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## BARRON'S COVER

### Bubble Redux

*Look out below! Internet stars Yahoo, eBay and Amazon again look way overinflated*

By **ANDREW BARY**

**INTERNET STOCKS HAVE BEEN** the surprise stars of a rocky market. The Dow Jones index of 'Net stocks is up 12% this year and has risen 70% from its October low. But, based on their current valuations, these stars, like supernovas, might have gotten too hot for their own good.

Among marquee 'Net names, [Amazon.com](#) is up 35%, to 25, this year, way above its 2001 low of 7. [Yahoo](#) has gained 48% in 2003, to 24, and has tripled since it bottomed at 8 last fall. Industry leader [eBay](#) is 30% higher, to 89, this year and now sports a market value of \$28 billion, not much less than media giants [News Corp.](#) and [Disney](#). Can you say "new Internet stock bubble"?

Yes, Amazon, Yahoo and eBay have parlayed "first-mover advantage" in their Internet "spaces" into sustainable businesses with varying degrees of profitability. But it's tough to justify their share prices. In fact, it could be argued that Amazon is worth no more than 10, that Yahoo would be fairly valued at 15 and eBay at 60.

"There's no fundamental reason for buying these stocks now," says Fred Hickey, editor of the High-Tech Strategist newsletter in Nashua, N.H. He attributes their rally this year to investment professionals' eagerness to scoop up volatile, or "high-beta," stocks in anticipation of a market rally. "You'd think people would have learned that not paying attention to valuation can be a way to shorten their careers."



Scott Pollack for Barron's

forecast '03 earnings.

Amazon, eBay and Yahoo look even pricier when the cost of their employee option and stock grants are taken into account. Yahoo and Amazon would have operated at a loss last year, if they had treated options as a cost, while eBay would have earned just 23 cents a share, not the 87 cents it reported. Accounting rule makers are expected to mandate the expensing of options next year.

The 'Net stocks have rallied on growing confidence that, amid the industry shakeout, a few leading companies will generate strong profit growth for the next several years. The success of two travel-oriented Internet companies, [Expedia](#) and [Hotels.com](#), both of which have received takeover bids from their controlling shareholder, [USA Interactive](#), demonstrates a lucrative potential.

Yet even some Wall Street fans of the stocks have been urging caution lately. There have been several downgrades of Internet issues, including Amazon and Yahoo, by analysts who have cited valuation. In cutting his rating on Yahoo to "In Line," or Hold,

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from Outperform, Smith Barney analyst Lanny Baker said: "Yahoo's share price has begun to reflect the company's strategic and financial resurrection."

Amazon's valuation is the most egregious of the 'Net trio. It trades for 80 times projected "pro forma" 2003 profit of 32 cents a share. Amazon's pro forma definition of profit, moreover, is dubious because it excludes restructuring charges and, more important, the restricted stock that Amazon now is issuing to employees in lieu of stock options. Amazon's reported profit this year under generally accepted accounting principles (which include restricted-stock costs) could be just 10 cents to 15 cents a share, meaning that Amazon's true P/E arguably is closer to 200.

Yahoo, meanwhile, now commands 70 times estimated 2003 net of 35 cents a share, and eBay fetches 65 times projected 2003 net of \$1.35 a share.

**Tables: Pricey Leaders, In a League of Its Own, Internet Opportunities**

What's fair value? By our calculations, Amazon is worth, at best, roughly 90% of its projected 2003 revenue of \$4.6 billion. That translates into \$10 a share, or \$4.1 billion. This estimate is charitable because the country's two most successful brick-and-mortar retailers, [Wal-Mart Stores](#) and [Home Depot](#), also trade for about 90% of 2003 sales.

Yahoo ought to trade closer to 15. That's a stiff 43 times projected 2003 earnings and gives the company credit for its strong balance sheet, featuring over \$2 a share in cash and another \$3 a share for its stake in Yahoo Japan, which has become that country's eBay.

Sure, eBay undoubtedly is the most successful Internet company and the only one that has lived up to the growth projections made during the Bubble. As the dominant online marketplace in the U.S. and Europe, eBay saw its earnings surge to 87 cents a share last year from three cents in 1998, when it went public at a split-adjusted \$3.00 a share.

Why would eBay be more fairly valued around 60, its price just several months ago? At 60, eBay would trade at 44 times projected 2003 profit of \$1.35 a share and 22 times an optimistic 2005 estimate of \$2.75. So confident are analysts about eBay's outlook that they're comfortable valuing the stock on a 2005 earnings estimate.

