

Under the Buzz **NUGGETS**



Commentary on Business Strategy for Tech Company Executives & Professionals

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Under the Buzz is an email "viewsletter" published by Philip Lay, managing director at TCG Advisors, a Silicon Valley-based firm that helps executive teams in tech companies to deal with complex strategic, organizational, and operational challenges. Now in its twelfth year, this journal is published periodically and delivered free to subscribers via email on an opt-in basis. It is also posted on TCG Advisors' website, <http://www.tcg-advisors.com/Library/utb/utb.htm>, where back issues are also available.

Things to Like - and Not Like - about the LinkedIn IPO

With LinkedIn's IPO last week, it's been very encouraging to see a social networking company achieve a strong showing after having spent eight years building a serious business. In the process, the company has gained a respectable level of adoption – 100m+ members - while also developing a diverse business model that might just stand up to competition going forward.

Not that there won't be serious competition for the recruitment part of the business from existing players such as Monster.com and CareerBuilder. There are also a slew of even younger disrupters angling for a piece of the \$20bn. recruiting pie, including these companies spotlighted in a recent SF Chronicle article:

- Gild - Uses a gaming approach to match employee and employer
- Branchout – Adds a career networking layer to Facebook
- Top Prospect – Allows outsiders to earn cash by participating in corporate referral programs
- Jobvite – Uses a CRM-based recruitment platform integrated into LinkedIn, Twitter, and Facebook
- Jibe – Uses social networking to connect people to jobs at their friend' employers
- RoundPegg – Uses psychological self-assessments to help become a kind of eHarmony for the employment process.

Since it's been a real challenge for internet companies to break through the cumulative obstacles of the dotcom bust and the 2008 financial crash, this largest tech IPO since Google in 2004 sends

positive signals to many deserving companies besides Facebook, Twitter, and Zynga, that are getting ready to go public in the next year or so. And among the many categories of internet business, social networking companies have spent the best part of the last decade overcoming heavy skepticism that they could ever develop a sustainable value proposition and business model.

It's also a healthy sign of a new mentality among today's young entrepreneurs to see them proceeding towards their IPOs thoughtfully and without rushing the process – to the contrary, some are now even delaying it. Presumably, the memories and even hearsay (since many of these young guns are in their early twenties) of a decade ago still linger enough to keep everyone sober about the often-dramatic ups and downs of going public too soon in a young company's life, in addition to understanding what they give up in exchange for obtaining much-needed capital to fund their business growth and cashing out part of their personal shareholdings.

That said, at least two familiar issues on the less encouraging side of the spectrum have come to the fore with this “wildly successful” IPO:

- 1) Dual-class stock ownership structures are a threat to corporate governance: Following Google's example in 2004, these anti-shareholder arrangements seem to be becoming fashionable among other internet companies. My hope is that, once the fervor of investors anxious to obtain a piece of the action is sated, these lopsided structures will be scrutinized and begin to weigh against the stock price of the companies that insist on having them. That said, U.S. investors are a complete puzzle to me. While they can at times be militant about the transparency of company owners and boards in various aspects, they don't seem to care enough about this problem to prevent young internet entrepreneurs from staking out disproportionate power no matter how much they dilute their stock ownership in the future, or lose their fire or their competitive edge.
- 2) Investment bankers are playing unsavory stock manipulation games once again. So little has been done to discourage parasitic behavior by investment banks that the three that were responsible for LinkedIn's IPO - Merrill Lynch, Morgan Stanley, and JP Morgan, who together had the responsibility of matching stock price to demand from investors – seem unable to have resisted the temptation to fleece their client of millions of dollars by vastly under-pricing the shares, in the process showering themselves and other insiders with cheap stock and the opportunity to earn an easy and quick profit from flipping.

