Overstock.com (OSTK)

Initiating Coverage: Underweight

November 7th, 2005

Karandeep Bains
Karandeep.Bains@yale.edu

Manish Consul
Manish.Consul@yale.edu

Jeremy Miller
Jeremy.Miller@yale.edu

Financial Data	
Share Price	$34.96
Shares Outstanding (mm)	18.7
Market Cap (mm)	$653.4
Debt (mm)	$102.5
Cash (mm)	$76.8
Average Volume (3 month)	502,689
Shares Short (as of Oct-05) (mm)	6.7
Book Value Per Share	$5.0
Profit Margin (ttm)	-3%
Operating Margin (ttm)	-3%
Return on Assets (ttm)	-5%
Return on Equity (ttm)	-20%

Target Price: $30

Overstock.com is closeout online retailer which offers discount brand-name goods. These goods include CDs, DVDs, books, magazines, video games, bed-and-bath ware, home and garden products, kitchenware, furniture, watches, jewelry, computers and electronics, sporting goods, apparel, and designer accessories among other things.

- **Price:** Given current e-Commerce trends and past company performance the stock price appears overvalued; especially when combined with qualitative concerns. The stock is currently trading at **$34.96** implying a premium of approximately 14% over our target price **of $30**.

- **Capitalization:** Overstock.com seems undercapitalized relative to competitors such as Amazon.com. However, un-modeled increases in future capital spending would further depress free cash flows and depress stock value.

- **Execution:** Recent hiccups at Overstock give reason for caution. The implementation of an enterprise data warehouse and customer analytics system, completion of the auctions tab, reconstruction of the travel website, and development of a search engine and keyword management application has proved difficult, costly, and time consuming.

- **Management:** Turnover in key personnel seems to have derailed focus. Management currently seems pre-occupied with litigation and financing activities, which will impair their ability to meet expectations for lofty growth and increased efficiency.

Please see Important Disclaimer at the end of this report

Company Overview

Overstock.com (OSTK) is one of the largest internet retailers specializing in the sale of closeout and liquidation merchandize. The company has created an online marketplace for retailers and manufacturers to effectively sell excess merchandize while providing value, selection and premium service to its customers. Overstock's market messaging and competitive position place it in a position to deliver incremental value to suppliers and help in minimizing wastage. Last year the company's gross merchandize sales jumped 84% and according to Comscore MediaMetrix, Overstock ranked 13th among all online retailers last year in the number of unique visitor's to its website.[1]

Size of the market
Overstock's management believes the size of the liquidation marketplace to be around $60 billion. As expected, this market is highly competitive and fragmented, and fraught with inherent insufficiencies in sourcing (a product may no longer be manufactured), stocking (desired quantity of a particular product might not be available at any given time) and distributing large volumes of merchandize and in dealing with obsolescence. Long term, we believe, the sales opportunities for overstock will continue to increase as more and more products can be sourced from the internet and as the supply chain for this market becomes increasingly efficient. The key for Overstock.com is to become the premium brand for selling overstocked products and to tap into an international supply and demand chain by not just sourcing products from suppliers around the world but, also supplying to the most profitable centers around the world.

Current Product offerings and Special Programs
Currently Overstock targets seven vertical markets:
Apparel
BMV (Books, Music and Video)
Consumer Electronics
Home & Garden
Jewelry
Travel (recently launched)

To drive frequency, they have initiated the "Club O" program which allows members to obtain a 5% discount on all Overstock purchases and a $1 shipping fee for all orders over a period of one year for a fixed price of $29.95 per annum. Overstock also has a "Club O Gold" program where customers pay $99.99 per annum and are eligible for 30% discount on certain bulk purchases. This idea, while being a good way to attract new customers and build loyalty, has proved to be a money-looser for other internet retailers such as Amazon.[2]

[1] CIBC World Markets coverage – Overstock.com report dated April 14, 2005.
[2] Amazon Annual Report 2004

Upside Potential

Limited Inventory Risk
Overstock assumes very little inventory risk. Around 56% of their revenues were generated by their "fulfillment partner" business (which was formerly called the "commission" business) in which merchandise of other retailers, cataloguers or manufacturers was sold through Overstock.com's Websites. Since these sales are generated by Overstock but partners handle shipping and fulfillment, there is no expenditure of Overstock working capital to purchase or handle inventory. Hence, for this business margins tend to be higher. However, since July 2003, Overstock.com is responsible for handling returns which is significantly reducing the profit margins for this line of business.

