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IPO Valuation and Profitability Expectations: Evidence from the Italian Exchange

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Abstract : This paper analyses the valuation process of companies listed on the Italian Exchange in the period 2000-2009 at their Initial Public Offering (IPO). One the most common valuation techniques declared in the IPO prospectus to determine the offer price is the Discounted Cash Flow (DCF) method. We develop a 'reverse engineering' model to discover the short term profitability implied in the offer prices. We show that there is a significant optimistic bias in the estimation of future profitability compared to ex-post actual realization and the mean forecast error is substantially large. Yet we show that such error characterizes also the estimations carried out by analysts evaluating non-IPO companies. The forecast error is larger the faster has been the recent growth of the company, the higher is the leverage of the IPO firm, the more companies issued equity on the market. IPO companies generally exhibit better operating performance before the listing, with respect to comparable listed companies, while after the flotation they do not perform significantly different in term of return on invested capital. Pre-IPO book building activity plays a significant role in partially reducing the forecast error and revising expectations, while the market price of the first day of trading does not contain information for further reducing forecast errors.

Keywords : initial public offerings, DCF, book building, post-IPO profitability drop
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