Facebook ought to ditch its initial public offering

John Gapper

At long last Facebook has filed for its initial public offering, the most eagerly-awaited event in Silicon Valley since Google went public in 2004. Having read the prospectus, with its details of how profitable and cash-rich the social networking enterprise is, may I suggest it calls the whole thing off?

There is still time to cancel its IPO and the filing provides plenty of reasons why it ought to, and why Mark Zuckerberg, its founder and chief executive, would probably be happier if it did. He could carry on running Facebook as a private company and would not have to justify himself to outsiders.

It begs a question if a company trying to raise capital from investors cannot think of anything to do with the money. Yet this is Facebook's predicament – as it admitted in its filing on Wednesday, its cash flow and credit "will be sufficient to meet our operational needs for the foreseeable future."

Facebook is far from the average Silicon Valley start-up, which has plenty of growth and little by way of revenues. In fact, it is turning into a veritable cash machine. Its free cash flow rose from $190m to $470m between 2010 and 2011, while its shareholders' equity increased from $2.2bn to $4.9bn.

So what are its plans for the additional $5bn it may raise from an IPO? It intends to put the cash into US government bonds and savings accounts, and perhaps use some to pay the tax due on converting into shares the "restricted stock units" it has given to its 3,200 staff.

That's right. Its sole tangible purpose for the IPO proceeds is to meet a tax obligation that will be triggered by going public. Welcome to the Catch-22 world of the venture capital liquidity event.

Even the graffiti artist who painted Facebook's walls took stock rather than cash, and may gain shares worth $200m

Meanwhile, Mr Zuckerberg does not want to cede any of the grip that he has exerted on the company for the past seven years by allowing the ordinary shareholders voting rights. Even the dubious dual-class equity structure used by Google and others for Silicon Valley IPOs, with insiders having 10 times the votes of others, is not enough for him.

As well as having 28 per cent of Facebook's privileged B class shares, Mr Zuckerberg wields proxy control of a further 30 per cent of Facebook's voting shares. That gives him a similar level of voting control to that held jointly by Larry Page and Sergey Brin following Google's IPO.

Mr Zuckerberg also has the right to appoint the directors, and "control the management and affairs of our company". He even granted himself the ability to pass control to his chosen successor when he dies, in true dynastic fashion.

Given that it doesn't need capital and doesn't want shareholders to get in the way of its autocratic founder, why the IPO? Apart from meeting US regulations for a private company to go public when it gains more than 500 investors, Facebook's motivation is clear: to gratify its venture capital investors and employees.

This is not a cynical statement; it is a quote from Mr Zuckerberg's letter to new shareholders. "We're going public for our employees and our investors," he writes. "We made a commitment to them when we gave them equity that we'd work hard to make it worth a lot and make it liquid, and this IPO is fulfilling our commitment."

In terms of Silicon Valley's logic, it makes sense. The returns from occasional winners such as Facebook make up for venture capitalists' losing bets on thousands of other start-ups – provided the winners are sold either to other companies or to the public markets.

Meanwhile, start-ups attract the best software engineers by giving them preferred equity and restricted stock units in the hope that they will get rich one day. As the New York Times reports, even the graffiti artist who painted Facebook's walls took stock rather than cash, and may gain shares worth $200m.

For the company itself, however, the logic is far less obvious. As a corporate entity, Facebook could clearly thrive without seeking new shareholders, whose main purpose is to allow the insiders to get rich and eventually exit. Facebook's IPO is mainly taking place to encourage the others in Silicon Valley.

There is an alternative. Since Mr Zuckerberg regards shareholders as a necessary inconvenience, he should study Cargill, the privately held commodities firm that also operates in 70 countries and "helps customers succeed through collaboration and innovation". Founded in 1865, it has yet to file for an IPO.

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Law firms have struck the limits of partnership

John Gapper

It is sad to see a venerable partnership disappear but Dewey & LeBoeuf, the New York-based law firm, wasn't one any more.

The sight of Dewey partners and employees in New York walking out with their belongings in cardboard boxes as their firm teeters on the edge of collapse brings back memories of Lehman Brothers' demise in 2008. Like Lehman, Dewey was a second-tier institution that over-borrowed and overextended itself in a push to become one of its industry's global elite.