Auction Business
This business line was launched in 2004 as an incremental channel for its liquidation and closeout merchandize. Overstock earns a listing and success fee – the 'eBay model'. The objective is to provide a one-stop destination for discount shopping, whether it is for products or services, in businesses proven to be successful on the internet. As per management advice, we have assumed that this business is will not contribute revenues in the near term.

Attractive growth in the E-commerce Sector
E-commerce is expected to grow at a rate of 25% annually in the near term. As a percentage of retail, E-commerce grew to almost 2% in 2004 (from approximately 1.6% in 2003).[3] This presents a huge upside potential to Overstock.com. Currently, Overstock.com has approximately 5% of the online liquidation market share (estimated to be $3 Billion). Due to a broad reach and low-cost structure, we believe this market will continue to grow. Overstock is also getting into internet retailing of goods that are not being liquidated. This is a much larger market and will continue to contribute to its growth.

Economics of Liquidation and Closeout
Traditionally, retailers have to limit what they can keep on their shelves. Unpopular or obsolete or even niche products are perfect sales material for Overstock. Efficiencies of internet shopping reinforce this business model. Another huge factor could be the extension of product lifecycles due to internet sales. The key here is for Overstock to offer competitive advantage by stocking the product at a cheaper price and offering it when it can no longer be found online at other bigger brands such as Amazon.com.

Competitive Advantages
Overstock has established itself as a one-stop shop in the internet closeout and liquidation market. Currently, the closeout landscape is highly fragmented, and most liquidators are focused on a specific vertical and niche. Nevertheless, competition could intensify as e-commerce grows and companies improve their distribution and supply chain capabilities to service the internet retail market.

With approximately 2.5 million new customers in 2004, Overstock is becoming increasingly popular as an internet retailer amongst both suppliers and customers (partner relationships with approximately 380 third parties whose products are offered on our websites; 2.5MM of

[3] US Census Bureau

the company's 5.5MM customers were added during 2004).[4] It has managed to leverage this growth into larger purchases which in turn has helped it secure favorable pricing for many of the products that are sold on its websites. However, as the inventory risk goes up (in handling returns), the growth in volumes has to be accompanied by better operational performance, namely lower packaging and handling costs, lower processing costs and better handling of customer returns.

Overstock has a negative cash conversion cycle and relatively high inventory turns (higher than Wal-Mart, for instance, but lower than AMZN). We believe that this trend will continue and Overstock will be able to reinvest this money in its business. As it becomes a better known brand, Overstock.com will be able to exert greater control over its suppliers because it understands the nuances of channel stuffing and price control in liquidation, traits that are very important to companies that manufacture premium brands. This in turn will help Overstock.com extend its days payable.

Branding and Scale

Its unprompted branding awareness score is at about 46% compared to nearly 70% for Amazon.com and eBay, but higher than that of premium brands such as Hewlett Packard and Dell.[5] With promotions such as free shipping and with sales and marketing budget allocation of approximately $74 million (estimated 2005 figures); Overstock's brand awareness should continue to grow. They exhibited an industry high 45% marketing efficiency growth in the first quarter of 2004 and we believe that they can get there again, thereby maintaining their competitive advantage over other liquidation companies. This large allocation of capital towards marketing (as shown above) shows upper management's commitment towards brand development.

[4] Overstock.com 10K , dated March 11, 2005

[5] According to a study commissioned by Overstock.com

Competitors

Amazon.com
The books, music and video (BMV) category is the largest revenue generator for Overstock (14% of the revenue in 2004) and therefore makes the company a natural competitor to Amazon.com. However, since Overstock was using the BMV category to bring in customers, they have been, historically, making a loss on this product line. Only now is it beginning to break-even. A comparison reveals that Overstock is as big now as Amazon was in 1998. In its fourth year of operations, Amazon spent about $188 million (11.5% of sales) in fulfillment related expenses versus Overstock which spent $68.5 million (14% of revenue) in fulfillment last year. This competition can be expected to intensify especially in the BMV category as both companies continue to woo customers through attractive discounts and shipping offers. As Amazon looks to expand its product offering and customer base we expect to see growing overlap between the Overstock and Amazon products and customers. In fact, Overtsock.com has already initiated a campaign comparing their prices to Amazon prices, after a customer clicks on the product. While Amazon continues to lead in technology with more user friendly interfaces, we expect Overstock will improve in this area and continue its price competition campaign.

