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Market Volatility and Its Impact on the Valuation Advisors Pre-IPO Database

The recent stock market volatility highlights the general risks inherent in capital markets. Often, this is felt the most by companies in the process of an initial public offering (IPO). This has ripple effects on pre-IPO studies, which are used to estimate a discount for lack of marketability (DLOM). During a recent webinar,[1] Brian Pearson (Valuation Advisors) addressed several risks pre-IPO shareholders face. Pearson is a senior valuation practitioner and creator of the Valuation Advisors Lack of Marketability Discount Study, an online database with close to 15,500 pre-IPO transactions spanning over 25 years.

Survivor bias? Pre-IPO studies examine the price of stock transactions before the stock is publicly traded and compares it to the price at some future event, such as when the IPO price is set or when the IPO actually occurs. The use of pre-IPO studies for estimating a DLOM has been accepted by courts and supported by authoritative texts and professional education courses in business valuation. There have been some misconceptions and criticisms about the use of pre-IPO studies; many of them have been effectively rebutted. For instance, an old criticism was that "the discounts only reflect successful offerings." In other words, "survivor bias" overstates the DLOM because the less successful companies (those with lower values and lower implied discounts) likely canceled their IPOs or could never go public and therefore are not in the pre-IPO studies.

1 Pre-IPO Revival: Up Your DLOM Game in 2020, BVR webinar (Jan. 29, 2020); a free recording is available at sub.bvresources.com/trainingeventpast.asp?WebinarID=752.

Pearson notes that this argument only reinforces the opposite: that pre-IPO discounts may likely understate overall discounts if you count all the companies that could never go public or have to postpone or pull their IPO due to market conditions. Another possible impact of such market conditions is a reduced IPO price, which results in lower discounts in the "successful" transactions database. For those companies that postpone their IPO permanently or can never go public, the presumed discount is likely much higher than the so-called "successful offerings."

Recent example. In 2019, GFL Environmental, the fourth largest waste disposal company in North America, filed to go public and later pulled its offering, finding the market conditions unacceptable for the stock pricing it desired ($20 to $24). The company refiled to go public in January 2020 and set a price range of $20 to $21. On March 3, it priced its IPO at $19, below the range it desired. To make matters worse, the stock fell 8% after it first day trading, and the company increased the size of its offering to compensate for the lower IPO price. This means that existing shareholders were further diluted due to the increased share offering and the pre-IPO discount figures from its pre-IPO transactions in the Valuation Advisors database are lower also (an example of one of the many factors that result in lower, not higher, reported discounts).

More important than just the absolute percentage of the reported pre-IPO discount, the GFL example points out one of the many risks private-company investors face: Market conditions can and do significantly impact the marketability of their shares.

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As with any approach or database, the Valuation Advisors Pre-IPO database can be a valuable tool if used properly. That is, you must understand the underlying data and the issues and limitations of the data and address all of that in your written analysis. Also, you should not rely on only one approach for estimating a DLOM. Evidence from several sources should be assembled and integrated into your analysis. Restricted stock and pre-IPO studies are the two main methods, along with *Mandelbaum* factors.