Thinking Like an Owner
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Dear Fellow Investors:

At Smead Capital Management we believe that thinking like a private equity firm is a good exercise when examining companies which we intend to hold for long-term investment purposes. As we look at companies which fit our eight proprietary criteria, we stop ourselves and ask two questions. First, how would we feel if we owned the entire corporation and, second, how comfortable would we be if stocks didn't open for trading for ten years? In other words, we think like an owner or think like an effective private equity buyer.

Today we'd like to hone in on two of our companies, Microsoft (MSFT) and EBay (EBAY). Our decision to look at them in this way was triggered by a fabulous rundown on MSFT in the October/2010 issue of Institutional Investor (II) magazine written by Stephen Davis. He covered almost everything anyone would want to think about MSFT; including a breakup of the company. By looking at these companies from a "sum of the parts" standpoint and from the view of a private equity buyer, we believe that an investor can get a sense of how truly undervalued these companies are.

Sum of the Parts—MSFT

	Comp PE Mdn '11	Comps		Value P/S	Net cash
Operating System	15.7	ADBE, GOOG, ADSK, EBAY, CSCO		*$17*	$3.58
Server & Tools	14.1	ORCL, VMW, CA, BMC, RHT, IBM		*$6*	
Business Division	14.9	CTXS, ADBE, ORCL, SAP, INTU		*$14*	
Entertainment & Device:	14.5	NTDOY, ERTS, ATVI, SNE		*$0*	
Online Services	15.7	GOOG, YHOO, EBAY, AOL		*-$1*	
Total	**13.8**	Share count:	8,900	*$35*	***$39***

Estimated PE Buyout Price--$32/share or $284 billion
Insider Ownership Percentage—12.8% or $36.45 billion
Cash on Balance Sheet—approximately $40 billion

PE Investment--$30 billion
Borrowing Needed for Buyout at $32/share--$168 billion
Annual Interest Expense at 7%--$11.76 billion
Cost Savings from Closing Money Losing Divisions, reduced Headcount and lower R&D expense--$3-6 billion annually

With estimated cash flow in the current fiscal year estimated at around $20 billion, this transaction would be very feasible.

Sum of the Parts—EBAY

eBay sum-of-parts model	**M-place**	**Payments**	**M-Svcs/Oth**		
Revenues '11	$4,981	$4,313	$1,240		
y/y growth	*4%*	*28%*	*15%*	Sum-of-the-Parts Value:	$42
				add Net Cash/sh:	$3.75
EBITDA	$2,192	$819	$855	** add Skype Stake:	$1
% margin	*44%*	*19%*	*69%*	Total:	$46
after tax *23%*	$1,688	$631	$659		
Multiple applied	12	* 6.9x p/s	6x EBITDA		
Share count	*1,323*	*1,323*	*1,323*		
Value per share	$15.31	$22.49	$3.88		

* PayPal's est 6.9x p/s equals what Visa paid for CyberSource on 4/21/10
** eBay sold 65% stake in Skype on 9/1/09 for $1.9bn, valuing Skype at $2.75Bn

Estimated PE Price to Buy--$32/share or $42 billion
Insider Ownership Percentage—12.6% or $5.8 billion
Cash on the Balance Sheet--$5 billion
Saleable Parts--$3 billion (Skype, Online Classifieds, Craigslist, etc.)
PE Investment--$6 billion
Borrowing Needed--$22 billion
Interest Expense at 7%--$1.554 billion

With estimated cash flow in excess of $2.2 billion, this transaction is very feasible.

In both cases, it would be very advantageous for a PE buyer of either company to include the insider owners as participants in the leveraged buyout of the company. Lender comfort and interest rates would be directly tied to beginning equity or “down payment” levels. In the case of EBAY, you could get the founders without employing the CEO, John Donahoe. In the case of Microsoft, it is unlikely that you’d get Steve Ballmer and Bill Gates as private equity owners without them being involved in running the company. The transaction is very doable without them participating because of the massive free cash flow and room for expense reduction.

In both cases, existing free cash flow levels would leave plenty of room for debt retirement. Motivated private equity owners would push for cost savings, reduced bureaucracy and make tough choices on R&D and capital allocation. Will the open market close these valuation gaps in the next couple of years or is it time to break these companies up to realize shareholder value?

Best Wishes,

William Smead

recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.

This Missive and others are available at www.smeadblog.com.