CASE THIRTEEN

Overstock.com[1]

At the beginning of 2004, Overstock.com, Inc., was one of the hottest growth stocks on Wall Street. Operating in the highly competitive “e-tail” industry, the company had grown revenue from less than $2 million in 1999 to over $200 million in 2003. By March of 2004, Overstock.com’s stock price had risen to around $30, representing a price-sales multiple of 2 and a market-book multiple of 10. The company’s spectacular rise was attributed in large part to its high-achieving chief executive, Dr. Patrick Byrne. Byrne, who holds a master’s from Cambridge University and a doctorate from Stanford University, had previously run a subsidiary of Warren Buffett’s Berkshire Hathaway. Enthusiasm for the company in early 2004 was summarized in *The Washington Post* as follows:

> Fifty-five venture capitalists turned down Patrick Byrne’s discount-shopping Web site for funding at the peak of dot-com investing mania. So the graduate of Walt Whitman High, Stanford University and Warren Buffett’s real-world school of business funded it himself. Five years later, Overstock Inc. is a publicly traded company, pulling in nearly 7 million shoppers a month to its Internet bargain bazaar and ranking right up there with Target.com and BestBuy.com as one of the Web’s top 20 e-commerce sites. But Byrne, its maverick chief executive, won’t be satisfied until Overstock.com becomes a household name on par with eBay and Amazon.com, the Internet’s top shopping hangouts, each of which draws more than 30 million people a month.[2]

The news, however, was not all good. Overstock.com had yet to report a positive annual profit and had only logged one quarterly profit, with that being back in the fourth quarter of 2002. The last 12 months had seen the departure of the company’s chief financial officer, chief operating officer, and president. Moreover, competition was heating up from the likes of industry giants Amazon.com and eBay as well as smaller start-ups, such as privately held SmartBargains.com.

Against this backdrop, Overstock.com entered 2004 with plans to raise an additional $50 million, primarily to fund the inventory acquisitions necessary to maintain the company’s aggressive growth plans. Its capital-raising plans called for the issuance of 1.5 million additional shares through an offering underwritten by W. R. Hambrecht and Co. and JMP Securities. Enthusiasm for Overstock.com remained high on Wall Street, with analysts at both W. R. Hambrecht and JMP Securities issuing “buy” recommendations on the stock. Analysts at W. R. Hambrecht summarized their investment opinion as follows:

> **Reiterating Buy rating and increasing price target to $40.** Our price target implies an enterprise value to CY04 revenue of 1.4x, vs. a 1.1x multiple for OSTK’s discount retailing peers and vs. 8.7x for internet bellwethers AMZN and eBay (EBAY: Buy Rated). We think OSTK shares deserve a premium to its discount retailing peers because of the company’s superior top-line growth prospects.[3]

Detailed information on Overstock.com’s business strategy, financial situation, and expansion plans are provided in its Form 10-K for the year ended December 31, 2003. This document is available as an online exhibit at www.lundholmandsloan.com.

QUESTIONS

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[1] This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation.

[2] Leslie Walker, “Underestimated Overstock.com Aims Higher,” *The Washington Post,* December 4, 2003.

[3] William J. Lennan and Andrew Mackay, “OSTK: Beating Amazon.com on NYT Bestsellers, but What Does It Mean for Margins?” *W. R. Hambrecht and Co. Research Report,* March 10, 2004.

Business Strategy Analysis

1. Evaluate the structure of the Internet retailing (e-tailing) industry and its ability to generate profits over the long run. As a starting point, consider the five forces of competition:
   • Competition from substitutes.
   • Rivalry between established competitors.
   • Threat of entry.
   • Bargaining power of customers.
   • Bargaining power of suppliers.
2. Evaluate Overstock.com's strategy for creating competitive advantage, identifying the key success factors and risks associated with this strategy. Make sure to evaluate Overstock.com's business strategy relative to established e-tailers such as Amazon.com, traditional liquidation retailers such as TJX Companies, and other liquidation e-tailers such as SmartBargains.com.