TJX Companies, Inc.
The TJX Companies, Inc. operates as an off-price retailer of apparel and home fashions in the United States and internationally. It sells off-price family apparel and home fashions through T.J. Maxx, Marshalls, and A.J. Wright chains in the United States, Winners chain in Canada, and T.K. Maxx chain in the United Kingdom and Ireland. The company sells off-price home fashions through HomeGoods chain in the United States and Canadian HomeSense chain, operated by Winners. As of September 13, 2005, the company operated approximately 2,295 stores[6]. With an established distribution network and customers in Overstock's sweet spot, TJX Companies is a direct competitor with Overstock. Year on Year growth in the last quarter was about 6.8% but the company is profitable with operating margins at about 7%. We predict that, for the apparel and home fashion lines-of-business, brick and mortar companies will continue to have a huge percentage of the retail market. While Overstock will continue to leverage its current relationships to operate in the apparel and home fashion market, we do not see this as their best area for growth. The brick and mortar presence of TJX provides a "touch and feel" environment that we feel is necessary to expand apparel and home fashion market share. Therefore, we see growth and competition with TJX for this market, but more so with Amazon in other areas.

[6] Yahoo! finance

Business Model

Direct and Partner Fulfillment

Ever since Overstock.com changed its returns policy in 2003, the share of sales from the fulfillment partners as a percentage of the total revenue has sky rocketed. The key motivation for Overstock.com to take the additional risk of product return was to make the terms attractive for new and existing vendors and thereby increase the scope of product offerings on the website. As Overstock.com tries to compete with established players such as Amazon.com, it is critical that it matches their product offerings. Increasing its network of vendors, which is now around 400 entities, allows Overstock.com to expand into newer offerings faster than it would have if the company was to stock all the products in its warehouses.

Millions of USD	2005		2004		2003		2002		2001	
Direct Operations	196.4	40.42%	$213.2	43.10%	$138.1	57.80%	$79.4	86.50%	$35.2	89.9%
Fulfillment Partner	289.4	59.58%	$281.4	56.90%	$100.8	42.20%	$12.4	13.50%	$4.0	10.1%
Total Revenues	**485.8**	**100.00%**	**$494.6**	**100%**	**$238.9**	**100%**	**$91.8**	**100%**	**$39.2**	**100.0%**

Source: Company Reports

Since the implementation of the new program, Overstock.com records revenue from sales transactions involving its fulfillment partners (excluding auction and travel products) on a gross basis, rather than on a net basis, as was earlier the case. However, taking on the product return risk increases the cost of goods sold significantly for Overstock.com. With a return rate of approximately 8%, Overstock.com bears a significant cost in running the program. Only cost of products returned due to manufacturing defects or some damage experienced during shipment are passed on to the vendor or shipping company. The exact cost of the returns program is not directly mentioned but looking at the margins for direct and fulfillment partners gives us some idea.

Gross Margins	2005	2004	2003	2002
Direct Operations	12.81%	13.05%	10.01%	10.98%
Fulfillment Partner	16.11%	13.49%	11.53%	77.74%
Segment Total	**14.77%**	**13.30%**	**10.65%**	**19.98%**

Source: Company Reports

Even with the risks associated with handling returned inventory, we can see that an increase in the overall share of the fulfillment partner revenue will boost the gross margins for the company. However, given the uncertainty associated with the future mix of revenue streams and their respective profit margins, for valuation purposes, we focused on the movement of gross margins for the entire firm. Given how much lower the gross margin numbers are compared to competitors such as Amazon.com, who deal with similar inventories, we expect these numbers to go up as the company expands and develops more streamlined operations. However, given that the company positions itself as a closeout/discount retailer it will have limited leverage in increasing prices and will have to make up in higher volumes and more efficient operations. A detailed discussion on margins follows in the next section.

Risks & Challenges

Risk of missing growth opportunities due to Undercapitalization

In order to capitalize on the growth opportunities that are implied in Overstock's current valuation, the company needs to ramp up its capital expenditures. Overstock is playing in an industry where it is critical to stay on the leading edge of technology in order to attract customers and compete with the other players. Even when compared with players such as Amazon.com, a direct competitor of Overstock, the company stacks up poorly in terms of capital expenditures. During its earlier years, when Amazon's sales were comparable to that of Overstock, the company was spending a considerably higher share of its revenues on capital expenditures. The highest amount that Overstock invested in capital expenditures over the last five years was 13% of revenues back in 2000. Since then the numbers seem to be settling down closer to about 2% even though the company is yet to implement some of the key features that customers have come to expect from online retailers.