Unlike Lehman, which went public in 1994, Dewey was still owned and run by its partners – US law firms are barred from allowing non-lawyers to become shareholders. But partnership ain't what it used to be. Not only did Dewey ill-advisedly borrow $200m to expand, but it set owner against owner.

Dewey is already a symbol for over-ambition and spectacular mismanagement. It is also a warning for those in a similar bind – trying to glue a partnership together with leverage is the way to destroy it.

In austere times, with greater cost pressures, law firms cannot borrow money and make rash promises to force their way into the top tier. Those beneath the UK's "magic circle" and firms such as Cravath and Davis Polk in the US will have to be more like utilities. They will be lower-margin businesses doing higher volumes of ordinary work, perhaps owned by outsiders.

Leverage comes in various forms in the legal industry and Dewey employed all of them. After its creation in a 2007 merger of two gilded names in New York corporate law, it issued $125m of bonds to supplement a bank credit line of $100m. Given that law firms shouldn't need capital, as long as they can pay their bills and their employees, that was a warning.

It made another set of unsustainable pledges by promising multimillion dollar payments to some partners while asking juniors to buy their way into the partnership, often with loans. Like other US law firms, its "partnership" was extremely unequal – some partners got $5m or more while others got $300,000 or less.

Like its rivals, it also "leveraged" its highly paid (and less highly paid) partners by getting trainees to do the grunt work for them. Law firms raised profits by billing their clients highly for associates' work – profits per equity partner at the top 100 US firms tripled between 1995 and 2007. "Frankly, they could get away with it," says Tony Williams of Jomati, a legal industry consultant.

Dewey was particularly badly run – its former chairman Steven Davis is under criminal investigation by the Manhattan district attorney – but the pressures it has faced since the 2008 crash are common. "What they did, while extreme in degree, was not different in kind from what many firms have done," says Bruce MacEwan of the industry consultancy Adam Smith Esq.

Like other professional services firms on Wall Street and in the City of London, law firms now face a far less friendly business climate. Deals used to be plentiful and they could charge clients a lot without much scrutiny, but that era has passed.

"Firms of this sort operate much more like big businesses than they used to," Mr Davis told Fortune in a last act of hubris in March. In practice, Dewey interpreted this as becoming bigger and riskier but remaining a partnership run by lawyers who gave large rewards to each other. It spurned the corollary disciplines – professional managers and external shareholders.

Leverage comes in various forms and Dewey used all of them

Partnership is under strain in other firms, especially those that have abandoned the old "lockstep" remuneration based on seniority for a division between star "rainmakers" who bring in clients and "service partners" who execute transactions behind the scenes with associates, and are second-class citizens.

At a similar moment in their history, investment banks broke with partnerships and went public. Goldman Sachs held out for the longest of the big firms and finally opted for an initial public offering after the 1994 bond crisis, in which partners threatened to leave, taking capital with them.

Law firms do not face such immediate pressures. They are advisory, not trading businesses, with no need for capital in their day-to-day operations. As long as they can generate sufficient cash to finance growth without having to reduce the rewards of top partners, the structure is viable.

But it will not work indefinitely for lower-octane firms – the Deweys of the world. They will either have to carry on without the benefit of leverage, some collapsing and being absorbed into other partnerships, or find a new way to operate.

Partnership has helped these firms resist changes common in other industries. "Suppliers to the motor industry, major supermarkets and fashion retailers are expected by customers to innovate continuously and reduce the cost of their products . . . the legal sector has been insulated," says Jomati in a study called "After the Golden Age".

The obvious way for the industry to develop is to divide into a few top-end firms and some large utilities that employ paralegals and lower-paid lawyers to do standard work. The evolution has been encouraged in the UK by the introduction this year of "alternative business structures" – law firms that are owned by non-lawyers.

Some UK and Australian companies are taking advantage but US lawyers still guard their turf – outside ownership of legal firms is barred and the New York State Bar Association has told members they cannot be employed by firms with non-lawyer owners. Guild instincts run deep.

In the long term this is untenable. Dewey pushed the notion of equity partnership at law firms to breaking point, financing itself with debt rather than accepting its reduced status. The industry it leaves behind no longer has that luxury.