Accounting Analysis

3. Identify Overstock.com's critical accounting policies. Briefly comment on whether you think that these accounting policies fairly present Overstock's financial performance.
4. The growth rate in Overstock's total revenue from 2002 to 2003 exceeded 150 percent. Do you think that this growth rate is sustainable? Explain your answer.
5. The growth rate in Overstock's gross profit from 2002 to 2003 was less than 50 percent, despite the fact that total revenue grew by over 150 percent. Explain why the growth rate in gross profit was so much lower.
6. Overstock.com has reported substantial losses in each of the last three years. Do you think these accounting losses provide a good reflection of Overstock. com's underlying economic performance? If you answered no to the first part of this question, how might you go about restating Overstock.com's accounting results in order to better reflect Overstock.com's underlying economic performance?

Ratio Analysis

7. Maximizing return on equity involves a trade-off between operating profitability (margin on sales) and turnover (efficiency of asset utilization). Consider the different business models of
   • A closeout e-tailer, such as Overstock.com (OSTK).
   • A regular e-tailer, such as Amazon.com (AMZN).
   • A traditional closeout retailer, such as Ross Stores (ROST).
   • A department store retailer, such as May Department Stores (MAY).
8. Discuss how the different business models involved in each of these categories will influence the trade-off between profitability and turnover.
9. Figures 1, 2, and 3 are *eVal* Ratio Analysis outputs for AMZN, ROST, and MAY through the end of fiscal 2003. Using *eVal*, load the Overstock.com case data and conduct a ratio analysis for OSTK. (Note: case data can be imported by going to the Case Data sheet in *eVal* and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.)
10. Provide both a time-series analysis of OSTK from 2001 through 2003 and a cross-sectional analysis using AMZN, ROST, and MAY as comparison companies. Summarize what you learn about the key strengths and weaknesses of OSTK's financial performance.

Forecasting

This is a real-time forecasting case. Your objective is to forecast Overstock.com's income statement, balance sheet, and statement of cash flows for its current fiscal quarter. You should place particular emphasis on trying to generate an accurate forecast of Overstock.com's current quarter EPS (both basic EPS and diluted EPS). Use the following framework and data sources in constructing your forecasting model:

11. Familiarize yourself with Overstock.com's business strategy and financial performance. You will find most of the information available from the Investor Relations link at the bottom of

Overstock.com's homepage (http://www.overstock.com). Make sure that you review Overstock.com's recent SEC filings and press releases.

12. Familiarize yourself with Overstock.com's expansion plans. Company press releases and the MD&A sections of the Form 10-Ks and Form 10-Qs are your best sources of information. This information is again available from the Investor Relations link at the bottom of Overstock.com's homepage.
13. Use the forecasting framework developed in the course, along with the insights generated by your analyses in questions 1 and 2 above to prepare forecasts of Overstock.com's income statement, balance sheet, and statement of cash flows for the current quarter.
14. Do a "reality check" on your forecasting model by comparing your EPS forecasts to sell-side analysts' forecasts (available at the following link: http://finance.yahoo.com/q/ae?s OSTK).

Valuation Analysis

15. The case introduction summarizes an investment opinion issued by analysts at W. R. Hambrecht on March 10, 2004. Critically evaluate the valuation method(s) used to justify the $40 price target contained in this opinion.
16. Load the Overstock.com case data into *eVal* and critically evaluate the default valuation provided by *eVal*.
17. In early 2004, Overstock.com was trading at around $30 per share. Using *eVal*, provide a set of forecasting assumptions that approximate this price. Use a cost of equity capital of 10 percent and a valuation date of March 10, 2004. Do you think that these forecasting assumptions are plausible?
18. Using *eVal*, provide your own valuation of Overstock.com on March 10, 2004. Select what you consider to be the most plausible set of forecasting assumptions and justify these selections. Use a cost of equity capital of 10 percent and a valuation date of March 10, 2004.

