



VALUE ADDED™

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IPO Pricing and Fair Market Value

The process of "going public" is exciting for those companies fortunate to grow to the point of being sufficiently attractive to the public stock markets. Companies "going public" go through a process called an *initial public offering*, or an IPO. It is important to realize, however, that there can be a significant difference between the IPO pricing of a company and the fair market value of its minority interests prior to the IPO.

In an IPO, the public is offered the opportunity to buy shares in a company that does not exist prior to the IPO. Relative to their formerly private configurations, purchasers of IPO shares receive shares in companies that have:

- **New Capital.** Generally there is an injection of capital from the IPO. This capital often recapitalizes a newly public company's balance sheet, changing its financial risk profile relative to its pre-IPO days.
- **Increased Earnings Capacity.** The newly raised capital changes the earnings capacity of a company. At the very least, earnings are augmented on a *pro forma basis* as result of the interest earnings to be expected from the new capital.
- **Increased Growth Prospects.** With new capital and increased earnings capacity, the growth prospects of a newly public company are often changed significantly. The market prices the new company based on these growth prospects.
- **A Public Market.** The IPO process is one of bringing a formerly private company to the public markets. A newly public company acquires hundreds, if not thousands, of new shareholders and an opportunity for an actively trading market for its minority shares.
- **Publicly Traded Stock.** While this may seem an obvious point, having publicly traded stock can facilitate growth of a newly public company through the ability to acquire other companies in stock-for-stock mergers or acquisitions that were simply not feasible prior to the IPO.

In other words, a newly public company is not the same company as the company that existed just prior to the IPO. Prior to an IPO, discussions about the ultimate pricing at the time of the IPO are discussions about a *hypothetical company* or one that will not exist until the conditions of the IPO have been fulfilled.

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Converting Distributions from "S" Corporations and Partnerships to a "C" Corporation Dividend Equivalent Basis

A key consideration in determining the appropriate marketability discount for any illiquid investment is the current cash return it provides to potential investors. The bulk of public comparative data on dividend yields is derived from the ratios of dividends to market price for "C" corporations, real estate investment trusts (REITs) and closed-end mutual funds. These three entities all share the same characteristic: in general, taxable income to investors is identical to cash distributed to investors.

For "S" corporations and partnerships, taxable income and distributions may

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The fact that there is a difference in the pricing of private companies within a short time prior to their actual IPOs has been the subject of considerable study. The most prominent of these studies is an ongoing series published by John D. Emory of Robert W. Baird & Company, Inc. The Emory studies have found that transactions occurring within five months of actual IPOs take place, on average, at about a 45% discount to the ultimate IPO-pricing. And while there is considerable variability in Emory's underlying data, the average results have been consistent over some seven studies conducted since 1980.

The Emory studies show clearly that there is substantial value in the relief from illiquidity brought about by an IPO. These studies have been cited many times by business appraisers as a basis to substantiate marketability discounts for minority interests in private companies.

A recent decision in the U.S. Tax Court considered the factors mentioned above and affirmed the basic differences between a private company, prior to an IPO, and the newly public company after its IPO (See *Eyler v. Commissioner*, T.C. Memo 1995-123. Call for a copy of the case).

In *Eyler*, the Court rejected the taxpayer's assertion that the price paid by an Employee Stock Ownership Plan ("ESOP") for a company's stock, which was based on an abandoned IPO offering price several months earlier than the ESOP transaction date, was the fair market value of the company's shares for purposes of the ESOP at its transaction date. The Court made several points in the decision:

- A company's *potential for earnings* is one of the primary determinants of value. An IPO price is based on a pro-forma estimate of earnings. While some known facts, such as historical earnings

and the trend of earnings in recent years, are considered, a projection of future earnings is one of the primary components of value. These projections reflect the use of the new capital injected into the company through the public offering.

- The underlying assumptions imbedded in the IPO pricing included a projection of earnings based upon a successful IPO and a capital infusion into the company. In an analysis of fair market value, the past performance of a company is typically an analyst's best evidence of expected future performance and current earning power is projected based upon past performance and future prospects. The prospects assumed for the IPO did not exist for the ESOP with no IPO.
- In an IPO, underwriters generally develop a range of value based upon a due diligence review, pro-forma earnings, and the price/earnings multiples of similar publicly traded companies. The value range is established as an estimate and does not represent the value of the company at a particular point in time.
- A determination of fair market value is a question of fact and, in general, is the value as of a particular date based upon market conditions and the facts available on that date. The IPO range of value is developed in order to determine the degree of interest of potential purchasers for the stock. Ranges of value are not considered binding. Further, the pricing range can often shift during the period leading to an IPO, depending upon market conditions and a company's performance.