Overstock.com

	2004	2003	2002	2001	2000
Sales ($ M)	494.6	238.9	91.8	40.0	25.5
CapEx	8.7	6.7	1.7	1.7	3.3
	1.8%	**2.8%**	**1.9%**	**4.3%**	**12.9%**

Amazon.com

	2004	2003	2002	2001	2000	1999	1998	1997
Sales ($ M)	6,921.12	5,263.70	3,932.94	3,122.43	2,761.98	1,639.84	609.82	147.79
CapEx	89.13	45.96	39.16	50.32	134.76	287.06	28.33	7.6
	1.29%	**0.87%**	**1.00%**	**1.61%**	**4.88%**	**17.51%**	**4.65%**	**5.14%**

Source: Company 10-K

Competition and Margins

With online retailing gaining momentum, more and more players are joining the game and thereby intensifying the fight for gaining a larger share of the customer's online spend. There is competition from not just online retailers like Amazon.com and eBay, but increasingly from the brick-and-mortar retailers who are increasing their web presence. The increased competition has an impact on not just the top line but the bottom line as well. Increased competition puts pressure on the pricing and has an impact on the total revenues. This is especially challenging for a closeout retailer such as Overstock.com since it dilutes the company's competitive advantage of lower prices. Also, the bottom line is impacted by the increasing cost of not just customer acquisition but also servicing repeat customers by offering free or discounted shipping. We expect this trend to continue in the short-term.

	2000	2001	2002	2003	2004	2005
Total revenue (in thousands)	25,523	40,003	91,784	238,945	494,635	485,842
Cost of goods sold						
Direct	27,431	33,497	70,686	124,302	185,390	171,246
Fulfillment partner	381	1,143	2,755	89,190	243,468	242,821
Total cost of goods sold (in thousands)	27,812	34,640	73,441	213,492	428,858	414,067
Gross profit (loss)	(2,289)	5,363	18,343	25,453	65,777	71,775
Margin	-8.97%	13.41%	19.98%	10.65%	13.30%	14.77%

Source: Company 10-K

How have the margins been projected? Make it consistent with the valuation. Say why out here!

Despite these challenges, for the nine months ending September 30, the gross margins increased from 11.7% in 2004 to 14.8% in 2005. The management attributed the improved numbers to efficiencies in purchasing arising out of increased volumes, superior process management, improved vendor relations and the reduced cost of processing returns. The margin numbers could get a further lift when savings from the much delayed technology implementations start taking effect. Another factor aiding the margins is Overstock's growing presence in the auction and travel segments since the revenues in both these businesses are recorded net. We believe that even though the company will continue to face short-term pressures on its margins, there is significant room for improvement over a longer horizon if the company executes its strategy well. For valuation purposes, we have gradually increased margins from the current figure of 14% to a more attractive 20%, which we believe represents the potential in Overstock's business model. We settled on the 20% figure based on Amazon's gross margin of 24% (in fiscal 2004). Overstock's management has declared its commitment to low prices and we believe this will limit their ability to meet or beat the margins achieved by Amazon which offers more premium brands that customers are willing to pay a higher amount for.

Another impact of increased competition is that it makes it harder for companies such as Overstock.com to differentiate themselves and forces them to spend a higher amount on marketing and advertising. This is especially painful since it not only pushes up the customer acquisition costs but also reduces customer loyalty as more and more competitors offer increasingly similar services such as discount pricing and free shipping. The customer acquisition cost for Overstock.com[7] has gone up from $15.95 per customer in 2Q04 to $23.72 in Q205. For a company such as Overstock.com which is still in growth phase and is heavily dependent on increasing its customer base for its long term success, these high acquisitions costs are especially painful. For the quarter ending September 30, Overstock's Sales and Marketing expense rose from $ 20.4 million in 2004 to $ 49.2 million in 2005. The Sales and Marketing expense will continue to rise as an absolute dollar figure since Overstock.com continues to increase its advertising efforts on both online as well as offline mediums. In the long run, however, we believe that Overstock's SG&A expense will settle at around 14% of revenues. This is not only consistent with the company's SG&A expense in recent years but also matches the numbers for some of its closest competitors such as Amazon.com, which has been spending close to 14% of its revenues on SG&A related activities in the recent years.