FIGURE 1 Ratio Analysis for Amazon.com

	Fiscal Year End Date				
	Actual 12/31/1999	Actual 12/31/2000	Actual 12/31/2001	Actual 12/31/2002	Actual 12/31/2003
Annual Growth Rates					
Sales		68.4%	13.1%	26.0%	33.8%
Assets		−13.6%	−23.3%	21.6%	8.6%
Common Equity		−463.2%	#N/A	#N/A	#N/A
Earnings		#N/A	#N/A	#N/A	#N/A
Free Cash Flow to Investors			#N/A	−1,308.2%	#N/A
Sustainable Growth Rate			47.1%	10.7%	−3.0%
Profitability					
Return on Equity		4.027	0.471	0.107	(0.030)
Return on Equity (b4 nonrecurring)		2.267	0.307	0.027	(0.118)
Return on Net Operating Assets		(0.876)	(0.449)	(0.007)	0.179
Basic Dupont Model					
Net Profit Margin	(0.439)	(0.511)	(0.182)	(0.038)	0.007
× Total Asset Turnover		1.199	1.655	2.168	2.535
× Total Leverage		(6.572)	(1.567)	(1.299)	(1.738)
= Return on Equity		4.027	0.471	0.107	(0.030)
Advanced Dupont Model					
Net Operating Margin	(0.387)	(0.464)	(0.137)	(0.002)	0.031
× Net Operating Asset Turnover		1.889	3.273	4.713	5.686
= Return on Net Operating Assets		(0.876)	(0.449)	(0.007)	0.179
Net Borrowing Cost (NBC)		0.072	0.065	0.064	0.061
Spread (RNOA − NBC)		(0.948)	(0.513)	(0.072)	0.117
Financial Leverage (LEV)		(5.171)	(1.793)	(1.598)	(1.775)
ROE = RNOA + LEV * Spread		4.027	0.471	0.107	(0.030)
Margin Analysis					
Gross Margin	0.218	0.238	0.239	0.273	0.253
EBITDA Margin	(0.192)	(0.123)	(0.032)	0.049	0.066
EBIT Margin	(0.364)	(0.240)	(0.074)	0.027	0.051
Net Operating Margin (b4 nonrec.)	(0.364)	(0.240)	(0.074)	0.027	0.051
Net Operating Margin	(0.387)	(0.464)	(0.137)	(0.002)	0.031
Turnover Analysis					
Net Operating Asset Turnover		1.889	3.273	4.713	5.686
Net Working Capital Turnover		8.002	8.867	9.098	9.272
Avge Days to Collect Receivables		0.000	0.000	5.210	8.472
Avge Inventory Holding Period		34.261	24.458	22.103	23.043
Avge Days to Pay Payables		80.458	70.558	69.293	68.349
PP&E Turnover		8.076	9.786	15.389	22.704

