure (2000), the Sarbanes-Oxley Act (2003) and the Dodd-Frank Act (2010) all brought changes in what is to be disclosed to investors and how.
[3] It is difficult to obtain quality data to document this, but we have made a number of comparisons in the enclosure to illustrate this trend.
[4] See, for example, Block, Colombo, Cumming and Vismara (2018) "New Players in Entrepreneurial Finance and Why They Are There".
[5] See, for example, Ewens and Farre-Mensa (2017) "The Evolution of the Private Equity Market and the Decline in IPOs".
[6] For more information, see, for example, Fontenay (2017) "The Deregulation of Private Capital and the Decline of the Public Company" and Vanguard Research Note (2017) "What's Behind the Falling Number of Public Companies?".

The Bank's framework for investing in unlisted companies sets requirements for the management, control and monitoring of relevant risks in the same way as for other investments. Before an investment can be made, both the market where the company is to be listed and the instrument must have been approved, cf. Section 4-10 of the management mandate. This approval is carried out on the basis of the Executive Board's risk management principles. The aim of the approval process is to ensure that relevant risks are identified, evaluated and accepted, and that the decision to approve a new market or a new instrument is consistent with the fund's overall investment strategy.[7]

Unlisted companies are not traded on regulated market places. In practice, this means that they are less liquid and less standardised. An investment must therefore be preceded by thorough review (due diligence) of financial, legal, tax and commercial matters deemed relevant to the investment.

The Bank has considered investing in a number of companies seeking a listing but has done so only once. In May 2012, we entered into an agreement with the investor group CVC on the purchase of 4.2 percent of the company Delta Topco Ltd. At that time, the company's board had applied for admission to the Singapore Stock Exchange.[8] Due to changing market conditions, the board then decided in June 2012 to postpone the listing. We chose to remain a shareholder in the company. Delta Topco was subsequently sold to Liberty Media in 2017 in return for listed shares in the latter. Shares in Liberty Media were already part of the fund's benchmark index at that time. Delta Topco paid substantial dividends during its period of private ownership. Once account is taken of differences in market risk, the total return on the investment was in line with the broad equity market.

The Ministry has asked the Bank to describe how it handles situations where companies in which the GPFG is invested may not come to be listed after all. The Bank's handling of the investment in Delta Topco illustrates how the Bank would normally approach such a situation. We will always consider different options in the light of the fund's role as a financial investor. The possibility of remaining a shareholder in the unlisted company gives the Bank an advantage over a situation where we were forced to sell the stock within a set period. During the time that the Bank held these unlisted shares, they were valued in line with IFRS and presented in the notes to the financial statements. Risk management, control and monitoring of the investment were performed in accordance with established principles and processes. Our experience is that the established framework worked well.

Investments in listed companies through participation in public offerings

The Ministry asks the Bank to report on the extent to which the GPFG participates in initial public offerings and whether the Bank believes that access to invest the fund in

[7] The Bank's policy on the approval and monitoring of the fund's investment universe is available at www.nbim.no.

[8] This investment complied with the management mandate. See, for example, the discussion in Norges Bank's Supervisory Council's report to the Storting for 2014.

companies at an earlier stage contributes to more efficient execution of the fund's management.

The fund participates frequently in initial public offerings and in transactions in the wake of these offerings. We have found that investors who take a passive approach to capital market transactions are at risk of a smaller allocation in public offerings than would be ideal. To reduce the chances of this, we have chosen in recent years to work more actively with sponsors, shareholders and companies considering such transactions.

The supplier of the GPFG's equity index, FTSE Russell, sets rules for the inclusion of newly listed companies in the fund's benchmark index. Participation in public offerings can contribute to more efficient management of the fund by investing the fund in shares before they are included in the benchmark index. Current rules mean, for example, that new companies are included in the index at regular, predetermined intervals. Their shares are therefore normally traded on the exchange for a certain period before they are included in the index. Some large companies, however, may qualify for earlier inclusion.[9]

Not all shares that are listed become included in the index. In more than half of the offerings in which the fund has participated since 2016, the shares have yet to be included. This applies primarily to listings of small companies. It can be difficult to ascertain in advance whether or when these small companies will be included in the index. Shares that are not included in the index are retained if they are a good match for the fund's overall portfolio.