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The A list

Investment is the key to green growth. Companies can be persuaded to spend, writes **Nicholas Stern**

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JPMorgan's fiasco exposes the myth of an imperial CEO

John Gapper

This February, as JPMorgan Chase financial traders in London were building a credit derivatives position that would soon cost the bank $2bn, Jamie Dimon was otherwise occupied. He was on a 550-mile bus ride through Florida.

Mr Dimon took a week-long tour of Chase branches in the Sunshine state, relying on other executives to warn him of problems in his far-flung empire – a bank with assets of $2.3tn and 240,000 employees in 60 countries. Two months later, he snappily dismissed the controversy over the trade as a "complete tempest in a teapot".

The latter was a mistake that exposed a big flaw in JPMorgan's financial and managerial controls, as he has admitted. More than that, however, it undermines the myth of Mr Dimon himself – the charismatic chief executive and master of detail inside the bank who could be trusted to get things right.

His humiliation comes as an even more forceful chairman and chief executive – Mark Zuckerberg of Facebook – takes his company public. As hard as it is for JPMorgan shareholders to change Mr Dimon's mind – its annual general meeting passed by quietly on Tuesday – they stand no chance at Facebook since Mr Zuckerberg controls most of the voting stock.

US shareholders have long tolerated a degree of dominance on the part of chief executives that would be untenable in London and elsewhere. They can be both chairman and chief executive, and ensure themselves control through dual voting structures. *Caveat emptor*, says the corporate emperor.

There are signs of change: 40 per cent of JPMorgan Chase investors voted this week to have an independent chairman. But this move towards shareholder democracy – like the "shareholder spring" in London – has been outweighed by the rush of Silicon Valley initial public offerings in which the company founders have arranged to retain absolute control.

The JPMorgan fiasco illustrates the danger in this. One lapse does not make Mr Dimon a poor chief executive – although we have yet to discover exactly what happened – but he has been behaving imperiously. Upset by new financial regulations, he berated regulators and barked at central bankers.

"Given a choice between a very good CEO and a 'star' CEO, the former is preferable to the latter. Very good CEOs tend to get the job done reliably, without undue fanfare . . . Star CEOs, by contrast, may conflate the institution's success with their personal goals . . . may start to believe their own press."

That warning came not from a shareholder activist but from the Group of Thirty, a group of bank executives and central bankers in a report on the governance of financial institutions. Its report, published a day before Mr Dimon's "teapot" remark, also noted the "compelling logic" of splitting the chairman and chief executive.

Mr Dimon is Wall Street's last star CEO. With Lloyd Blankfein of Goldman Sachs on the defensive and Dick Fuld of Lehman Brothers departed, the "too big to fail" banks are being managed by low-key, more emollient, leaders such as Vikram Pandit of Citigroup and Brian Moynihan of Bank of America. In both of these cases, the board is headed by a non-executive chairmen.

JPMorgan remains Jamie's show. Until now, that has produced good results for shareholders and senior executives insist that his ebullient, in-your-face style coexists with a willingness to listen to others.

One lapse does not make Dimon a poor CEO, but he has been behaving imperiously

"I've worked with Jamie for 20 years and he expects and wants direct engagement and feedback. He encourages it," says Michael Cavanagh, the JPMorgan executive investigating the London mess.

The formula failed this time. Ina Drew, the former head of the bank's chief investment office, who lost her job for playing down the seriousness of the problem and making Mr Dimon look foolish, was among his closest confidants. She was one of the bank's top five executives, earning $15.5m last year.

Mr Dimon's temperament has also proved a liability in the past. He was fired from Citigroup in 1998 by Sandy Weill and John Reed after a physical altercation with Deryck Maughan, his co-CEO of the corporate bank.

It takes an exceptional board to stand up to such a wilful figure and JPMorgan's board is not set up to do it. As Robert McCormick, chief policy officer of Glass Lewis & Co, an investor advisory group that supports the division of Mr Dimon's jobs as chairman and chief executive, says: "It is potentially insurmountable conflict. How can you oversee yourself?"

That question applies to any company at which the chief executive also chairs the board, but particularly to banking institutions, where risk oversight is vital. They can easily boost revenues by taking on trading or lending risk. The question is whether they are doing it wisely. In this case, clearly not.

At the annual meeting this week, Mr Dimon rejected criticism of his membership of the New York Federal Reserve's board of governors: "It is not like a board. It is more of an advisory group, in my opinion," he said. My suspicion is that he regards his own bank's board in the same manner.