	2000	2001	2002	2003	2004	2005 (9m)
Total revenue	25,523	40,003	91,784	238,945	494,635	485,842
Operating expenses:						
Sales and Marketing	11,376	5,784	8,669	20,173	40,533	49,280
General and Administrative	7,556	9,441	10,825	16,911	30,235	24,853
Total SG&A	18,932	15,225	19,494	37,084	70,768	74,133
	74.18%	**38.06%**	**21.24%**	**15.52%**	**14.31%**	**15.26%**

Source: Company 10-Q

Management and Execution Risk:

Overstock.com is competing in a market segment which is challenging even for the best run companies. Given that, a company such as Overstock.com, which is still trying to get a foothold, can ill afford to make mistakes in executing its strategy. In 3Q05, the company reported an operating loss of $11.2 million, up from $6.1 million the previous quarter, at a time when most

[7] Calculated as total sales and marketing expense divided by the number of new customers for the period

investors were expecting the numbers to improve. The management attributed the loss to technology projects (an ERP implementation, to be specific) gone wrong. Earlier in the report, we mentioned the need for a higher investment in technology but we should mention that we assumed a higher investment to be accompanied by sound execution as well. In the case of implementing the ERP, the management forced a cut-over before the system was tested thoroughly. The system caused more problems than it solved and prevented Overstock from posting new products on its website thereby foregoing significant revenues on several items. There were other highly anticipated applications that could not come online due to implementation issues and failed to yield the anticipated benefits. It might not be wise to ignore these issues as one-time teething troubles since we believe they give an insight into the management's (in)ability to execute and meet operational targets.

The departure of the President and CFO in 2003 for "personal reasons" is cause for concern. Since that time Overstock as implemented a lot of change including fulfillment partner model and accounting, avenues for business, financing activities, and significant litigation activities. The company is involved in a lawsuit against a major hedge fund and a research firm for conspiring to drive down the company's stock. These activities seem to have derailed focus from growth and efficiency issues; perhaps also due to personnel change.

Small Float: Potential for Dilution

Overstock.com has a relatively small float of 12.6 million shares and might need to issue more shares to meet its capital expenditures requirements. As mentioned earlier in the report, the company's growth target requires them to make significant investments in capital expenditures and with limited cash reserves and inadequate cash flow from operations, it seems logical the company would have to look at markets to raise capital. In fact, in April 2005, the company filed a shelf registration with the SEC which would allow the company to issue and sell up to $500 million of debt/equity securities. This after the company issued $116 million of convertible debt in November 2004. If Overstock.com had to raise another $100 million, the company would be issuing close to 3 million shares (almost a quarter of the current float) at the current stock price which would be highly dilutive for existing stock holders. The management did announce a share buy back program simultaneously to counter any dilutive effects. Under the buyback program, Overstock.com repurchased 665,000 shares of common stock in open market transactions for $24.1 million during the nine months ended September 30, 2005[8]. However, we believe that such measures will have limited success given the company's capital requirements.

[8] Overstock.com 10-Q Form, Filed 11/9/2005 for period ending 9/30/2005

Valuation

Comparables

With no positive earnings the typical price-to-earnings comparisons will have to wait. However, the price-to-sales comparison below shows that Overstock.com is about where you would expect to see them – sandwiched between the slower moving brick-and-mortar players and the internet high-flyer. At half of Amazon it might seem reasonably priced, but then one might ask if Amazon is reasonably priced? Perhaps a better question would be if the P/S multiple should be roughly double the brick-and-mortar players?

Comparables	Price/Sales
Overstock.com	1.03
Amazon	2.47
JC Penney	0.67
TJX Companies	0.62

DCF Model

Assumptions:

- Revenue – continues at 2004 pace in 2005, which then slows at negative 25% compounded annually.
- Margins – improvements but not to Amazon levels. We have them at COGS 80% and profit margins of 4%, which is equivalent to department store margins.
- Discount Rate – We use the 10 year treasury rate of 4.60% and a risk premium of 6%. We then assume current debt levels to hold and the beta to trend down along with the growth to a resting state of one.

Assumptions Discussion:

The model we have built is driven by our revenue forecasts. To forecast revenue growth we began by looking at historical trends in the industry and sub-industries.

