Is the Lingering Criticism of Using Pre-IPO Studies for DLOM Justified?

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The use of pre-IPO studies to measure a discount for lack of marketability has gained acceptance among valuation analysts and the Tax Court even though the method continues to be a target of some criticism. Of course, criticism can be made of all data that BV practitioners use. The trouble is, this criticism can sometimes be based on “old” facts, which can lead to misinformation.

Pre-IPO studies and restricted stock studies are the two general types of empirical evidence of the existence and magnitude of the DLOM. Restricted stock studies compare the trading prices of a company’s publicly held stock sold on the open market with those of unregistered or restricted shares of the same company sold in private transactions. The pre-IPO studies move a step closer to measuring DLOM for closely held business interests than the restricted stock studies. They consist of transactions in privately held stocks prior to an initial public offering compared with the subsequent public offering price in the same stock.

Over the years, three main sources of pre-IPO data have emerged. The Willamette Management Associates studies cover the period from 1975 to 2002. The John Emory studies cover the period from 1980 to 2000. The Valuation Advisors Lack of Marketability Discount Study is an ongoing study and commercial database that has current information and is updated regularly.

Key court cases. In 1998, the Tax Court recognized the relevance of pre-IPO studies in Davis v. Commissioner, finding that “the prevaluation date data in the IPO studies are relevant and provide some insight into the price differences between stock that is freely tradable and [stock that] is not freely tradable.” In 2003, the Tax Court rejected the use of pre-IPO studies in McCord v. Commissioner. Dr. Mukesh Bajaj was the expert witness for the IRS, and the court opinion states: “[i]n his rebuttal testimony, Dr. Bajaj offers a compelling criticism of both the Willamette studies and [the Emory studies].” There was no such criticism directed at the Valuation Advisors Pre-IPO database. Bajaj proposed an alternative method that was a variation of restricted stock analysis.

Valuation analysts have been extremely critical of the McCord decision. Restricted stocks are, by definition, stocks of publicly traded companies that are prohibited from public trading for some limited time. When the restrictions expire, they can be freely sold into an established public market. But an interest in a private company that has no established market (and is not likely to ever have an established market) is less marketable than the restricted stock of a public company. Therefore, DLOM calculations based on a group of restricted stocks need to have an upward adjustment to reflect the lesser marketability of the closely held interest.

The alternative to using restricted stock studies is to use pre-IPO studies. Many valuation analysts use both methods, plus information from other sources. Regardless, there is some ongoing criticism over the use of pre-IPO studies to measure DLOM.

BVU recently sat down with Brian Pearson of Valuation Advisors LLC, who developed the Valuation Advisors Lack of Marketability Pre-IPO Discount Study. This is the only online database
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One that is coming up recently is the issue of “double counting” of the discount. That references are significant, we choose to exclude actions in the database. This makes it the largest source of DLOM data for BV professionals.

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Our database is exhaustive. It includes all IPOs except REITs, LPs, and companies with no transactions. REITs and LPs typically pay high dividends, which give them a yield, which is different from most privately owned common stock, which typically doesn’t pay recurring dividends. LPs are pass-through entities, which typically share profits with partners, whereas REITs, by law, must distribute 85% of their current-year ordinary income to owners. Since these differences are significant, we choose to exclude these transactions from the database.

**BUV: What is the source of the information contained in the study and database?**

**BUV: Do you update the database as new companies go public?**

**BP: Yes. We get prospectuses for new IPOs usually the week after they go public. It takes some time to review the information and compile it for the database, but the database is updated for new IPOs at least once per month.**

**BUV: Does your study include all IPOs?**

**BP: Our database is exhaustive. It includes all IPOs except REITs, LPs, and companies with no transactions. REITs and LPs typically pay high dividends, which give them a yield, which is different from most privately owned common stock, which typically doesn’t pay recurring dividends. LPs are pass-through entities, which typically share profits with partners, whereas REITs, by law, must distribute 85% of their current-year ordinary income to owners. Since these differences are significant, we choose to exclude these transactions from the database.**

**BUV: There’s been some criticism over the years about the data in the pre-IPO studies. One that is coming up recently is the issue of “double counting” of the discount. That is, some of the transactions in the database are calculated with a DLOM already in them.**

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**BP:** Double counting of discounts is not occurring when viewed in the larger context of the transaction. While it is true that some of the transactions include a prior discount, it helps to understand the process by which this “discount” was calculated. Under the fair value standards for option and stock issuance and the AICPA’s guide to fair value, the commonly used valuation method of PWERM (probability-weighted expected return method) requires consideration of a DLOM. So if the enterprise value is $10 per share and the CPA BV professional, under the fair value guidelines, assigns a 30% discount, the reported transaction price is $7. If the company goes public at $12, in theory, you have two discounts at two different periods (30% and 20%). However, this is where the theory of multiple discounts fails, since in reality the transaction is just one transaction, from the time of investment until the time of liquidity (i.e., the IPO date).