He says not. Lee Raymond, the tough former chairman and chief executive of ExxonMobil, is the board's lead independent director and Mr Dimon is the only executive on an 12-member board. That is in line with the Group of Thirty's call for a board to operate "efficiently, cohesively and decisively". All the shareholders have an equal vote.

But neither the shareholders nor JPMorgan's regulators ought to be happy to let Mr Dimon carry on wielding undivided power at the top. He promised this week to "admit our mistakes, learn from them and fix them". There is an obvious lesson in corporate governance for him to apply to himself.

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The A list

How to get out of Afghanistan. Nato's summit must produce a new policy, says **Francis Fukuyama**

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It is too late for America to eliminate Huawei

John Gapper

To read the scathing condemnation of Chinese telecoms equipment suppliers fired from Washington this week, you would think we still lived in another world. In that world, telecoms networks were built by national monopolies such as AT&T, France Telecom and British Telecom, and outsiders stayed away.

But we don't.

You know things have come to a pretty pass when US politicians throw their weight behind a French company because the alternative is worse. That would be the effect of barring Huawei and ZTE from the US market on the grounds that they are shifty front organisations for the Chinese government and the People's Liberation Army.

It would aid Alcatel-Lucent, the troubled 2006 merger of the French company with Lucent, descended from Western Electric of Cleveland, Ohio, which was bought by AT&T in 1881. Things have since moved on and Huawei Technologies and ZTE of Shenzhen in southern China are the new Western Electrics.

The US House of Representatives intelligence committee, with its demand to bar Huawei or ZTE from gaining US contracts or merging with US companies, is living in the past. The time to declare telecoms a strategic, protected industry like defence, was 20 years ago; now is the time to make a deal.

"Huawei and ZTE represent something new: a former third-world country producing first-world technology. The American corporate psyche finds this difficult to handle," says John Quelch, dean of the China Europe International Business School in Shanghai.

It was obviously tough on the House intelligence committee, which has thrown many accusations at both companies, in particular Huawei, which has grown to share industry leadership with Ericsson of Sweden since it was founded in 1987 by a former PLA officer.

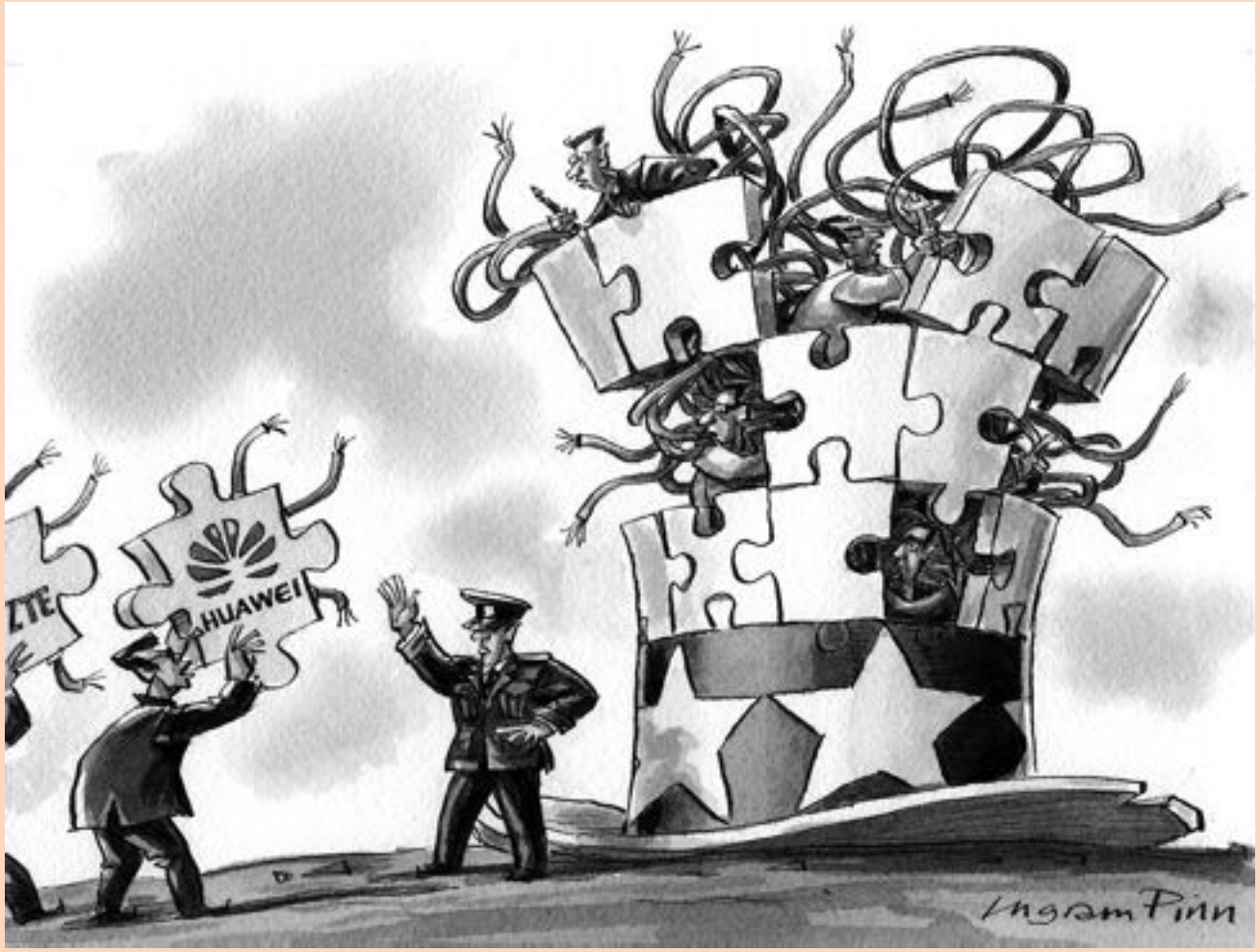
This sounds dodgy, given the PLA's ambitions in cyber espionage and mass efforts by Chinese hackers to acquire US military and industrial secrets. Former executives of Nortel Networks, the Canadian group that was Huawei's rival until it went into Chapter 11 bankruptcy protection in 2009, complained of constantly being hacked from China in the 2000s.

