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Was LinkedIn Scammed?

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If there's one thing we've all learned in the aftermath of the financial crisis, it's that stiffing your client is not a crime. Not if you're an investment bank.

Deutsche Bank, according to a recent report [http://www.nytimes.com/interactive/2011/04/14/business/14crisis-docviewer.html] by the Senate Permanent Subcommittee on Investigations, sold its clients subprime mortgage bonds that one of its own traders at the time described as "pigs." Goldman Sachs took unseemly advantage of unsuspecting clients to offload its most toxic assets in 2007 and 2008. During the subprime bubble, this kind of behavior was par for the course.

It still is, apparently. On Thursday, LinkedIn, an Internet company that connects business professionals, became the first major American social media company to go public. The company had hired Morgan Stanley and Bank of America's Merrill Lynch division to manage the I.P.O. process. After gauging market demand — which is what they're paid to do — the investment bankers priced the shares at $45. The 7.84 million shares it sold raised $352 million for the company. For this, the bankers were paid 7 percent of the deal as their fee.

For a small company with less than $16 million in profits last year, $352 million in the bank sounds pretty wonderful, doesn't it? But it really wasn't wonderful at all. When LinkedIn's shares started trading on the New York Stock Exchange, they opened not at $45, or anywhere near it. The opening price was $83 a share, some 84 percent higher than the I.P.O. price. By the time the clock had struck noon, the stock had vaulted to more than $120 a share, before settling down to $94.25 at the market's close. The first-day gain was close to 110 percent.

I have no doubt that most everyone at LinkedIn was thrilled to see the run-up; most executives at start-ups usually are. An I.P.O. is an important marker for any company.

And, of course, the executives themselves are suddenly rich. But, in reality, LinkedIn was scammed by its bankers.

The fact that the stock more than doubled on its first day of trading — something the investment bankers, with their fingers on the pulse of the market, absolutely must have known would happen — means that hundreds of millions of additional dollars that should have gone to LinkedIn wound up in the hands of investors that Morgan Stanley and Merrill Lynch wanted to do favors for. Most of those investors, I guarantee, sold the stock during the morning run-up. It's the easiest money you can make on Wall Street.

As Eric Tilenius, the general manager of Zynga, wrote on Facebook: "A huge opening-day pop is not a sign of a successful I.P.O., but rather a massively mispriced one. Bankers are rewarding their friends and themselves instead of doing their fiduciary duty to their clients."

There is nothing wrong with a small "pop" in the aftermath of an I.P.O.; investors, after all, don't want to buy a stock that is going to go down immediately. But during the Internet bubble of the 1990s, the phenomenon of investment bankers wildly underpricing I.P.O.'s so that money could be diverted to favored investors got completely out of hand — stocks would sometimes rise 500 percent on the first day. It was obscene.
Indeed, most business journalists writing about the LinkedIn deal focused on the first-day run-up as evidence that we've entered another Internet bubble. But over at the Business Insider blog [http://www.businessinsider.com/linked-in-ipo-2011-5-b], Henry Blodget — who knows a thing or two about bad behavior on Wall Street — had the perfect analogy for what the banks had done to LinkedIn.

Suppose, he wrote, 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 the new owner for $2 million. "How would you feel if your agent did that?" he asked. That, he concluded, is what Merrill and Morgan did to LinkedIn.

It's worth remembering that most of the young Internet companies with those eye-popping I.P.O.'s back in the day are long gone. With their flawed business models, maybe they were doomed from the start — but the cash they left on the table at the I.P.O. might have allowed at least a few of them to survive.

Similarly, LinkedIn is still a fragile enterprise. Its business model remains unproved. It is going to have to grow awfully fast to justify its stock price. Its executives may yet rue the day they let themselves be sold down the river by their investment bankers. LinkedIn is supposed to be the client, but it was treated like the mark.

Ever since the financial crisis, investment bankers have been constantly questioned about whether they have any larger social purpose besides making money. What they invariably say is that they play a critical role in capital formation, meaning that they help companies raise the money they need to grow and prosper.

The LinkedIn deal suggests something darker. The crisis hasn't changed them a bit. They're still just in it for themselves.

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