Prior to the fair value standards, in an arm’s-length negotiation of the price, the same process would have occurred, except it would simply have been reported as a $7 transaction with the discount as (($12 - $7)/$12, or 41.66%). Thus, the concept of “two discounts,” although implicit in the process, wasn’t being publicly reported. In fact, the same level of DLOM is occurring in both situations—it’s just that the fair value standards for pre-IPO transactions shed better light on the process of how such pre-IPO values are being arrived at now.

Let’s look at it another way. If I assess ABC Company and believe on a 100% controlling basis that it’s worth $10 per share, I am certainly not going to pay that as a shareholder when there is no market to sell such shares. Let’s say we agree on a price at $7 per share, which reflects my illiquidity concerns and a 30% DLOM. Then, two years later, the company has an IPO at $15 per share. The implied two-year DLOM is 53.33%. The fact that I determined a DLOM to get to my $7-per-share value reflects the reality of the marketplace of real investors. The price per share is going to reflect my illiquidity concerns, not the prorata share of a 100% controlling value. Thus, the DLOMs in our database are consistent with the change in value from the stock being illiquid to the stock being liquid. If ABC Company doesn’t go public, clearly the shares aren’t worth $15—they are worth much less. Then the real “discount” is likely larger, since I have no immediate or likely avenue to gain liquidity.

**BVU:** There’s also been the argument that IPOs are overpriced due to hype.

**BP:** Interestingly, that argument is counter to another argument that IPOs are underpriced in order to have a successful offering. Both arguments are wrong. The privately held company owners generally don’t like to underprice the offering since they receive less money if they are selling shares, and it only makes the underwriters look good. Conversely, if you overprice the offering (such as Facebook) and the stock price falls, the offering is viewed poorly and the underwriters get a lot of bad press, which they do not want. Clearly, both sides, the owners and underwriters, have an incentive to “get it right” and not be greedy at the expense of the other.

Also, another key issue is that the investor road show helps both parties gauge demand for the shares. If it’s high, the offering price may be raised or the number of shares sold increased. If demand is too low, the opposite happens, or the offering may be pulled altogether.

With the exception of a very well-known company like Facebook where media and user hype created a huge demand for the shares allowing the underwriters and company owners to get piggy, I think you can see that the process is really driven by investor demand counterbalanced by the underwriters’ ability to gauge the demand and set a fair price. In 95 out of 100 times, it works perfectly. Thus, both the overpricing and underpricing criticisms are unfounded.

**BVU:** Do IPO studies imply overly large returns?

**BP:** When investors buy into a closely held IPO company, they usually expect a 20%-to-35% return. If the company performs better, their returns are even better, and this would support the ability to both go public and the high rates of return implied by the discounts. Further, when you go beyond one year, the returns begin to compound, offering even more support for the returns implied from the pre-IPO discounts.
Also, the database has many negative discounts. This shows that, even in a “successful” company that managed to have an IPO, it was previously worth more, and investors have lost money on paper. When you can lose money on a successful offering, it shows why returns need to be high on pre-IPO transactions. A further example of this outcome is the money lost by investors in failed pre-IPOs. This is, of course, potentially a zero rate of return. These negative factors must also be considered in the “total” return investors receive, not just the successful, high-rate-of-return IPOs that are easy to identify.

**BVU:** What about the issue of a difference in earnings between the time of a transaction and the IPO?

**BP:** Clearly, if a company is growing, there will be an increase in the earnings during this time frame. This is to be expected. Presumably, a reasonably intelligent investor is going to ask to review forward projections that would incorporate such growth in earnings.

The price you pay for any asset is supposed to reflect all known future information. Therefore, an investor would clearly review and assess such information, so a lot of these changes in earnings should have been considered by the investor in determining the price per share that was used by them in their purchase (and is what we use in the database to determine the discounts). Clearly, actual performance will differ from projections used to determine the original price, but most of this difference (which represents future projected growth) should have already been considered in the original transaction.

**BVU:** Any other comments you’d like to make?

**BP:** If you’re going to use pre-IPO studies as one of your DLOM methods—and the IRS and Tax Court have pretty much said you should—you should use the latest data. Our database is updated monthly. For example, in 2013, we added more transactions to the database than in any year since 1999. Also, it’s the largest database of such information in the world. If you’re not using the most currently available data or you are simply citing older studies in your valuation reports, you are simply highlighting that your research and data are old and outdated.

For more information on the Valuation Advisors Lack of Marketability Discount Study, go to www.bvmarketdata.com, which includes details of the database, sample data, FAQs, and more.