"A number of states are engaged in economic espionage and China is the most prolific," says Mike McConnell, a former head of the US National Security Agency who is vice-chairman of Booz Allen Hamilton, the consultancy. "Research and development costs a lot and it is cheaper to steal it."

The chief accusation is that, if permitted to build networks for operators such as AT&T and Verizon, Huawei would build traps into the software and hardware. Its friends in the Communist party could then use them to hack databases or to bring the networks down in a war.

It is foolish to ignore the potential security holes in telecoms networks. The NSA has itself been accused of spying on US and foreign internet traffic by monitoring traffic passing over American networks.

But barring Chinese companies does not solve it. Alcatel-Lucent has a venture in China with Shanghai Bell and much of the equipment used by Ericsson and others is made in China. If the party and the PLA wanted to be sneaky they would tamper with these components.



The best thing for consumers would be to admit Huawei and ZTE with safeguards

Nor is there direct evidence of malfeasance against Huawei and ZTE in the report, although one section is classified. Meanwhile, the committee alleges that the companies breach patents and enjoy support from China in the form of soft loans.

Both could be true but they are the stuff of trade and intellectual property disputes rather than an intelligence concern. The committee undermines its case by sounding as if it seeks any excuse to exclude Chinese competitors.

The companies have not helped themselves. Huawei is a reclusive outfit that did not publish the names of its directors until a few years ago. Sun Yafang, its chairwoman, is reported to have once worked at the Ministry of State Security and, like other companies, it has an internal Communist party committee whose exact purpose is mysterious.

Yet Huawei is not easily categorised as a state stooge. It is not state-owned (ZTE has closer links with Guangdong province) and was among start-ups that flourished in Shenzhen's economic zone in the 1990s. It is still private and claims to be wholly employee-owned. "Huawei is an independent, quite arrogant, company," says Duncan Clark, a Beijing-based consultant.

In some ways, it is a symbol of the very China the west has an interest in encouraging. China's government declared in 2006 that telecoms was one of seven strategic industries over which state-owned enterprises should retain "absolute control" yet Huawei was built by an entrepreneur who admires Silicon Valley.

Huawei seized 20 per cent of the global market, according to Bernstein Research, by producing equipment at lower prices than western rivals, triggering a wave of consolidation. In the US, where competition has been effectively curbed, Ericsson and Alcatel-Lucent have a duopoly.

