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The Increase of Initial Public Offerings (IPOs) in 2013 and the Impact on Lack of Marketability

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SPECIAL FEATURE

The Increase of Initial Public Offerings (IPOs) in 2013 and the Impact on Lack of Marketability

By Brian K. Pearson, CPA/ABV/PFS/CFF, ASA

There has been a noticeable increase in the number of IPOs in 2013 versus 2012. Through Aug. 31, 2013, there have been 132 U.S.-based IPOs. This amount has already exceeded the total of 128 IPOs from all of 2012. Certainly the gradual rebound in the economy has helped the process, but a little-known law passed in 2012 has had a much bigger impact on IPOs this year.

New law. In early 2012, Congress passed a law called the Jumpstart Our Business Startups Act (the Act). The basic concept was to make it easier for smaller companies (so-called "emerging growth companies," hereinafter "EGCs") to have an IPO by lessening the initial and ongoing financial reporting requirements they are normally were required to disclose. This also lessens the cost and reduces the timetable for such companies to possibly go public, as well as lower some annual costs once a company is publicly traded.

Congress defined EGCs as companies with less than $1 billion in annual gross revenues in their most recent fiscal year. A publicly traded company will remain an EGC as long as it satisfies these four criteria:

1. Its annual revenues remain under $1 billion;
2. It is still within the five-year period from when it sold securities (that is, had an IPO) under the Act;
3. It has not issued more than $1 billion in debt during the previous three years; and
4. The company is not deemed to be a "large, accelerated filer" under SEC rules. This is a company with a market capitalization over $700 million and that has been publicly traded in at least one year.

The new law is favorable for IPOs because:

- Only two years of audited financial information need to be presented in a registration statement;
- It is not necessary to present "selected financial data" prior to the earliest audited financial period presented (that is, only two years);
- The company may not need to comply with any new or revised financial accounting standards until similar private companies are required to comply;
- Certain disclosures on CEO compensation may be limited;

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- The company can obtain confidential reviews and comments on registration statements (as was the case recently with Twitter);

- Research analyst coverage is less restrictive; and

- The law provides less restrictive communication with accredited investors and institutions.

Impact on DLOM. According to the Valuation Advisors Lack of Marketability database, a summary of the discounts in 2013 versus 2012 is as shown in the exhibit.

Summary of the Discounts in 2013 Versus 2012

		Under 2 Years Timeframe
IPO Year	Median Revenues	Median Discount
2013	$53,587,000	38.60%
2012	$103,389,000	29.80%

As the exhibit shows, the size of the discounts in 2013 is greater than 2012, while the company size (based on revenues) is significantly smaller. Clearly, this is a result of EGCs with more speculative futures going public. The new law has made these offerings easier. A basic business valuation tenet is that as risk rises, so does the required return. Higher valuation discounts provide higher returns to the owner.

For example, in 2013 seven companies with no revenues went public versus five in 2012. Further, in 2013, 19 companies with revenues under $25 million went public versus seven in 2012.

What's quite stunning is how the new law has quickly changed the liquidity prospects for smaller companies with promising futures. It wasn't long ago that the capital markets were virtually seized up, with no growth capital available to fund IPOs. The new law has kick-started the process again. In particular, the largest beneficiaries of the new law have been medical companies that need large funding to

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carry out further research and development, testing, and product rollout. Since these companies are very speculative, higher lack of marketability discounts should be expected and, in fact, have occurred.

As the IPO market continues to spring back to life, especially with the aid of the Jumpstart Act, we will continue to monitor the IPOs of emerging growth companies and update you on the trend in their valuation discounts.

For those readers interested in knowing more about the Act, we have provided below a more detailed discussion of the Act's key provisions:

- *Confidential Review of Draft Registration Statements.* Section 106 of the Act allows emerging growth companies the option to receive confidential review of an IPO registration statement by the SEC. Thus, preliminary draft registration statements (as well as any subsequent SEC comments) generally will not appear on the SEC's EDGAR website while the company is preparing for its IPO. Since a company must publicly file its initial IPO registration statement (and any amendments thereto) at least 21 days prior to its anticipated "road show," this confidential review process will better allow a company to determine when to file its documents. This could minimize the risk of potential delays or cancellation associated with market volatility or other company-related operational or strategic issues.

- *Scaled Executive Compensation Disclosure*. The JOBS Act permits reduced executive compensation disclosure in the IPO registration statement of an emerging growth company. An emerging growth company will be permitted to provide: (i) executive compensation disclosure for three named executive officers (specifically including the principal executive officer, but not the principal financial officer) rather than five officers; (ii) Summary Compensation Table disclosure for two years rather than three years; (iii) two of the other six tables typically required; and (iv) an alternative narrative disclosure.

- *Testing the Waters.* Under the Act, emerging growth companies are allowed to communicate with institutional accredited investors and qualified institutional buyers to gauge interest in IPO securities without being subject to the traditional prohibitions on pre-IPO publicity. These types of communications would allow emerging growth companies to weigh institutional investor interest during the IPO registration process even prior to the time of the initial filing of a registration statement, thereby providing management with greater insight into the likely success of an IPO prior to incurring the expense and time allocation associated therewith, all without expectations being set in the public domain if confidential review is requested.

- *Reduced Research Analyst Restrictions.* Under the Act, research analysts of investment banking firms that are a part of the underwriting syndicate of an emerging growth company would not be prohibited from publishing research related to the company around the company's IPO. In addition, research analysts would be allowed to participate in meetings with the company in the presence of members of its investment banking team.

Key post-IPO considerations. A company's status as an emerging growth company may be temporary. Many issuers who conduct IPOs could become "large accelerated filers" within the first several years following their IPO. Accordingly, companies should be mindful of the more stringent requirements that become applicable upon ceasing to qualify as an emerging growth company and be aware that such requirements may apply sooner than expected.

Brian K. Pearson *is the managing member of Valuation Advisors LLC, a Buffalo, N.Y.-based valuation firm, and the creator of the Valuation Advisors Discount for Lack of Marketability database, available at BVResources.com.*

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