Short Amazon, Long eBay

by Henry W. Schacht, CFA

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Conventional wisdom these days is that Amazon (AMZN) is eating eBay's (EBAY) lunch. Amazon is growing. eBay is not. So the investment decision is easy, right? Buy Amazon.

The relative market capitalizations of the two Internet giants shows support for this buy-the-growth thesis. $37 billion for Amazon vs. $27 billion for eBay

Comparing relative revenue growth rates isn’t enough to make an investment decision. The magnitude of the aggregate numbers matters. So let’s take a closer look at the underlying facts.

In the title of its most recent earnings release, Amazon brags "Free Cash Flow Exceeds $1.5 billion", referring to the preceding 12 months. To justify a $37 billion market value, this seems like a low number. Or at least one I wouldn't brag about. Nonetheless, Amazon is genuinely proud and perhaps it should be. The corresponding number last year was $800 million. An 87% increase in free cash flow? Have things gotten that much better for Amazon?

Increases in accrued expenses and accounts payables added over $800 million to Operating Cash Flow in the period. So $1.5 billion is a very generous fcf calculation. This trend can't continue. Make the same adjustment last year, and free cash flow was actually negative. Cash generation is improving, but the aggregate level is still VERY low, especially relative to a massive market value. But this is where the "smart" money is.

Amazon's net income for the previous 12 months is $663 million (Trailing PE = 60) vs. $588 million in the prior year. That's a 12.8% growth rate. Pretty pedestrian for a company with a forward earnings multiple around 45x. It gets worse. Amazon earned $142 million in the quarter, down 10% from $158 million in the linked quarter from 2008. Where is the torrid growth?

At its peak in 2004, online auction giant eBay (EBAY) had a market value of around $80 billion ($59 a share) and earned about $800 million. That’s 100 times earnings or around a 1% implied earnings yield. Company investors would have been lucky to break even. By January 2009, shares were down to $13, giving eBay a $17 billion market cap. It didn't matter that eBay was a much larger, more profitable company or that shares outstanding decreased. The company was labeled an Internet loser.

Nonetheless, eBay earned nearly $1.8 billion in 2008 profits (AMZN: $600 million) and generated $2 billion in cash (AMZN: $559 million). In the first 6 months of 2009, Ebay reported net income of $920 million. Amazon won't earn that much all year! eBay generated $1.2 billion cash in the first 6 months of '09 without any tailwinds from accrued expenses.

What did eBay do with the cash? It bought Korean online auction and retail site Gmarket for $1.2 billion. What a coincidence! And I thought online auctions were dead?!? And eBay still has $2.5 billion cash against $400 million of debt. Amazon's balance sheet looks almost identical in terms of cash and debt with around $2 billion in net cash.

So Ebay's earnings are at least double those of Amazon's. The disparity in free cash flow is even larger. The balance sheets are similar and yet Ebay sells at a $10 billion discount to Amazon?

I bought eBay in January and I've enjoyed a very nice run... from $13 to $21. Ebay isn't a screaming buy here, but relative to Amazon, it is. Disclosure: I still own eBay.

eBay management is planning to sell Skype in an IPO next year. Estimates of its “value” run as high as $3 billion. Some think that a mainstream telecom company may buy it before the IPO. Trust me, if you ever get a chance to sell a money-losing business for billions, do it! I have nothing against Skype, but my capitalist heart swells with pride at the thought of another $2 to $3 billion in net cash on eBay's balance sheet. And without Skype, eBay’s earnings look even better. eBay is essentially subtracting a negative.

eBay had no business buying Skype. They know it and seem eager to undo the mistake. A renewed focus on the auction business (think Gmarket) and online payment service, PayPal, can only be a good thing.

I love shopping Amazon, but the stock is overvalued. Yes, even after today's drop. eBay is priced as if it will never grow again. Amazon as if it will never stop growing. Given the huge disparity in earnings power, eBay deserves a valuation on par with Amazon. Growth is fickle.

Oh, to run a long/short hedge fund!

Disclosure: At the time of publication, the author owned shares of eBay personally and on behalf of clients.

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