IPO pricing is also influenced by what is commonly referred to as the Wall Street, or IPO "window." IPO markets are sensitive and cyclical. Attractive IPO markets occur when low interest rates affect the yield on fixed income

securities and investors look to the public equity markets for higher returns on investment or when earnings projections are optimistic and alternative investments are limited. The window is considered to be open when the timing is right for an offering. The window can slam shut at any time, which will adversely affect the pricing or even the feasibility of an IPO.

Offering prices are affected by a number of other factors which result in a price that can be very volatile, particularly in the days just prior to the offering. A pre-offering discount to the determination of IPO value may be applied in order to entice institutional investors to buy the stock, while a prestige premium may be applied to the stock of certain types of industries or to particular companies within an industry. Often, underwriters' fees are negotiated just prior to the offering and can have a significant impact on the price. Demand for the stock at the time of issuance may also result in a price that differs substantially from the "final issue price" determined by the underwriters the day before an IPO.

Finally, one of the major differences in IPO pricing and a determination of fair market value is the liquidity of the stock. Once a company goes public, its shares become marketable. The stocks of privately held companies do not have this characteristic and the value is discounted accordingly. In other words, value is enhanced by the shareholder's ability to trade the stock on an open market.

The bottom line is that it is not realistic to compare the pre-IPO, illiquid value of a closely held stock with the IPO pricing of that same stock without adjusting for the IPO and the changes it has on value.

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Converting Distributions from "S" Corporations and Partnerships to a "C" Corporation Dividend Equivalent Basis

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differ significantly. In the example below, an "S" corporation/partnership has \$1.0 million of annual taxable income attributable to its shareholders/partners, \$650,000 in annual cash distributions, and a fair market value on a marketable, minority interest basis (that is, before discounting for lack of marketability) of \$5.0 million (5.0x pre-tax income). At first glance the gross distribution of \$650,000 would appear to imply a generous dividend yield of 13.00% per annum (\$650,000 divided by \$5.0 million). However, one must remember that a shareholder/partner's personal tax liability is based on *income of \$1.0 million*, not the amount of the distribution.

TABLE 1
S-Corporation Example

"S" Corporation/Partnership Distribution		\$650,000
"S" Corporation/Partnership Taxable Income	\$1,000,000	
Less: State Taxes @ 6%	(60,000)	(60,000)
	940,000	
Less: Federal Taxes @ 39.6%	(372,240)	(372,240)
Net Income to Shareholders/Partners	\$567,760	
Net, After-Tax Distribution to Shareholders/Partners		\$217,760
Combined State & Federal Income Taxes	\$432,240	

Assuming a state tax rate of 6% and a Federal rate of 39.6%, the shareholders/partners have an aggregate tax liability of \$432,240, resulting in a net, after-tax distribution of \$217,760. Under the same state and Federal tax rates, a \$650,000 distribution from a "C" corporation, REIT, or closed-end mutual fund would have a net, after-tax value of \$369,044 as calculated in Table 2.

TABLE 2
C-Corporation Example

"C" Corporation/REIT/Closed End Fund Dividend	\$650,000
Less: State Taxes @ 6%	(39,000)
	611,000
Less: Federal Taxes @ 39.6%	(241,956)
Net, After-Tax Dividend to Shareholders	\$369,044
Combined State & Federal Income Taxes	\$280,956

TABLE 3

Blended Personal Tax Rate $[6\% + ((100\% - 6\%) \times 39.6\%)] =$	43.2%
One Minus the Blended Personal Rate $[100\% - 43.2\%] =$	56.8%
Net, After-tax Distribution to Shareholders/Partners	\$217,760
Divided by One Minus the Blended Personal Tax Rate	<u>56.8%</u>
"C" Corporation Equivalent Dividend	\$383,380

Given that a \$650,000 dividend from an "S" corporation or partnership may be worth considerably less on an after-tax basis than an identical dividend from a "C" corporation, REIT, or closed-end mutual fund, it is clearly appropriate to adjust the "S" corporation or partnership distribution to a "C" corporation equivalent basis before making comparisons for valuation purposes. Such an equivalency is derived by "grossing up" the distribution by dividing the net, after-tax distribution by one minus the blended state and Federal personal income tax rate of 43.2% (as shown in Table 3).

