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ILLUSTRATION BY JESSE LENZ

Mark Zuckerberg, September 2011

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Facebook will survive its IPO. But most companies aren't Facebook. FELIX SALMON on why Wall Street is the tech industry's worst enemy.

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When Facebook goes raise at least $5 billion Internet IPO the world

it debuts on the stock exchange, Facebook will be worth more than General Motors, the New York Times Company, and Sprint Nextel combined. The next morning, Mark Zuckerberg's smiling face will appear on the front page of newspapers around the world.

But don't be surprised if that smile looks like the forced grin of someone dragged to the altar. Truth be told, Zuckerberg is going public not because he wants to but because SEC rules have forced his hand. Once a company takes on more than 500 shareholders—a number that Facebook easily surpasses if you include all the investors and employees who have bought or received shares over the years—it must register its stock. That means shareholders can trade it in the OTC (over the counter) markets, out of the company's control and without its consent or cooperation. No high-profile business wants its shares to be traded in that opaque purgatory of low valuations.

And so, like a hapless groom, Zuckerberg is about to become just one part of an institution much bigger than himself—a publicly listed limited-liability joint-stock company. The visionary who turned down a billion-dollar offer to cash out at the age of 22, the imperial CEO with complete control over the company he built from scratch, will now run a company owned by hordes of shareholders from all over the world.

Zuckerberg clearly does not relish this prospect, and he has taken great pains to preserve his iron grip on Facebook. When the company goes public, Zuckerberg will still control 56.9 percent of the votes, will be free to single-handedly appoint directors, and will even be able to name his successor. Technically, Facebook may be going public, but Zuckerberg will continue to run it like his own privately held concern.

Thanks to those safeguards, Facebook will probably weather its IPO just fine. But when the world's most successful young tech entrepreneur does everything in his power to minimize the impact of public ownership, it makes one thing clear: The IPO model is broken.

Going public might be good for a company's investors and employees, but it is usually bad for the company itself. It forces CEOs to focus on short-term stock fluctuations at the expense of long-term growth. It wrests control from the founders and gives it to thousands of faceless shareholders.

For hugely successful mega-businesses—Apple, Facebook, Google—going public has its benefits. Public companies enjoy cachet, tax advantages, and access to more and better financing options. But for many young companies, the drive to go public results in a death spiral of unsustainable growth.

It doesn't have to be this way. There are

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public this year, it will making it the biggest has ever seen. The day

better options for financing technology companies. But first we have to kill the tech industry's senseless addiction to the IPO.

FOR ROUGHLY 65 YEARS-say, from 1933 to 1998—the initial public offering was the engine of American capitalism. Entrepreneurs sold shares to investors and used the proceeds to build their young companies or invest in the future. After their IPOs, for instance, Apple and Microsoft had the necessary funds to develop the Macintosh and Windows. The stock market has been the most efficient and effective method of allocating capital that the world has ever seen.

