Why Peter Lynch Would Like Ebay

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Dear Fellow Investors:

Early in my career I studied the investment philosophy of the most successful and admired investors like John Templeton and Peter Lynch. Both men had great long-term track records in portfolio management. John Templeton's concept of buying common stocks at the "point of maximum pessimism" usually marks the only time you can buy a superior publicly traded business at a deeply discounted price. From Peter Lynch we got the common sense idea of observing what is going on around us to look for ideas. I'm fond of taking pictures of the lines at Starbucks or noticing three days before Christmas that Nordstrom had sold out of Gucci "Guilty". Owning a company that meets our proprietary eight criteria and holding it for many years was also an idea Peter Lynch popularized. Doing so requires something about the company which stops it from gaining maniacal popularity, one of our sell criteria. We'd like to explain how Ebay fits Peter Lynch's two ideas.

Internet commerce is in its early years, but any alert business person can see that there is mass adoption of PayPal. They currently have a 15% market share of internet transactions. Last year, our marketing director, Cole, commented that American Airlines has the fact that they accept PayPal on the back of their boarding pass. I used my I-phone Starbucks app yesterday to pay for my iced tea and many folks refill their Starbucks card with PayPal. The growth in PayPal probably keeps the top executives of Visa and Mastercard awake at night. Numerous other parts of Ebay's stable of companies are seeing very fast growth and could be observed by Mr. Lynch.

To understand why Ebay won't get a maniacal stock price, you have to understand their original business. Ebay Marketplace is the New York Stock Exchange of pre-owned goods. It also is a home for numerous "power sellers" of new and refurbished goods. It is a retailing entity which pays no rent and carries zero inventories. It is like the NYSE in that they really don't care what the hot selling item is, as long as someone has a hot selling item on their system. This business produces massive free cash flow, but is a niche business and is probably not in a position to dominate internet retail sales growth and market share, in our opinion.

Ebay reported earnings on January 20, 2011 and pleasantly surprised the Wall Street analyst community. However, numerous analysts and news reports framed the earnings release in a very negative light even though operating earnings grew 24%. They say that since internet retail sales grew by 12% in 2010's fourth quarter, Ebay is somewhat of a failure by only growing gross merchandise value (GMV) by 6%. I don't remember folks criticizing Berkshire Hathaway for the slow growth in its insurance businesses, which provided Warren Buffett the float to invest in other businesses and stocks like Coca Cola, Wells Fargo, Burlington Northern and Gillette.

One of the stocks that Peter Lynch invested in to build his successful track record at the Fidelity Magellan Fund was Phillip Morris. It was the largest tobacco company in the US and was using its massive free cash flow to become a major player in the food business in the 1980's and early 1990's. No matter how well the earnings, cash flow and dividends grew, the stock never got an inflated price-to-earnings ratio (PE). Philip Morris was being sued by the families of smokers. Who wants to own shares in a company which is getting sued constantly? It stayed reasonable for decades and made its common stock owners wealthy in the process. From 1972 to 2001 it produced a 17.8% average annual gain for its common stock holders who stayed for the entire 30-year stretch.

Ebay has about $5 per share in cash and is expected to have operating earnings of $1.90-1.95 this year. When you back the cash out of today's price of around $30 per share, you get $25 per share. This means that a company (PayPal), which is growing at 20% per year in sales and could be one of the most exciting businesses in the world is hiding inside a company with a 13 PE multiple. We think Peter Lynch could be smiling.

Best Wishes,

William Smead

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