According to the US Census Bureau numbers (see Appendix A) the retail industry seems to be growing at roughly GDP growth – 4% CAGR. However, e-Commerce within the retail industry is growing much faster. We do not believe that retail will break from its long tradition, but we do feel that e-Commerce can continue to grow its piece of the retail pie, but the 25% CAGR (see Appendix A) will slow down. We forecast e-Commerce to take over 20% market-share within the next 20 years – beginning at roughly 1.9% in 2005. We feel this is a generous assumption given that many "touch and feel" merchandise appears to be a tough sell in the digital marketplace. However, we did not drill deeper into sub-industries such as closeout retail, but instead assumed that the closeout "piece of the pie" would remain roughly the same since this is a mature industry. We also did not attempt to model international growth. While Overstock does have some international business, the revenue and margin breakdowns are not available. However, we do believe that the cost of creating a presence abroad would be significantly higher than it has been domestically – not that it has been easy here either. Therefore, we feel that a significant increase in their share of the generously forecast US pie is more than reasonable.

We then turned our focus to historical and competitor growth. Overstock has shown strong revenue growth to date, but it does seem to be slowing based on historical data and current management guidance (see Appendix B). Amazon, and other internet players, also showed strong growth out of the gate, but as the low hanging fruit became less abundant revenue slowed. Thus, we allowed for continued growth in 2005 and then "smoothed" the numbers downward with time, as per competitor and industry patterns (see Appendix C). This growth has Overstock.com arriving at single digit growth in 2014 and then steady state growth in 2018.

With top-line forecasts in place, we then focused on margins and spending trends. Most historical margins followed a fairly identifiable trend (except perhaps for fulfillment partner COGS, since they changed the recording methodology when they went to a customer service model). We have forecast margins to improve significantly but fall short of Amazon margins as they are in the lower margin close out business and largely competing on price, which is not good for margins. It should be noted that going forward we feel capital expenditures could be a big issue in translating top-line dollars to the bottom-line given the aggressive growth assumptions and the lack of low hanging fruit.

In an attempt to understand profit margins we looked at their historical abilities, as well as competitor and industry averages. We settled on a profit margin of 4%, which is the industry average for department stores. This requires significant operational efficiencies to be realized, as Overstock currently has negative profit margins. However, we feel that they could make some improvement in COGS since Amazon has shown some promise in this area. We feel this is a generous assumption since online price competition is the name of the game and this is usually a very bad thing for margins. Again, free cash flow could be seriously impaired despite these generous profit margins if capital expenditures were to rise – perhaps to keep pace with Amazon's technological capabilities.

The cash flow was discounted using a beta which was "smoothed" downward, so as to match steady state growth with a beta of one (see Appendix C). The smoothing allows for the discount rate to decrease with time, starting at 14.39% and settling in at 9.67% for the steady state. The initial beta for 2005 was calculated using monthly excess returns for Overstock since its inception in 2002. The weight of debt to equity was assumed to remain constant at 14%/86% as internet player debt ratios typically remain low. The risk premium was conservatively set at 6%. The cost of debt was based on the most recent debt issuance at 3.75%. Please see Appendix D for an in depth look at the model. For sensitivity analysis based on the above assumptions please reference Appendix E.

Recommendation

The DCF model produces a share price of $29.80 – 15% below the current price of $34.96. We feel that model assumptions have not been conservative and qualitative risks outweigh the potential upside, and hence we are issuing a sell recommendation.

We feel that the market is again being enticed by lofty future potential which we feel has a lower outcome probability than the more reasonable "earthbound" scenarios. The upside is hard not to bet on since the payout can be significant if realized, but given the current risks and challenges we feel the less grand outcomes are much more likely and thus the current price makes the bet overpriced. Perhaps comparisons of Overstock with Amazon, which is in-turn compared with Google, eBay, and Yahoo is helping to fuel these unrealistic expectations. We are especially wary of betting on Overstock given that upside realization is largely a bet on management. The current CEO in a recent conference call said "…CEOs who tangle with shorts are crooks. I think shorting plays a healthy role in a normal market. But…". Management turnover, unprofessional conduct of management in recent conference calls – battles with analysts, and a pre-occupation with short sellers does not calm our fears.