The Ministry has also asked the Bank to compare the return and risk characteristics of investments in unlisted companies where the board has expressed an intention to seek a listing, and participation in public offerings. We do not have sufficient data to draw a direct comparison between these two strategies. Over time, participation in initial public offerings has generated an excess return over purchasing the shares immediately after listing.[10] This excess return varies from transaction to transaction and from market to market. All in all, the fund's participation in such offerings over the past five years has produced an excess return over shares in the same sector. For a general discussion of the return and risk characteristics of investments in unlisted shares, we would refer to the report from the Ministry's expert group[11] and the Bank's letter of 8 January 2018.

Overall conclusion

As presupposed by the Ministry in 2011, access to invest in companies before they are listed enables the Bank to exploit the fund's special characteristics and helps ensure

[9] FTSE Russell sets the rules for how this is to be handled. Large companies may be eligible for "fast entry" and be included in the index five days after admission. These have accounted for only 20 of the more than 400 offerings in which the fund has participated since 2016. Measured in terms of capital, however, these companies account for a much larger share. The average return on these 20 companies in the five days before inclusion in the index is 11 percent.

[10] See, for example, Loughran and Ritter (2002) "Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?" and Leite (2007) "Adverse Selection, Public Information, and Underpricing in IPOs". See also https://site.warrington.ufl.edu/ritter/files/2019/07/Monnew-1.pdf for an update of the study.

[11] https://www.regjeringen.no/no/aktuelt/ekspertrapporter-om-spu/id2585465/

efficient execution of the fund's management. When it comes to the latter, this will be most relevant for large companies included in the benchmark index shortly after listing.

The Bank is of the opinion that the wording of the current regulation that the board must have expressed "an intention" to seek a listing should be amended. To date, we have interpreted this mandate regulation as requiring a concrete board resolution to apply for listing in the near future. Our experience is that such resolutions are passed relatively late in the process, and that a number of transactions that might have been relevant to the fund have not therefore been pursued. The investment in Delta Topco goes to show that it is not certain that listing will actually take place even when the company's board has submitted a formal application.

One alternative to the current regulation is to allow the fund to be invested in unlisted shares in large companies that are not yet listed. Companies of this type will often already have other institutional investors as shareholders. This, in turn, can help generate some liquidity in the shares. Based on experience, it is reasonable to expect some of these companies to go public at a later date. The probability of this is a matter that the Bank will need to prioritise in its due diligence. The option of investing in large companies that are not yet listed will make it possible for the fund to build up the desired exposure over a longer period.

The regulation of such investments should be designed such that the Bank is able to manage these investments in a way that supports the management objective. The fund should be permitted to invest in unlisted companies that are not yet listed for as long as the Bank considers this to be appropriate. In our opinion, the fund's investments in companies that are not yet listed should be regulated more closely in line with other investments that are not part of the benchmark index than is currently the case, through a combination of restrictions imposed by the Ministry and the Executive Board respectively. Clearer regulation can help ensure that the risk associated with such investments is adequately anchored.

If the wording of the mandate is altered in line with the Bank's proposal, the Ministry should set a limit for the weight of unlisted shares in companies that are not yet listed. The Bank believes that a limit of 1 percent of the equity portfolio would be sufficient to address the intentions behind this type of investment. The management mandate should also contain a requirement that the Executive Board is to issue supplementary risk limits. In the first instance, it would be natural for the Executive Board to set limits for the minimum size of these companies and for the maximum ownership share. In addition, the Executive Board may issue guidance on the markets in which the fund may make such investments.