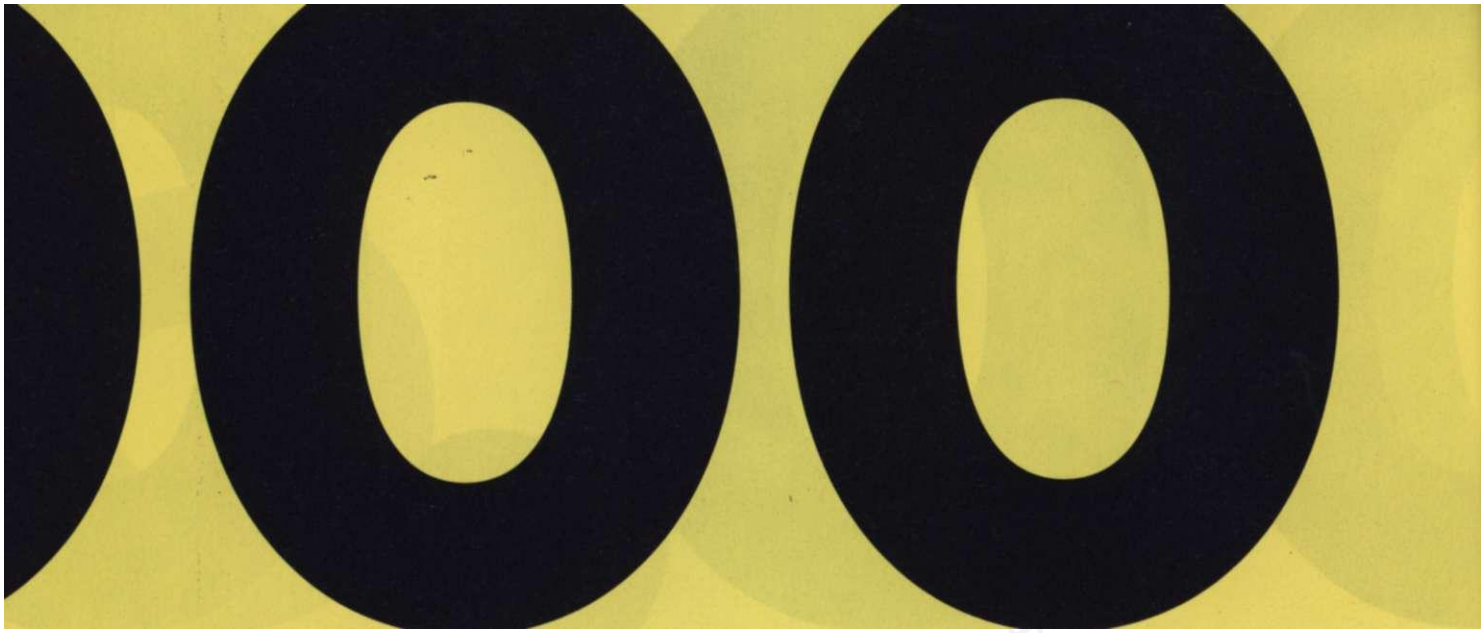
That was a useful function, but it's one that IPOs no longer serve. Going public is more difficult than it used to be—Sarbanes-Oxley regulations have made filing much more difficult, and today's investors tend to shy away from Internet companies that don't have a proven track record of steady profitability. That has created a catch-22: By the time a company can go public, it no longer needs the cash. Take Google. It had already been profitable for three years before raising $1.2 billion in its 2004 public offering. And Google never spent the money it raised that year. Instead, it put the cash straight into the bank, where the funds have been sitting ever since. Today, Google's cash pile has grown to more than $44 billion.

Of course, tech industry startups don't have to wait for an IPO to raise capital. Hordes of venture capital firms and angel investors are clamoring to offer them money. (And there are more all the time: VCs invested $18.2 billion in 2011, up 32 percent from 2010.) And many entrepreneurs don't need as much capital anyway—cloud technology has made it vastly cheaper to start a web company. That's one reason why startups haven't been in any rush to go public. In 1985 most VC-backed companies were less than four years old at the time of their IPOs. By 2009 most of them were more than 10 years old.

If the primary goal of the IPO is no longer to provide funds for promising young companies, what purpose *does* it serve? For the most part, it has become a reward for the founders, employees, and early investors—a jackpot for those who placed their bets correctly. That's not as bad as it sounds. Without the promise of going public, companies couldn't use stock options to attract talented employees—a crucial tool for startups, which usually can't offer competitive salaries. And it's the possibility of a future IPO that makes a company attractive to venture capitalists and angel investors in the first place.