The best thing for US consumers would be to admit Huawei and ZTE with safeguards. In the UK, Huawei's equipment is examined by former staff of GCHQ, the UK intelligence service, before being used by BT. The US and Australia, which has barred Huawei from a planned network, could go further.

The US might require Huawei to list in London or New York to illuminate who owns the company; submit technology to the NSA; and separate its US division like a defence group. It could even demand the dissolution of its Communist party committee. What it cannot do is recreate the past.

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The A list

Beijing transfer
China's next generation of leaders will defy western detractors, writes Kishore Mahbubani
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FINANCIAL TIMES

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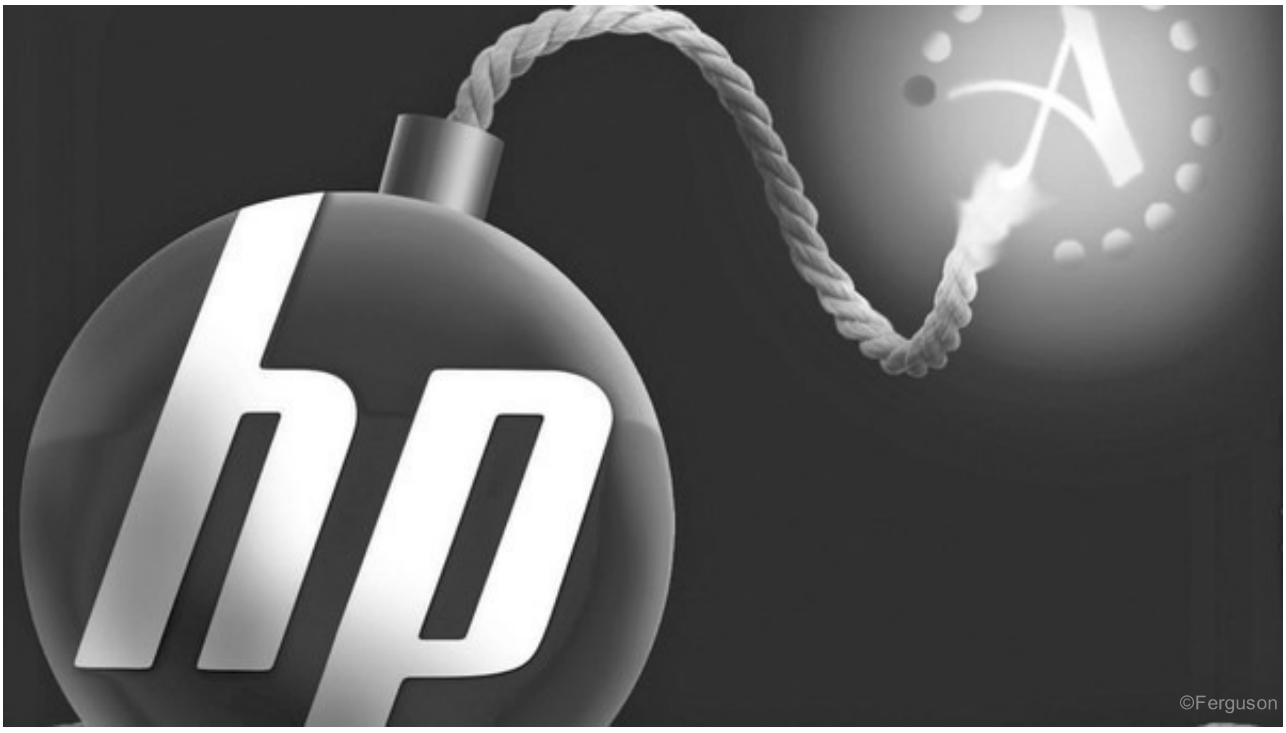
HP should have known all about Autonomy

By John Gapper

It was no secret that some analysts and investors suspected the UK software company of flattering its figures



Things got quite exciting in London at noon on Tuesday. First Kweku Adoboli, the rogue trader formerly employed by UBS, was sentenced to seven years in prison for fraud. Then Hewlett-Packard accused the former management of Autonomy, the UK software company, of wrongdoing. The moral appeared to be, as a New York journalist wryly tweeted: "Don't trust the British."