FIGURE 2 Ratio Analysis for Ross Stores

	Fiscal Year End Date				
	Actual 12/31/1999	Actual 12/31/2000	Actual 12/31/2001	Actual 12/31/2002	Actual 12/31/2003
Annual Growth Rates					
Sales		9.7%	10.2%	18.2%	11.0%
Assets		2.9%	11.0%	25.7%	21.7%
Common Equity		−1.2%	16.4%	18.1%	17.4%
Earnings		1.1%	2.2%	29.8%	13.4%
Free Cash Flow to Investors			#N/A	−336.3%	#N/A
Sustainable Growth Rate			28.0%	31.4%	30.1%
Profitability					
Return on Equity		0.323	0.306	0.339	0.326
Return on Equity (b4 nonrecurring)		0.323	0.306	0.339	0.326
Return on Net Operating Assets		0.306	0.292	0.332	0.310
Basic Dupont Model					
Net Profit Margin	0.061	0.056	0.052	0.057	0.058
× Total Asset Turnover		2.818	2.903	2.890	2.598
× Total Leverage		2.043	2.033	2.058	2.158
= Return on Equity		0.323	0.306	0.339	0.326
Advanced Dupont Model					
Net Operating Margin	0.061	0.057	0.053	0.057	0.058
× Net Operating Asset Turnover		5.391	5.551	5.824	5.321
= Return on Net Operating Assets		0.036	0.292	0.332	0.310
Net Borrowing Cost (NBC)		0.066	0.060	0.014	0.000
Spread (RNOA − NBC)		0.240	0.231	0.318	0.310
Financial Leverage (LEV)		0.068	0.063	0.021	0.054
ROE = RNOA + LEV * Spread		0.323	0.306	0.339	0.326
Margin Analysis					
Gross Margin	0.314	0.312	0.311	0.274	0.275
EBITDA Margin	0.123	0.114	0.107	0.112	0.115
EBIT Margin	0.103	0.093	0.086	0.094	0.095
Net Operating Margin (b4 nonrec.)	0.063	0.057	0.053	0.057	0.058
Net Operating Margin	0.061	0.057	0.053	0.057	0.058
Turnover Analysis					
Net Operating Asset Turnover		5.391	5.551	5.824	5.321
Net Working Capital Turnover		12.847	13.087	13.552	11.131
Avge Days to Collect Receivables		2.028	2.136	2.010	2.031
Avge Inventory Holding Period		103.866	104.916	95.437	100.076
Avge Days to Pay Payables		52.056	52.599	52.606	56.791
PP&E Turnover		9.426	9.433	9.619	8.841

FIGURE 3 Ratio Analysis for May Department Stores

	Fiscal Year End Date				
	Actual 12/31/1999	Actual 12/31/2000	Actual 12/31/2001	Actual 12/31/2002	Actual 12/31/2003
Annual Growth Rates					
Sales		4.7%	–2.3%	–4.8%	–1.1%
Assets		5.8%	3.0%	0.1%	1.3%
Common Equity		–5.4%	–0.4%	5.1%	3.9%
Earnings		–7.5%	–18.6%	–23.4%	–20.6%
Free Cash Flow to Investors			#N/A	162.5%	–26.3%
Sustainable Growth Rate			9.6%	5.5.%	2.6%
Profitability					
Return on Equity		0.212	0.178	0.133	0.11
Return on Equity (b4 nonrecurring)		0.210	0.177	0.147	0.154
Return on Net Operating Assets		0.131	0.107	0.091	0.078
Basic Dupont Model					
Net Profit Margin	0.065	0.058	0.048	0.039	0.031
× Total Asset Turnover		1.289	1.207	1.131	1.110
× Total Leverage		2.838	3.053	3.029	2.922
= Return on Equity		0.212	0.178	0.133	0.101
Advanced Dupont Model					
Net Operating Margin	0.080	0.074	0.065	0.058	0.049
× Net Operating Asset Turnover		1.764	1.650	1.585	1.609
= Return on Net Operating Assets		0.131	0.107	0.091	0.078
Net Borrowing Cost (NBC)		0.055	0.050	0.055	0.056
Spread (RNOA − NBC)		0.075	0.057	0.036	0.022
Financial Leverage (LEV)		1.074	1.233	1.161	1.016
ROE = RNOA + LEV * Spread		0.212	0.178	0.133	0.101
Margin Analysis					
Gross Margin	0.358	0.351	0.350	0.340	0.339
EBITDA Margin	0.164	0.156	0.145	0.134	0.138
EBIT Margin	0.131	0.120	0.105	0.093	0.096
Net Operating Margin (b4 nonrec.)	0.079	0.074	0.065	0.062	0.065
Net Operating Margin	0.080	0.074	0.065	0.058	0.049
Turnover Analysis					
Net Operating Asset Turnover		1.764	1.650	1.585	1.609
Net Working Capital Turnover		4.758	4.837	5.327	5.293
Avge Days to Collect Receivables		53.501	51.744	49.768	47.817
Avge Inventory Holding Period		111.519	115.175	117.459	115.828
Avge Days to Pay Payables		39.162	39.121	43.396	46.779
PP&E Turnover		3.002	2.790	2.515	2.514