Fans of eBay believe its profit can rise at a 35% annual clip in the next five years, a difficult rate for any company to maintain, even one, such as eBay, with a "scalable" business model that allows it to easily accommodate more transactions while maintaining its enviable gross margins of 80%. If the company earns \$5 a share in 2007 -- nearly six times last year's profit -- it would still trade at 18 times that very optimistic profit level.

**SHORTS' TARGET**

Given those lofty valuations, short sellers have targeted all three stocks, especially Amazon, which has a short interest of 54 million shares, about 13% of the company's outstanding stock. The shorts haven't been the only sellers, however. Insiders also have been unloading shares, including eBay's chief executive, Meg Whitman, and Amazon's founder and CEO, Jeff Bezos. Whitman has sold 359,000 eBay shares for \$27 million this year. Both CEOs do retain significant stakes.

It's notable that Amazon's current market value of \$10 billion is about four times the combined market capitalization of its two main "bricks and mortar" competitors, [Barnes & Noble](#) and [Borders](#), which together are expected to generate twice the profit of Amazon this year. In the bubble era, such comparisons drew scorn from 'Net fans, who argued that cyber stocks deserved enormous premiums over their mainstream rivals, thanks to their fantastic growth prospects. But while Amazon should enjoy decent revenue gains -- 20% this year and 15% in 2004 -- its growth certainly won't be fantastic.

In initiating coverage of Amazon last week with an "underweight" rating and a price target in the mid-to-high teens, J.P. Morgan analyst Daryl Smith cited "numerous near-and long-term concerns," most notably, slower projected expansion of Amazon's domestic books, music and video segment.

Rarely in the recent history of the stock market have investors gotten so excited about so small an amount of earnings. Using its controversial pro forma definition, Amazon may earn \$120 million this year after ringing up losses of \$3 billion since



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**COMPANIES**

	Dow Jones, Reuters
<b>Amazon.com Inc. (AMZN)</b>	
PRICE	25.75
CHANGE	0.08
U.S. dollars	4/11
<b>Yahoo! Inc. (YHOO)</b>	
PRICE	24.43
CHANGE	0.16
U.S. dollars	4/11
<b>eBay Inc. (EBAY)</b>	
PRICE	88.29
CHANGE	-0.41
U.S. dollars	4/11

\* At Market Close

its formation in 1995. Does that support a \$10 billion market value? *Barron's*, it should be said, has written critically about Amazon on several occasions, including a cover story ("[Amazon.bomb](#)," May 31, 1999) when the stock traded at 59 3/8.

All three 'Net favorites face challenges. Amazon must contend with a difficult retailing environment. And it must also demonstrate that it can make appreciable profit outside its core book, music and video business. It and eBay eventually may have to grapple with a tax on Internet sales, which could come as early as 2004. Cash-strapped states are pressing for such a tax and many traditional retailers, including Wal-Mart and [Toys "R" Us](#), have begun to collect sales tax on purchases from their Websites. Those retailers are apt to push for a level playing field versus online-only merchants such as Amazon.

For reasons of politics and fairness, it seems inevitable that sales taxes will hit the Internet in the coming years, removing a major incentive for consumers to shop online. Amazon collects sales taxes in only the two states in which it has a physical presence -- Washington, where it's based, and North Dakota. Buyers from Amazon are supposed to remit sales taxes to their home state, but few do. In its 2002 10-K filing, Amazon said that Internet sales taxes "could create administrative burdens for us and could decrease our future sales."

While Amazon says that convenience, selection and price are key drivers of its sales growth, J.P. Morgan's Smith wrote that, for many online buyers, sales taxes are a major factor. He cited a UCLA Internet report that found nearly half of consumers surveyed said a tax would prompt them to cut their online buying.

In initiating coverage of eBay with a [Sell](#) recently, analysts at the Avalon Group in Boca Raton, Fla., cited the U.S. sales-tax issue, the imposition of a value-added-tax on eBay's European fees and potential problems stemming from its purchase last year of PayPal, which facilitates the use of credit cards to pay for purchases over eBay's network. The company, however, may be less affected than Amazon by the imposition of a sales tax in the U.S. because it doesn't sell goods on its Website, but instead allows others to use it to auction goods.

eBay's huge market value discounts enormous growth. "There's no doubt that eBay is a great company," wrote Merrill Lynch tech strategist Steve Milunovich in a recent note. "But its shares, at 20 times trailing sales, are more expensive than Microsoft's at any time in its history except for 1999 and early 2000."