On the surface, there's nothing wrong with this arrangement. It simply allows young companies to raise cash while deferring their IPO until they're more established. But it has created a series

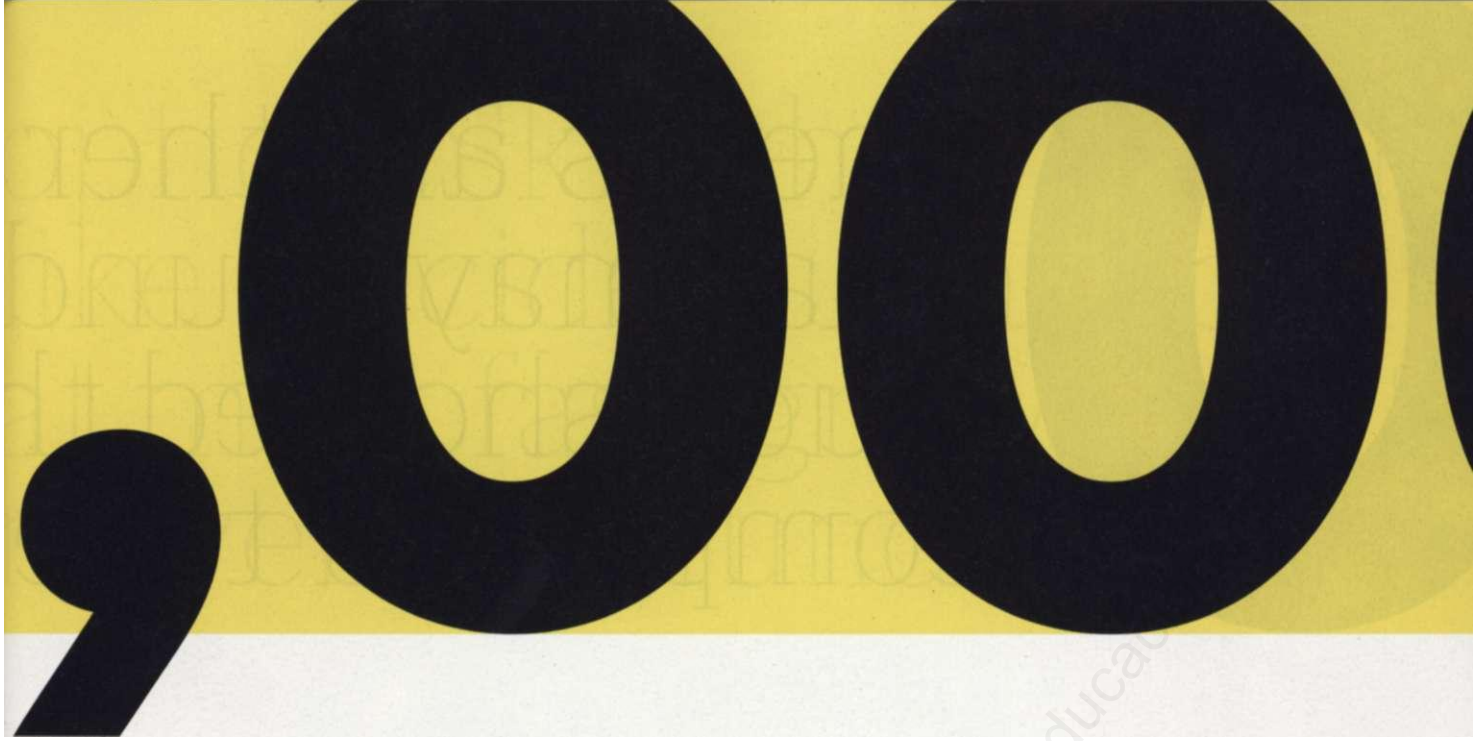
JUSTIN SULLIVAN/GETTY



SUPERSIZING THE IPO

When the web was new, all you needed to launch a public company like Netscape was an idea, a couple hundred employees, and a multimillion-dollar loss in the previous year. After the dotcom bubble burst, the bar to going public got much higher. When Google held its IPO in 2004, it had already been profitable for three years. And when Facebook hits the public market, it will be truly huge—with a profit of $1 billion in 2011. So if you want to go public today, here's the secret: Build a company that's so big you don't need the money. —JOANNA PEARLSTEIN

