The poor folks at LinkedIn

This piece is part of a roundtable with Post columnist Steve Pearlstein and four of our On Leadership expert contributors about LinkedIn, and life after an IPO.

Pity those poor folks at LinkedIn – their world has changed dramatically for the worse, and they may not even realize it yet. But reality will soon sink in. Or more precisely, expectations will soon sink in. And with newly minted multimillionaires in senior positions, who all hold lots of LinkedIn stock, the temptation to focus on all the wrong things will be almost irresistible. That's the real danger LinkedIn and, by extension, its shareholders face post-IPO.

From its fabled founding in Reid Hoffman's living room in 2002, LinkedIn has focused on an important real market: building its member base to more than 100 million users by the time it went public last month. But with the IPO, LinkedIn left the world of reality behind and entered the world of expectations. The IPO was priced at $45 per share, but, once on the market, the new shares immediately shot up in a bubble-worthy buying frenzy, going as high as $122.70 before falling back and, dare we say, 'stabilizing' in the $90 range. That makes LinkedIn's current market capitalization $8 billion or thereabouts.

What does a market capitalization of $8 billion mean for a non-dividend-paying company like LinkedIn? Let's assume that shareholders have an after-tax cost of equity of 7 percent (a conservative number). Such a scenario means that investors would reasonably expect LinkedIn to generate approximately $560 million of incremental value for shareholders in the next year. But how reasonable is the expectation?

LinkedIn management doubled real revenue earned from$120 million in 2009 to $243 million in 2010 and converted a loss of $4 million to a profit of $16 million. That $16 million represents real and immediate value created for shareholders and a foundation for future growth. But $16 million is a long way from $560 million.

Even if LinkedIn is able to dramatically grow over the next three years – assuming heady growth rates in which revenue doubles and net income triples each year – it would earn $48 million on $250 million of revenue in 2011,$144 million on $500 million in 2012 and $432 million on $1 billion in 2013. All told, that averages out to $208 million per year. By almost any measure that would be impressive

growth. But, given current expectations of $560 million per year in shareholder value creation, that impressive growth would work out to a three-year expectations deficit of more than $1 billion. In other words, LinkedIn could grow net income 27 times over three years and still massively disappoint the market. To meet current expectations, it would have to generate 82 times profit growth in the same period.

But maybe that's no problem. Maybe this is the next Google. Except that even Google only grew net income 29 times in the first three years after IPO. So maybe this is the next Google, but tripled! No doubt LinkedIn has a tough – if not outright impossible – road ahead of it to meet the newly established market expectations.

This is the nature of its new world. Prior to its IPO, LinkedIn lived in the real world – of building membership to build real revenues and real profits. On May 19, 2011, LinkedIn crossed a huge gulf into the expectations world – where CEOs react to and attempt to satisfy the expectations of faceless, nameless public shareholders, regardless of how disconnected from reality those expectations may be. From now on, LinkedIn's leaders will be tempted to focus on stock price and earnings estimates and shareholder value instead of focusing on growing the fundamentals of their business. That's the danger they face from the "success" of the IPO: turning their attention from what made them successful in the first place to matters largely outside their control.

The LinkedIn folks have done wonderfully well financially with the IPO. Their paper wealth is huge. But going forward, they will have to get used to disappointing their new BFFs – the public shareholders – in the expectations market. In that world, they will be able to do nothing right. The new shareholders may believe that it would be good for management to focus primarily on them. But they are sadly mistaken. Everyone will be better served if management focuses on what actually they can do, which is building their business for the long term, regardless of short-term expectations.