Despite a successful diversification effort that includes so-called paid searches, Yahoo still gets nearly half its revenue from banner advertising and other online ads -- a market with hazy growth prospects, given doubts about the effectiveness of such advertising.

One of Yahoo's fastest-growing businesses is a joint venture with Overture Services, in which companies pay Yahoo for prominent placement when Yahoo users search for, say, "books" and then click on the sponsor's site.

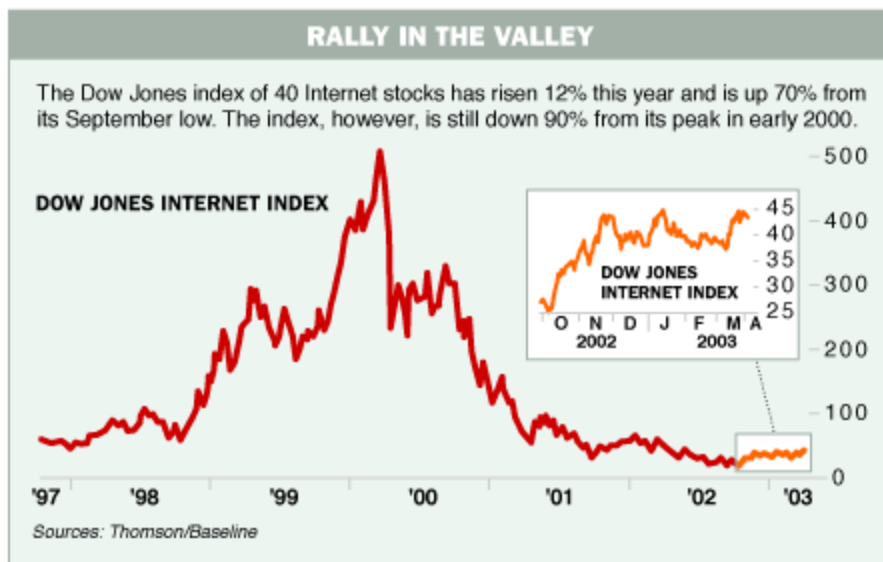
Yahoo's recent revamping of its search engine, however, amounts to an admission that rival Google has trumped Yahoo in that critical driver of online profits. In the eyes of many Internet users, Google has become synonymous with searches. It recorded 112 million searches a day in January, nearly triple Yahoo's 42 million, according to SearchEngineWatch.com.

Yahoo now is back in vogue on Wall Street, while the America Online division of [AOL Time Warner](#) has fallen from favor. Two years ago, the opposite was true. AOL Time Warner's current pariah status could present an opportunity.

The stock languishes at 12.50 a share and the company's valuation is below most of its media peers'. "AOL trades at a significant discount to its intrinsic value," says Henry Berghoeff, co-manager of the Oakmark Select fund, an AOL holder. He puts fair value for AOL at close to 20 a share. "People seem to be focusing almost exclusively on the AOL segment. Even if you make a draconian assumption and assume it's worth nothing, AOL Time Warner is still a cheap stock."

## FEW BARGAINS ONLINE

With the run-up in many Internet stocks, bargains are few. Among the online brokers, [E-Trade](#) is intriguing because it sells at a discount to rivals [Ameritrade](#) and [Schwab](#). E-Trade, at 4.25, trades at book value and for about 10 times projected 2003 profit. Ameritrade commands twice book, and Schwab, nearly three times. Both trade for about 25 times 2003 projected net.



"With E-Trade, you're getting the brokerage business almost for free," says Justin Hughes, analyst with Jefferies. Most of E-Trade's profit comes from its banking business, particularly from its mortgage operations. Hughes has a price target of \$6 on the stock and figures it would be worth almost \$10 in a takeover.

Other Internet plays include [Earthlink](#), [Freemarkets](#), [Tibco Software](#) and [Radvision](#). Earthlink, an Internet-service provider, changes hands at \$5.50 a share, possesses more than \$3 a share in cash and is expected to operate close to break even this year. Freemarkets, a formerly hot 'Net stock that enables businesses to cut their materials costs by holding online auctions, trades for about \$5 a share and also has \$3 a share in cash and is expected to

post break even results this year. Radvision, a small-cap stock with a market value of \$100 million, changes hands at \$5 a share, equal to its net cash position, meaning investors effectively are paying nothing for its videophone technology. If videophones ever catch on, Radvision could be a big beneficiary.

The Financial Accounting Standards Board is expected to mandate that companies begin to record grants of stock options to employees as an expense, starting in 2004. So, it's important to look at option-adjusted corporate profits, especially because more than 100 companies in the S&P 500 index are expensing option costs this year. Few tech outfits are among them.