	NETSCAPE	GOOGLE	FACEBOOK
Year of IPO	1995	2004	2012*
Dollars raised	$207 million	$1.5 billion	$5 billion*
Number of employees at time of IPO filing	257	2,292	3,200
Revenue in fiscal year before IPO	$8 million	$1.8 billion	$3.7 billion
Profit (loss) in year before IPO	($16.5 million)	$128.9 million	$1 billion
Quote from prospectus	"There can be no assurance that the market for the Company's products and services will develop ... or that individual PC users will use the Internet for commerce and communication."	"Don't be evil. We believe strongly that in the long term, we will be better served by a company that does good things for the world even if we forgo some short-term gains."	"Simply put: we don't build services to make money; we make money to build better services."



of perverse incentives, in which investors' interests conflict with—and usually trump—those of the companies they fund.

VCs and angels may talk about changing the world, but their business model rests on a more prosaic calculation: Buy low, sell high. They invest in companies they think will become more valuable, so they can sell their stake for a sizable profit. From the time that VCs invest in a company, they have five years—10 at the most—to sell their entire position, hopefully for many times more than their original investment. After that, it doesn't matter to them whether the company survives a year or a century.

To put it another way, the VC model is based on creating wealth for investors, not on building successful businesses. You buy into a company early on and sell out a few years later; if you pick well, you can make lots of money. But your profits don't accrue to the company itself, which could implode after your exit for all you care. Silicon Valley is full of venture capitalists who have become dynastically wealthy off the backs of companies that no longer exist.

Of course, once VCs make their investments, they don't just sit back and hope for the best; they push the companies to grow as fast as possible. That may work for the likes of Apple, Facebook, and Google—all-or-nothing bets on legitimately world-changing technologies. But it creates problems for more modest startups, which might have the potential to grow into perfectly sustainable medium-size firms.

Because venture capitalists require such massive returns, they invariably force the companies they invest in to take outsize risks. Look, for instance, at Groupon. In the first quarter of 2010, it made a profit of $8 million on revenue of $44 million. That's a healthy profit margin for a young company, and it's easy to see how it could have grown steadily from that point onward.

But in the first quarter of 2011. Groupon's revenue skyrocketed to $645 million—an increase of 1,357 percent in one year. Meanwhile, the once-profitable company was suddenly faced with a loss of $146 million. In one quarter. The reason for the reversal? Groupon, with the full support of its VC backers, juiced revenue by spending gobs of money on marketing, sacrificing profits for growth. That's an enormous bet: If the company grows fast enough, everyone gets extremely wealthy—but if it stumbles, it can quickly wither.

In this case, the gamble paid off. When Groupon went public in November 2011, just three years after it first launched, it was valued at almost $13 billion, making billionaires of founders Eric Lefkofsky, Brad Keywell, and CEO Andrew Mason. But now the company must keep up its torrid pace of growth or risk alienating its many investors. Indeed, Groupon's very first quarterly earnings report sparked hand-wringing news stories about the company's performance.

And for every Groupon success story, there are scores of VC-backed companies that never go public. Sometimes the flame-outs are truly spectacular: The phone service Amp'd Mobile, for example, was so eager to grow that it signed up customers regardless of their ability to pay. When too many of them turned out to be deadbeats, the company went bankrupt in 2007, taking $360 million in venture capital down with it. Amp'd didn't need to fail. It might well have achieved sustainable and modest profitability had it not expanded at such a breakneck pace.

Or take Zappos. CEO Tony Hsieh had hoped to maintain control of his company, but his investors, led by Sequoia Capital's Mike Moritz, had other ideas. In 2009, worried about Zappos' cash flow, they started pressuring Hsieh. "If the economy didn't improve." Hsieh recalled in *Inc.* magazine, "the board would fire me and hire a new CEO who was concerned only with maximizing profits." As a result, Hsieh decided to sell Zappos to Amazon, which he thought would be a better steward than the investor-packed board of directors. Hsieh may have kept the board from seizing control of his company, but he had to give up his independence to do so.