The (potential) bubble dynamics associated with the whole emerging category of social media is helping companies such as Facebook and LinkedIn, as well as Zynga (whose growth is hugely predicated on its residency in Facebook) to get away with an unbalanced ownership/voting structure that, in the words of the NYT business section (Dealbook note by Steven Davidoff), “has the potential to turn into a corporate governance nightmare”. It looks as if investors are so desperate to get a piece of the action that they are turning a blind eye to what is in essence an abuse of corporate authority. One can only hope at least that the valuations settle down a bit, to allow these and other successful social media companies to grow into their valuations without suffering from overly dramatic fluctuations.

Back in 2004, Google was the most significant internet company to mimic media companies (such as the New York Times, Ford Motor Company, Hollinger, Berkshire Hathaway, and others) in

adopting the dual-class ownership/voting structure, which provides founders and other individuals that hold Class B stock with ten or more times the voting power of holders of Class A stock. Thus, at Google Sergey Brin and Larry Page wield disproportionate control over the company's strategy and general behavior, no matter how small their shareholding becomes as they gradually divest themselves of stock in order to maintain their expensive lifestyles. What are shareholders to do if they object to the way in which the dominant stockholders lead the company, or if its performance begins to suffer due to misguided or otherwise unsuccessful strategies? Google may have been the fastest tech company to achieve industry dominance, but it also may be the quickest of its kind to endure a flat (even regressive) stock price, as has been the case for the past four years or more. The company is still in essence a one-trick pony, and now its U.S. market share in its primary category – search – is suffering erosion in the face of a determined push by Bing and other competitors.

Ben McClure of Investopedia reminds us that, “while there are two sides to the dual-class ownership approach, academic research offers strong evidence that dual-class share structures hinder corporate performance. A [Wharton School and Harvard Business School study](#) shows that while large ownership stakes in managers' hands tend to improve corporate performance, heavy voting control by insiders weakens it. Shareholders with super-voting rights are reluctant to raise cash by selling additional shares--that could dilute these shareholders' influence. The study also shows that dual-class companies tend to be burdened with more debt than single-class companies. Even worse, dual-class [stocks](#) tend to under-perform the stock market...”

McClure goes on to write: “Not every dual-class company is destined to perform poorly--Berkshire Hathaway, for one, has consistently delivered great fundamentals and shareholder value. Controlling shareholders normally have an interest in maintaining a good reputation with investors. Insofar as family members wield voting power, they have an emotional incentive to vote in a manner that enhances performance. All the same, investors should keep in mind the effects of dual-class ownership on company fundamentals.” That said, my belief is that the positives of dual-class structures are vastly outweighed by the negative aspects – particularly in the tech industry, where entrepreneurs tend to lose their edge, cash out, or pursue other existential activities not consistent with continuing to grow their companies, in relatively short order.

Onto the second negative aspect of LinkedIn's IPO: the (now-familiar) sharp practices perpetrated by the investment bankers in so clearly under-pricing the IPO despite the frenetic interest expressed by investors and clear to anyone with half a clue about market dynamics. As Eric Tilenius, GM of Zynga, reportedly wrote on his Facebook page, “A huge opening-day pop is not a sign of a successful IPO, but rather a massively mispriced one. Bankers are rewarding their friends and themselves instead of doing their fiduciary duty to their clients.” And as Joe Nocera went on to relate in his recent NYT Op-Ed column, the formerly infamous but always perceptive Henry Blodget, in his Business Insider blog, provided an accurate analogy for what the banks had done to LinkedIn: “Suppose your trusted real estate agent persuaded you to sell your house for \$1 million. Then, the next day, the same agent sold the same house for \$2 million. How would you feel?” Is it any surprise that increasing numbers of people feel animosity toward bankers who, two years or so after the most recent meltdown, continue to act with scant professional integrity?

But back to the positives. If, despite the two negative factors described above, LinkedIn and the next several social media, mobile and/or cloud computing companies can go public once they have sustainable business models and a clearly profitable revenue stream, it will help to spur a welcome cycle of growth for the tech marketplace in general.

This article was authored by Philip Lay, managing director at TCG Advisors.

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