Yours faithfully

Øystein Olsen　　　　　　　　　　　　　　　　　　　　　　　　Yngve Slyngstad

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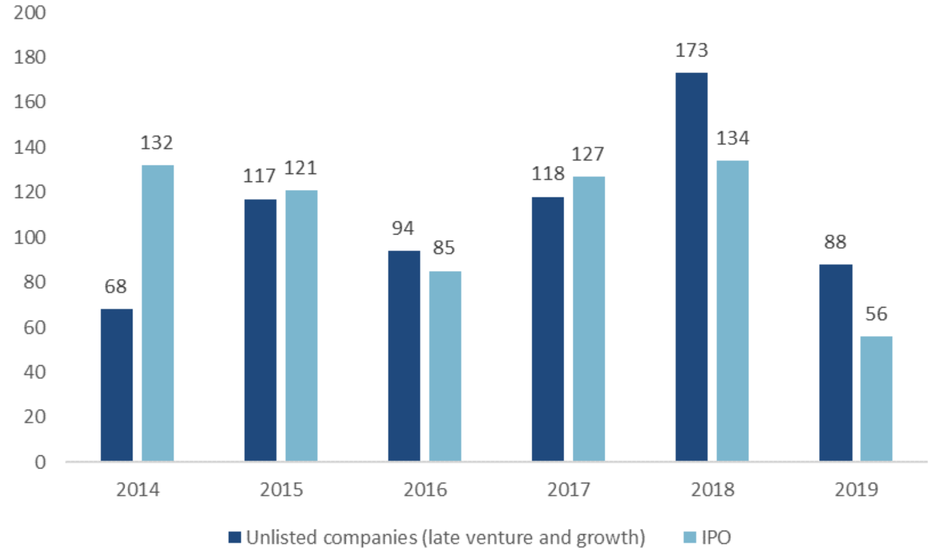
In Figures 1 to 4, we compare initial public offerings (IPOs) with PE-funds transactions in unlisted companies classified as late venture and growth since 2014. These private equity funds account for only a small share of the unlisted market, but the figures can still give an idea of the trends described in the letter. On average, around 110 billion US dollars has been raised each year in both types of transactions. The size of the private companies raising capital and the size of the transactions have increased since 2014.

Figure 1: Size of market for IPOs and PE-funds transactions in unlisted companies classified as late venture and growth, billions of US dollars



Source: Pitchbook, BAML, Dealogic and Norges Bank Investment Management. Data from 1 January 2014 to 1 July 2019. Estimates for unlisted companies in late venture and growth phase is based on transactions by a sub-set of private equity funds focusing on late-stage venture capital and growth equity. For both types of transactions, we have excluded a number of sectors in order to reflect the investment universe relevant to the GPFG as best possible.

Figure 2: Size of PE-funds transactions in unlisted companies classified as late venture and growth