Once a company goes public, the demand for constant growth only increases. Conventional public companies enter into a devil's bargain: "Give us capital now and we'll attempt to grow in perpetuity," says Silicon Valley-based IPO consultant Lise Buyer. "The problem comes when companies try to do heroic things to meet

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expectations every quarter, even when that's an unnatural act."

It's like British cyclist Tom Simpson, who took a combination of cognac and amphetamines before a brutally hot stage of the 1967 Tour de France. It enabled him to push past his limits—until he collapsed and died on the slopes of Mount Ventoux. Sometimes it's best to conserve energy, to play the long game, and not to risk everything for the sake of a short-term win. But once you're public, the markets start pushing you to hit those numbers every quarter. And the results can be fatal. Look, for example, at Hewlett-Packard—arguably the most venerable and respected company in Silicon Valley, stifled by cost-cutting managers and board members who were always trying to do what was right for the share price rather than what was right for the company and its legacy. Today HP is struggling to define itself.

Of course, plenty of venture-backed companies fail before they have a chance to go public. VCs tend to shrug that off as a cost of doing business; their model depends on funding a whole lot of losers in order to discover a few big winners. And if they can't take their portfolio companies public, they'll simply sell them. Indeed, selling out to an established player has become a popular alternative exit strategy for young companies. (Last year 429 VC-backed companies were acquired, while 52 went public.)

The problem is that, despite every assurance, acquired companies almost always give up their identity and mission when they get folded into a larger behemoth. It's a story you hear again and again: Flickr was a flagship of the Web 2.0 era until Yahoo bought it and turned it into a photo-sharing afterthought; TechCrunch dominated the tech blogosphere until AOL's meddling alienated founder Michael Arrington and many of his top staffers.

Something has to change. It's time to stop forcing young companies into a broken process. We need to And a way to invest in new businesses without jeopardizing their future.

SO, WHAT DO YOU DO if you're a young company that doesn't want to go public or get acquired? First you have to find another way of offering equity. After all, without the ability to give away shares, startups would have a much harder time competing for top-notch talent. And as it grows, a company can use that stock on all manner of tactical or strategic priorities. When Apple, say, wants to hire a couple of great engineers, it can throw lots of stock options and restricted stock units at them instead of just paying enormous salaries. It's the Silicon Valley way, and it helps Apple save cash—not that it really needs to, given the rate at which its $98 billion trove of cash and marketable securities is growing.

Look at it this way: When Apple went public in 1980, it had 54.2 million shares outstanding. It has since split three times, so those original 54.2 million shares have now become 434 million shares. But in fact, Apple currently has 929 million shares outstanding. Many of the extra 495 million shares—worth well over $200 billion, at current valuations—were issued over the years to pay for companies or people. And Apple isn't even particularly acquisitive.

All that equity has no value if there isn't some way to convert it into cash eventually. If there's no IPO, how can any shareholders, be they employees or investors, hope to sell their shares?

In fact, there are some clear—and increasingly popular—alternatives. One is to enter the private markets. These are online platforms, like SecondMarket and SharesPost, that let companies trade their stock without inviting public scrutiny. In recent years, these markets have become a crucial step on the way to an IPO. Since 2008, more than $1 billion of stock has changed hands on SecondMarket, the largest of the private markets.

Here's how SecondMarket works: Companies set periodic auction dates, at which point buyers and sellers can post the prices at which they're willing to transact. The company usually retains a right of first refusal, giving it the option to buy back its stock at whatever the winning bid price might be. Unlike public markets, private markets let companies control who buys their stock and who gets access to confidential financial information. From a company's point of view, the great advantage of these markets is that they give outsiders less power and influence.