Appendix A – Industry Information

Historical

Period	Retail Sales (millions of dollars)		E-commerce as a Percent of Total Sales	Quarter-to-Quarter Percent Change		Year-to-Year Percent Change		
	Total	E-commerce		Total Sales	E-commerce Sales	Total Sales	E-commerce Sales	e-Commerce / Total Retail
1999 4th Quarter	787,212	5,335	0.7	8.1	(NA)	9.1	(NA)	0.7%
2000 1st Quarter	714,561	5,663	0.8	-9.2	6.1	11.2	(NA)	0.8%
2nd Quarter	774,677	6,185	0.8	8.4	9.2	7.4	(NA)	0.8%
3rd Quarter	768,139	7,009	0.9	-0.8	13.3	5.5	(NA)	0.9%
4th Quarter	812,809	9,143	1.1	5.8	30.4	3.3	71.4	1.1%
2001 1st Quarter	724,731	7,893	1.1	-10.8	-13.7	1.4	39.4	1.1%
2nd Quarter	802,662	7,794	1	10.8	-1.3	3.6	26	1.0%
3rd Quarter	779,096	7,821	1	-2.9	0.3	1.4	11.6	1.0%
4th Quarter	850,265	10,755	1.3	9.1	37.5	4.6	17.6	1.3%
2002 1st Quarter	738,185	9,549	1.3	-13.2	-11.2	1.9	21	1.3%
2nd Quarter	814,626	10,005	1.2	10.4	4.8	1.5	28.4	1.2%
3rd Quarter	818,061	10,734	1.3	0.4	7.3	5	37.2	1.3%
4th Quarter	859,250	13,999	1.6	5	30.4	1.1	30.2	1.6%
2003 1st Quarter	767,433	12,115	1.6	-10.7	-13.5	4	26.9	1.6%
2nd Quarter	852,760	12,718	1.5	11.1	5	4.7	27.1	1.5%
3rd Quarter	867,242	13,651	1.6	1.7	7.3	6	27.2	1.6%
4th Quarter	912,109	17,512	1.9	5.2	28.3	6.2	25.1	1.9%
2004 1st Quarter	834,716	15,515	1.9	-8.5	-11.4	8.8	28.1	1.9%
2nd Quarter	919,041	15,654	1.7	10.1	0.9	7.8	23.1	1.7%
3rd Quarter	886,091	16,473	1.9	0.6	4.6	6.3	22.1	1.9%
4th Quarter	952,572	21,159	2.3	7.5	30.6	8.3	24	2.2%
2005 1st Quarter	852,249	19,124	2.2	-10.5	-11.1	6.3	23.4	2.2%
2nd Quarter	952,347	19,797	2.1	11.7	3.5	8.1	25.7	2.1%

Forecast

	Year-to-Year Total Sales	Year-to-Year E-commerce Sales
CAGR TTM	4%	25%

Period	Retail Sales (millions of dollars)		E-commerce as a Percent of Total Sales	
	Total	E-commerce	Forecast Growth	E-commerce / Total Retail
2005	3,593,859	68,974		1.9%
2006	3,737,805	86,357	25%	2.3%
2007	3,887,516	108,120	25%	2.8%
2008	4,043,224	135,368	25%	3.3%
2009	4,205,169	169,482	25%	4.0%
2010	4,373,600	212,194	25%	4.9%
2011	4,548,777	265,670	25%	5.8%
2012	4,730,971	332,623	25%	7.0%
2013	4,920,462	408,066	23%	8.3%
2014	5,117,543	491,365	20%	9.6%
2015	5,322,517	581,638	18%	10.9%
2016	5,535,702	677,809	17%	12.2%
2017	5,757,425	778,675	15%	13.5%
2018	5,988,029	882,964	13%	14.7%
2019	6,227,869	989,394	12%	15.9%
2020	6,477,316	1,096,727	11%	16.9%
2021	6,736,754	1,203,807	10%	17.9%
2022	7,006,583	1,309,587	9%	18.7%
2023	7,287,220	1,413,156	8%	19.4%
2024	7,579,098	1,513,739	7%	20.0%
2025	7,882,666	1,610,706	6%	20.4%