Hold on a minute, though. This is HP we're talking about, a company that has a sorry record of overpaying for acquisitions and then writing off most of the value shortly afterwards. If Autonomy inflated its value in its $11bn sale to HP last year, which it firmly denies, it was bought by the world's biggest deflater.

As Meg Whitman, HP's latest chief executive, disclosed a writedown of $8.8bn on the Autonomy deal, she made it sound like a unique scandal. But three months ago, she wrote down $8bn on its $13.9bn purchase of Electronic Data Systems in 2008. Not even that collapse matched Léo Apotheker, her predecessor, who wrote off more than the $1.2bn HP had paid for Palm in 2010.

With management and accounting like that, it is surprising HP has a balance sheet left. Indeed, the EDS writedown triggered a revaluation of its other assets that contributed $3bn to the Autonomy kitchen-sinking. This cascade took $20bn of goodwill and intangibles off its assets this year – almost matching its $23bn market capitalisation.

Even in a world where mergers and acquisitions are risky, and big companies struggle to make them work, this is remarkable. As any shareholder might ask – and many do – what is going on?

The initial temptation – one encouraged by HP – is to blame Autonomy for the debacle. But although it bears plenty of responsibility for what occurred, it isn't the entire story. In many ways, Autonomy and HP were natural partners in an industry that is prone to wild misvaluation.

One reason is that Silicon Valley companies, and now those from London's Silicon Roundabout, have always lived or died by growth. Venture capitalists fund software and internet companies on the promise of rapid growth and high margins. When growth slows, as it has for HP, they have an identity crisis.

The temptation, indulged by HP's various chief executives over the past few years, is to restore it by buying high-growth companies at inflated prices to tack on to mature operations. Autonomy was a classic example: Mr Apotheker paid an eye-watering premium in an effort to shift HP from hardware.

It is also relatively simple to inflate the value of software companies with sharp accounting. "There is more scope for abuse because you can press a button and record a sale at almost zero cost," says Paul Morland, a technology analyst at Peel Hunt in London. "In other businesses there tends to be more involved, like making and delivering something."

Mike Lynch, Autonomy's founder and former chief executive, insists that HP is making baseless charges and that it spoiled his business after buying it. But the tactics HP accuses Autonomy of using – for example, prematurely recognising the lifetime value of a software licence sale – have been employed by others.

In some extreme cases, that has led to fraud charges against those involved. Seven senior executives of Computer Associates, the US software company, were jailed in 2006 for fraud and obstructing justice after massaging their results by recording sales made in one quarter in an earlier one.

In other cases, companies manage to test the boundaries of accounting practice without breaching any rules. HP has handed its complaints about Autonomy's former senior managers to the Securities and Exchange Commission in the US and the Serious Fraud Office in the UK, and those bodies will decide.

The mystery is why HP, and the advisers that handled the deal, did not dig deeper in the

first place. It was not a secret that some analysts and investors thought Autonomy was flattering its figures. “When the deal was announced, I wrote to HP telling them they were making a big mistake,” says Mr Morland. “I never got a response.”

Jim Chanos, founder of Kynicos Associates, a US hedge fund, told investors in 2009 that Autonomy was hiding weaknesses in its results by buying companies and adding their revenues to its own. Autonomy “appears to have consistently overstated revenue and grossly understated expenses as part of its acquisition strategy”, he wrote.

Yet Autonomy’s reported record of vibrant software sales and high margins made it a tempting target for HP under the growth-hungry Mr Apotheker. Mr Chanos was also critical of HP, describing it last year as “a tech roll-up whose constantly changing management team has wrecked the balance sheet”.

That was his view even before Ms Whitman went on the balance sheet writedown spree of the past few months. It does not encourage much faith that HP has changed its ways since she replaced Mr Apotheker. Whatever the merits of her case against Autonomy, it was a timely distraction from HP’s own operational weaknesses.

Ms Whitman, who sat on the board of HP when it approved the purchase of Autonomy, is trying to remodel her company into something more stable and better under control. She talked to analysts last month of providing “a steady hand on the tiller” and of halting HP’s tendency to keep changing strategy.

She has used some pretty punchy accounting methods herself to write off HP’s past acquisition errors and false hopes. With those taken from the balance sheet, it needs time to rebuild. A good start would be to stop acquiring exciting-looking growth companies.

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