All companies are required to show in annual financial footnotes what their earnings would have been if they had expensed stock options. Many tech companies hope that investors ignore the options issue and focus on profits excluding options. But Wall Street is starting to come around to Berkshire Hathaway Chairman Warren Buffett's contention that options are a form of compensation, have real value and therefore ought to be treated as a cost. The pervasiveness of options in the tech sector shows they're very much a substitute for cash pay.

During 2002, eBay issued 17 million options, equal to 5% of its shares outstanding, to reward many of its 4,000 employees. In contrast, many big companies keep their grants to 1% of shares outstanding. As noted, eBay's 2002 earnings would have been just 23 cents a share, against its reported 87 cents, if it had expensed options. That means eBay shares trade for about 400 times option-adjusted 2002 profit.

The option expense recorded in financial footnotes typically represents the cost of options issued over several years, as companies tend to amortize option expense over vesting periods of three to five years.

"If you take into account the options expense at eBay, it materially changes the economics of the business," says Ken Broad, a portfolio manager with Transamerica Investment Management in San Francisco. Broad, like many others, is enamored of eBay's business model but can't stomach the company's valuation because he has focused on option-adjusted earnings.

Some investors estimate option expense simply by taking the value of the 2002 grants, as measured by the Black-Scholes pricing model, and then deduct that amount on the income statement. If eBay's 2002 option issuance were treated this way, its costs would have risen by about \$300 million, which would have cut profit by about 65%.

"If eBay doesn't cut options issuance, it's an extremely expensive stock," says Broad. The good news for it and other big options issuers is that they can reduce their grants -- and may indeed do so once options expensing is mandated.

Yahoo's chief executive, Terry Semel, who came from the entertainment industry, is trimming his company's grants, saying earlier this year that they're "not a healthy way to reward people." Yahoo aims to limit its annual options grants, net of forfeitures, to less than 2% of its share count. That's an admirable goal, but their cost would remain appreciable.

Assume a 2% net grant this year and Yahoo's options costs would be around \$100 million, roughly 10 cents a share after taxes and nearly a third of expected net income. And if Yahoo had expensed options last year, it would have reported a loss of 63 cents a share, instead of reported profit of 18 cents a share.

Amazon is among the few tech-oriented companies that have largely abandoned options in favor of restricted stock. This reflects the influence of its largest outside shareholder, the Legg Mason funds, whose top portfolio manager, Bill Miller, has been very critical of options. Restricted stock must be expensed under current accounting because it clearly is a substitute for cash pay and its value, unlike that of options, isn't debatable. Amazon, however, wants investors to exclude its restricted-stock grants when viewing its earnings because they are a noncash cost. Such treatment is rare outside the tech sector.

Amazon has yet to provide guidance on its restricted-stock grants for this year but they could total \$50 million or more. The company will have to record just a portion of that as an expense because the issued stock will vest over several years. Many investors, however, simply deduct the cost of restricted stock in the year that it's granted because it's an ongoing expense. A \$50 million grant would thus be equivalent to about 12 cents a share for Amazon, a sizable chunk of projected proforma net income of 32 cents this year. (Amazon pays no income tax because it has large tax-loss carryforwards.)

Like eBay, Yahoo has a high-margin business model, yet its challenge is to expand at a 20%-25% annual clip in the coming years when its largest revenue source, online ads, may grow at 5% a year.

Yahoo deserves credit for monetizing its search capabilities by charging Website operators to steer Yahoo users to their sites. Yahoo also boasts that its number of paying customers has risen to nearly three million from 375,000 at the end of 2001, owing to the success of its personals premium service and a relationship with [SBC Communications](#), which features Yahoo in its DSL high-speed Internet access operations.

On Wednesday, Yahoo came through with solid first-quarter results of eight cents a share, two cents above the consensus estimate and up sharply from two cents a share in profit in the first quarter of 2002. This prompted analysts to lift their 2003 earnings estimates to 35 cents a share from 30 cents.

Say Yahoo earns 60 cents a share in 2005, in line with the guidance offered analysts in February; then its stock trades for about 40 times that bullish profit projection. Let's not forget that its earnings have been cyclical, hitting 48 cents a share in 2000 on a torrent of ad revenue from other Internet companies and collapsing to eight cents in 2001 when ad revenue was nearly halved.

As the 2001 Yahoo experience shows, even the strongest Internet companies stumble. There are apt to be setbacks ahead for Amazon, Yahoo and eBay, yet their stars and stock prices are burning bright. Too bright, unless they achieve perfection.

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