

Rebuttal to Bajaj: answers to criticisms of pre-IPO studies

By Shannon Pratt, DBA, CFA, FASA, MCBA, CM&A, MCBC

Pre-IPO transactions should be presented in every valuation case regarding a discount for lack of marketability.

Detailed pre-IPO data well received

Courts universally have reacted favorably when actual pre-IPO transactions have been presented, as in *Estate of Gallo v. Commissioner*,¹ *Howard v. Shay*,² and *Okerlund v. Commissioner*.³ Courts have acted almost as favorably when detailed explanations of the pre-IPO studies and their results have been presented, as in *Mandelbaum v. Commissioner*⁴ and *Davis v. Commissioner*.⁵

Now that restricted stock discounts have shrunk due to loosening of SEC regulations on trading of restricted stocks and general increases in the liquidity of the public stock market, the pre-IPO studies are more relevant than ever before. But recent flawed attacks on the pre-IPO studies have gone largely or totally un rebutted, casting unwarranted doubts on the validity of the pre-IPO studies.⁶

Answer to pre-IPO study attacks

The purpose of this column is to provide answers to some of the attacks against the use of pre-IPO transaction evidence by Dr. Bajaj and a few others. It is a very brief summary, but with some extensive references.

“Ad hoc selection”

First Dr. Bajaj says “The sample selection in these studies is ad hoc and unexplained. There are many, many more IPO’s each year than any of those studies cover, and there is no description of what firms were considered, “how the data was picked, and why certain firms were not considered.”⁷

In fact, the studies on the Valuation Advisors Discount for Lack of Marketability Database cover *every* company IPO in recent years (over 2,200 transactions in all).

IPO hype

A few have said that IPO prices are inflated because of “hype.” But many responsible studies have concluded that the opposite is true—IPOs are, often intentionally, underpriced.⁸

IPO studies imply “incredibly large returns”

Dr. Bajaj has made the point on several occasions that a 50% discount 6 months before an IPO implies 200% annualized returns, which “simply defies logic.” This argument is flawed in two ways.

First, it implies that investors in pre-IPO stock can gain liquidity at the time of the IPO. This is not generally true. Most underwriters will not register selling shareholder stocks on the IPO. Those that do register it generally have an extended “lockup” period before the existing shareholders can sell.⁹

Second, it implies that a comparable investment opportunity will be available to and recognized by the investor immediately. This is almost never true.

IPO’s timed with rising earnings

One criticism of the IPO studies is that the earnings at the time of the IPO may be higher than the earnings at the time of the private transaction.

The reported results of the Willamette studies already reflect an adjustment for differences in earnings between the time of the private company transaction and the time of the IPO.¹⁰ Analysts using the Valuation Advisors or Emory data can go to the SEC filings and make this adjustment. I have made the adjustment for difference in earnings many times, and the results tend to average 45-50% discount after the adjustments.

Data errors

Dr. Bajaj says he found “data errors” in the John Emory studies. Emory rechecked *all* his data from 1980 forward, and the corrections resulted in less than one percentage point change in the results.¹¹

Transactions reflect “compensation for services”

Another criticism is that buyers of the shares prior to the IPO are likely to be insiders who provide some sort of compensation to the firm. Thus, part of the discount may reflect compensation for these services rather than compensation for the lack of marketability.

In fact, the Willamette studies attempt to eliminate insiders. The Emory and Valuation Advisors studies contain a substantial amount of arm’s-length transactions, usually with institutional investors, who usually have rights that make their stock *more* valuable than the common stock with which it is compared at the time of the IPO.

One-third to one-half of the pre-IPO transactions in recent years are convertible preferred stock, which, of course, is more valuable than the common stock with which its price is

compared. Also, many of the institutional investors demand “put” rights. These factors would result in a downward bias in the calculated discounts.

Selection bias

One criticism is that only companies that eventually have successful IPOs are selected. However, the effect of this bias is minimal. Only about 20% of companies that file for IPOs fail to have them when scheduled. Some are merely delayed, and others are acquired. Still others remain as viable private companies. Very few actually become worthless.

Summary and conclusion

The pre-IPO transactions are actual transactions in private company stock, although it is probable in most instances that the parties to the private transaction anticipated an IPO at the time of the transaction. Although the studies are not perfect (what is perfect in business valuation?), they are an important part of the body of empirical evidence supporting discounts for lack of marketability.

For every criticism of the IPO studies, there is an answer. The serious student can look up the references supporting the assertions in this column. It is my hope that this column will prove helpful to analysts in using pre-IPO studies more frequently, more effectively and with greater confidence as evidence to quantify discounts for lack of marketability.

1. *Estate of Gallo v. Commissioner*, T.C. Memo 1985-363, 1985 Tax Ct. Memo LEXIS 273 (July 22, 1985).
2. *Howard v. Shay*, 100 F.3d 1484 (9th Cir. Nov. 22, 1996).
3. *Okerlund v. U.S.*, 53 Fed. Cl. 341, 2002 U.S. Claims LEXIS 221 (Aug. 23, 2002).
4. *Mandelbaum v. Commissioner*, T.C. Memo 1995-255, 1995 Tax Ct. Memo LEXIS 256 (June 12, 1995).
5. *Davis v. Commissioner*, 110 T.C. 530, 110 T.C. No. 35 (June 30, 1998).
6. Shannon P. Pratt, “Editor believes Tax Court erred in McCord case illiquidity discount,” *Shannon Pratt’s Business Valuation Update* (July 2003) : 1, 5.
7. “Discounts for Lack of Marketability: Uses and Misuses of Databases” Telephone Conference, May 13, 2004, CD-ROM and transcripts available from Business Valuation Resources, www.bvresources.com.
8. See, for example “Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling,” Rajesh K. Aggarwal, Laurie Krigman, and Kent L. Womack, *Journal of Financial Economics* (October 2002): 105-137; Allen, F., Faulhaber, G. R., 1989, “Signaling by underpricing in the IPO market,” *Journal of Financial Economics*, 23, 3003-323; Jenkinson, T., Ljungqvist, A., 1996, *Going public: The theory and evidence on how companies raise equity finance*. Oxford: Clarendon Press; Reese, W. A., 2000, *IPO underpricing, trading volume, and investor interest* [working paper], Tulane University; Ritter, J. R., 1991, “The long run performance of initial public offerings.” *Journal of Finance* 46, 3-27; Welch, I., 1989, “Seasoned offerings, imitation costs, and the underpricing of initial public offerings” *Journal of Finance* 44, 421-449.
9. See, for example Bradley, D., Jordan, B., Roten, I., Yi, H., 2000, “Venture capital and IPO lockup expiration: an empirical analysis,” *Journal of Financial Research*; Brav, A., Gompers, P. A., 2000, *Insider trading subsequent to initial public offerings: Evidence from expirations of lockup provisions* [working paper], Duke University; Field, L. C., Hanka, G., 2001, “The expiration of IPO share lockups,” *Journal of Finance*, 56, 471-500; Ofek, E., Richardson, M., 2000, *The IPO*

- lockup period: Implications for market efficiency and downward sloping demand curve [working paper], Stern School of Business, New York University.
10. For a description of the Willamette Management Associates Pre-Initial Public Offering Studies see Shannon P. Pratt, *Business Valuation Discounts and Premiums* (New York: John Wiley and Sons, 2001), pp. 84-85.
 11. John D. Emory Sr., F.R. Dengel III, and John D. Emory Jr., "Emory responds to Dr. Bajaj – minuscule adjustments warranted," *Shannon Pratt's Business Valuation Update* (May 2002) : 1, 3.

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