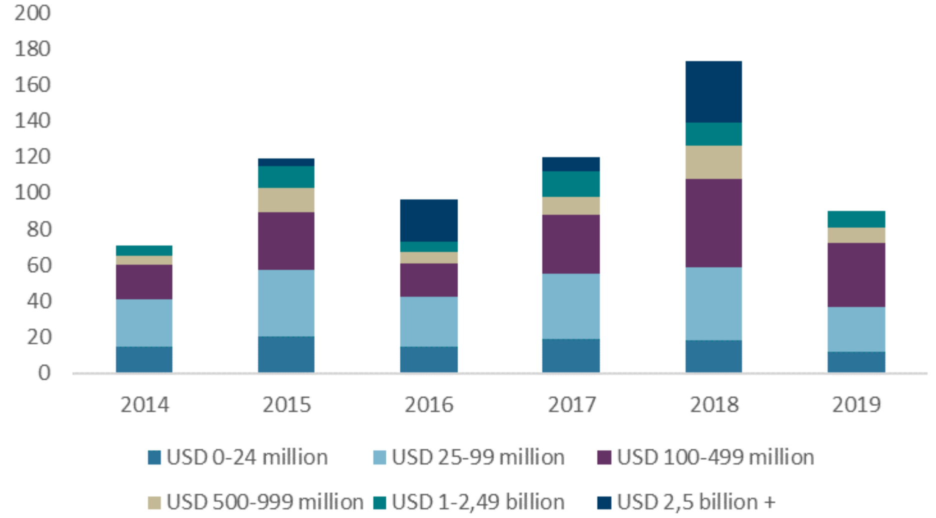


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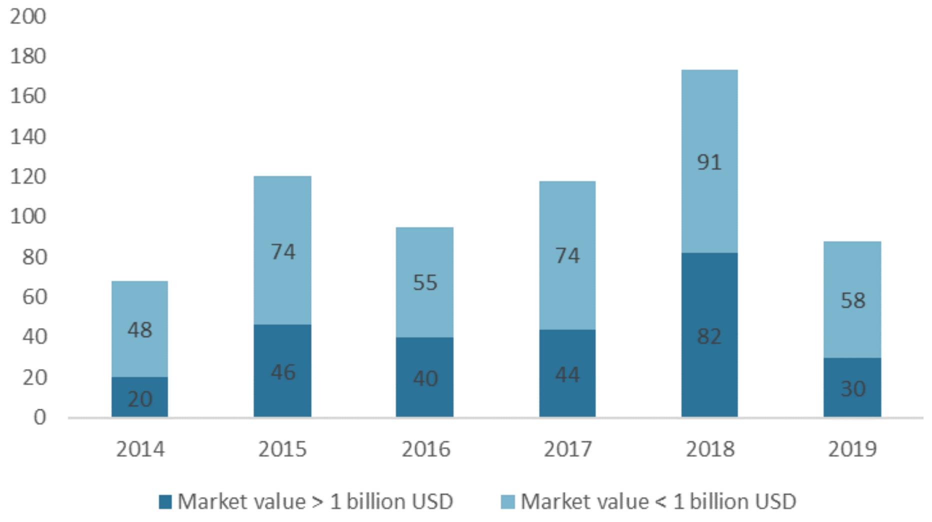
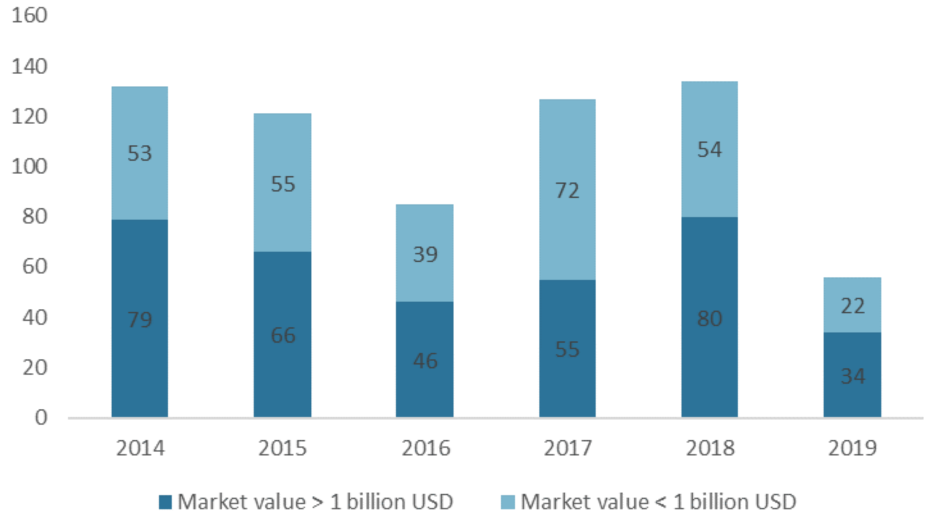
Figure 3: PE-funds transactions in unlisted companies classified as late venture and growth by market value of companies



Source: Pitchbook, BAML and Norges Bank Investment Management. Data from 1 January 2014 to 1 July 2019. Estimates for unlisted companies in late venture and growth phase is based on transactions by a sub-set of private equity funds focusing on late-stage venture capital and growth equity. We have excluded a number of sectors in order to reflect the investment universe relevant to the GPFG as best possible. Companies broken down into market value above ("unicorns") and below 1 billion dollars.

Figure 4: Size of market for IPOs by company market value



Source: Dealogic and Norges Bank Investment Management. Data from 1 January 2014 to 1 July 2019. We have excluded a number of sectors in order to reflect the investment universe relevant to the GPFG as best possible. Companies broken down into market value above and below 1 billion dollars.