For investors, buying shares through the private markets is very different from trading public stocks. You can't just sell your shares whenever you want but must wait

option: Skip the VC cash. like suicide, but a recent at most fast-growing US no venture funding at all.

for an arranged auction—by which point their value may have plummeted.

In other words, these are risky bets, and they are treated as such. To buy shares on these private exchanges, you need to be a rich, accredited investor; they're not accessible to most of us. And it's certainly true that many people are going to lose substantial sums of money in these markets. But that's the whole point of early-stage equity-market investing: It offers massive returns and also very big risks. (Still, it's worth noting that SecondMarket is a broker-dealer and so is regulated by the Securities and Exchange Commission.)

Private markets are important for other reasons too. In the 1980s, when companies normally went public at four or five years of age, it was reasonable to ask employees to wait until the IPO before they tried to sell stock. Today, when it can easily take a decade to go public, companies are more willing to let their early employees trade shares on secondary markets.

But if private markets currently serve as a way station on the road to an IPO, in theory they could end up replacing the IPO altogether. That would be a boon for most companies. Because these markets restrict the number of times a company's stock can be traded, they avoid the problem of overtrading. In public markets, high-frequency algorithms can trade in and out of a stock hundreds or thousands of times a day, making tiny profits and losses on each transaction. They neither know nor care what the company does; they just trade the flows. At the same time, billions of dollars flow in and out of passive instruments like index funds, which buy and sell a set group of stocks. The result is that we've recently seen record highs in market correlation-stock prices driven by broad market movements rather than by any unique qualities of the companies themselves. The private markets remove those factors, meaning that share prices rise and fall based on a company's unique prospects, not just on global trends over which it has no control.

And there's another option for startups that don't want to go public: Forgo VC and angel investments entirely and fund the company with the profits from your business. That organic-growth option may sound quaint, but it can still be quite successful. Indeed, VC funding is by no means necessary to fund a fast-growing company. In 2009 Paul Kedrosky, a Kauffman Foundation senior fellow and venture capitalist, looked at the *Inc.* 500 list of the fastest-growing companies in the US for every year between 1997 and 2007—a period that includes the VC boom of 1999-2000. He found about 900 companies in all, of which only 16 percent had VC backing. "Such companies almost certainly could have venture investors, if they wanted them," Kedrosky wrote in a paper for Kauffman. In other words, the overwhelming majority of the fastest-growing companies decided that they didn't need VCs.

If the tech industry is to move away from the IPO model, it will have to change some deeply ingrained attitudes. Because most startups hand out equity, any company not offering that perk risks dooming itself to irrelevance, unable to hire the talent it needs to survive. And if a founder says he'll never go public, demand for his company's shares will diminish and its valuation on private markets will be lower; outside investors will always favor companies that are heading toward an IPO. Until a groundswell of CEOs commit to not going public, they'll face overwhelming pressure to do so.

But it's about to get easier for tech CEOs to ignore the IPO's siren song. Legislation wending its way through Congress would change SEC rules, meaning no tech company would find itself forced to go public in the way that Facebook has. The bills, which have been supported quite vocally by a number of CEOs at pre-IPO companies in Silicon Valley, as well as VCs who want more control over the timing of their companies' IPOs, would not count employees toward a company's 500-investor limit. The legislation would also raise that limit to 1,000 shareholders.

It will take a while for tech companies to fully explore the options available to them. Entrepreneurs can be surprisingly conservative about such things. But venture capitalists in the Valley are already resigned to the fact that most of their portfolio companies will never go public. And the more alternatives there are, the better the chance that some of those companies might find some other way to survive or even thrive. Businesses that have choices tend to be worth more money. Venture capitalists even have a term to describe it—option value. It could just be the next big thing.

Fonte: Wired, San Francisco, ano 20, n. 4, p. 86-93, Apr. 2012.