Thus, in Table 3, a \$650,000 distribution from an "S" corporation or partnership is equivalent to a gross dividend of \$383,380 from a "C" corporation, REIT, or closed-end mutual fund. The various implied dividend yields are illustrated in Table 4.

TABLE 4

Assumed Value of "S" Corporation/Partnership on a Marketable, Minority Interest Basis (5.0x Pre-tax Income)	\$5,000,000	
	Dividend Amount	Dividend Yield
Gross Dividend & Implied Yield	\$650,000	13.00%
Net, After-Tax Dividend & Implied Yield	\$217,760	4.36%
"C" Corporation Equivalent Dividend & Implied Yield	\$383,380	7.67%

Use of the 13% gross distribution yield would tend to overstate the ongoing effective cash flows to investors in Table 4 and possibly lead one to apply an inappropriately small marketability discount (or reach an improper investment conclusion). Dividends from "C" corporations, REITs, and closed-end mutual funds are generally quoted on a pre-personal income tax basis. Grossing up the net, after-tax distribution yield on an investment in an "S" corporation or partnership provides a figure which corresponds directly to dividend yields quoted for comparable publicly traded entities. The "C" corporation equivalent dividend is the best point from which to begin assessing the interim cash flows provided by an investment in an "S" corporation or partnership.

If you have questions about "S" corporations and partnerships, including family limited partnerships, please call. ♦

IPO Pricing and Fair Market Value

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In *Eyler*, the Court assessed a significant fine to the taxpayer because he relied on an estimate of value determined by underwriters several months prior to the IPO as an indicator of fair market value for ESOP purposes. The Court strongly disagreed, stating that the price was not a determination of fair market value because it relied on assumptions valid only in the context of an offering at a specific point in time and did not represent subsequent events.

The Court's mandate was clear: previously determined IPO prices are clearly not considered a determination of fair market value in the context of Revenue Ruling 59-60. As always, there is no substitute for a timely appraisal of closely held business interests to substantiate their fair market values for gift or estate tax purposes, charitable contributions, ESOP transactions, or other significant transactions. Please call if we can help you with any of these issues. ♦

Case Law Update

Kosman v. Commissioner, T.C. Memo 1996-112

The issue in this case is the value of the minority shares of Kosman, Inc., a family holding company owning shares of stock in two small Nebraska banks at the time of two gifts. In 1986 and 1987, Kosman Inc.'s only assets consisted of its stock in Scottsbluff National Corp., holding company for Scottsbluff National Bank (12,834 shares or 32.1%), and Western National Bank (2,000 shares or 10%).

The Court was presented with expert testimony from both sides. Both experts used comparables but the Court criticized each expert's methodologies for lack of adequate analysis and supporting evidence. First, the Court noted that the IRS expert's comparables were all out-of-state bank holding companies and indicated that the IRS expert did not adequately address whether economic conditions in those bank markets were similar to those in northwestern Nebraska. Second, the Court did not accept the taxpayer's expert's use of a discount rate of 14% simply because "that is the rate used to value S&P small capitalized companies."

The Court concluded that the subject value should be 70% of book, between the two experts' opinion of 60% and 86% of book value. The Court applied the same 10% minority interest discount both experts used. Then the Court applied a 15% marketability discount. The rationale for this was based solely on a mention of the 1971 SEC Institutional Investor Study and a 1994 *Wall Street Journal* article discussing sales of restricted stock to foreign investors. The Court also applied a 4% discount to the non-voting shares, rejecting the 10% used by the taxpayer's expert.

It should be noted that the discount discussion by both experts and the Court is extremely sparse. Many business appraisers have interpreted recent cases, culminating in *Mandelbaum v. Commissioner* (T.C. Memo 1995-255), as mandating more extensive analysis of specific factors when determining the appropriate discounts (See *Estate of Jung v. Commissioner*, 101 T.C. 412 (1993), *Estate of Lauder v. Commissioner*, T.C. Memo 1994-527, and *Estate of Berg v. Commissioner*, T.C. Memo 1991-279). However, this Court seems to ignore the trend and accepts only nominal support for the discounts applied.

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