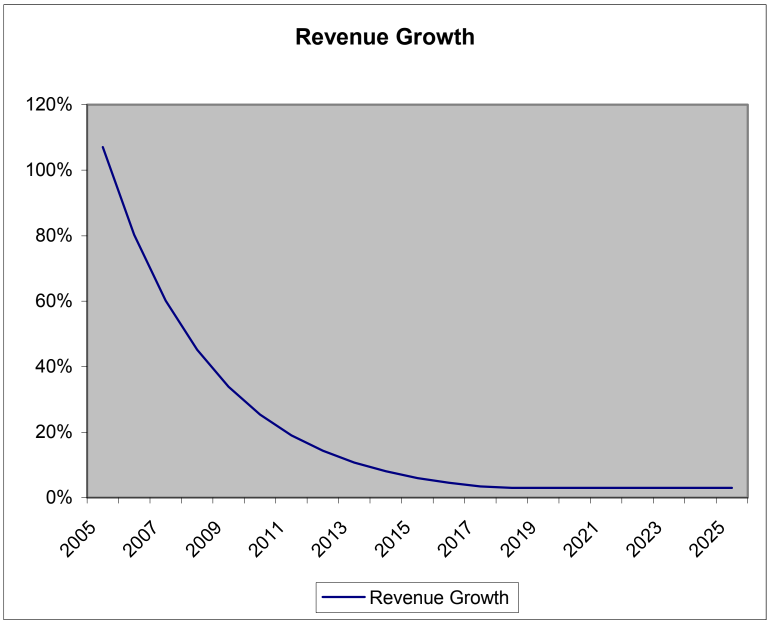
2004	Annual	Quarter	Percentage
Amazon	6,921	1,730	10.1%
eBay	3,271	818	4.8%
Overstock	495	124	0.7%
e-Commerce (ttm)	68,801	17,200	100.0%

Appendix B – Historical Information

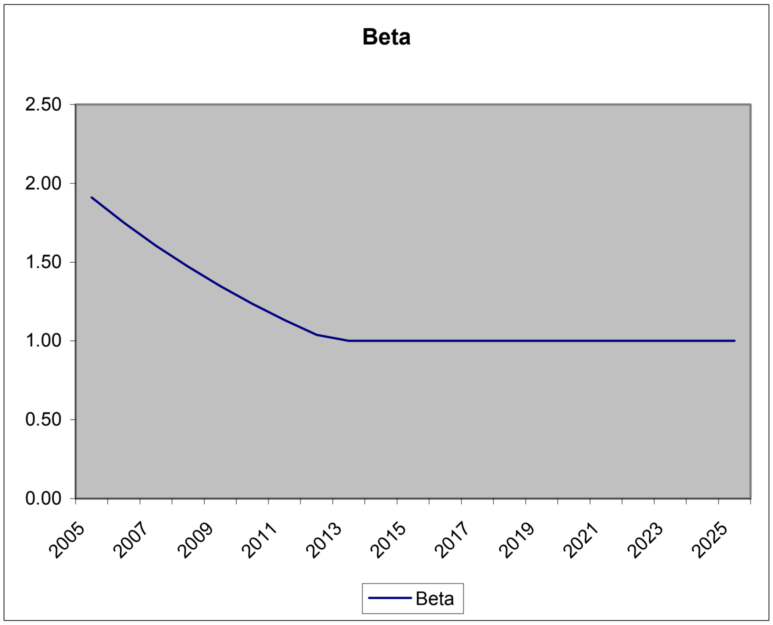
Overstock.com, Inc.					
Annual Income Statements ($ Millions)	**2000**	**2001**	**2002**	**2003**	**2004**
Direct Revenue	$22	$35	$78	$137	$213
Fullfillment Partner Revenue	$1	$4	$12	$101	$281
Warehouse	$3	$1	$2	$2	NA
Total Revenue	*$26*	*$40*	*$92*	*$239*	*$495*
Revenue Growth		*56%*	*130%*	*160%*	*107%*
Cost of Direct	$27	$34	$71	$124	$185
Cost of Fulfillment Partner	$0	$1	$3	$89	$244
COGS	$28	$35	$74	$214	$429
COGS	*109%*	*87%*	*80%*	*89%*	*87%*
Gross Profit (Loss)	($2)	$5	$18	$25	$66
Sales/Marketing	$11	$6	$9	$20	$41
General/Admin.	$8	$9	$11	$17	$30
Goodwill Amort.	$0	$3	$0	$0	NA
Stock Comp.	$0	$1	$3	$1	$0
SG&A	$19	$19	$22	$38	$71
SG&A	*75%*	*47%*	*24%*	*16%*	*14%*
Operating Income (Loss)	($21)	($14)	($4)	($13)	($5)
Interest Expense	($0)	($1)	($1)	($0)	($1)
Net Income Before Taxes	($21)	($14)	($5)	($12)	($5)
Provision for Income Taxes	$0	$0	$0	$0	$0
Net Income (Loss)	($21)	($14)	($5)	($12)	($5)
Profit Margin	*-83%*	*-35%*	*-5%*	*-5%*	*-1%*

Appendix C – "Smoothing" Charts

Revenue Growth	
2005	107%
2006	80%
2007	60%
2008	45%
2009	34%
2010	25%
2011	19%
2012	14%
2013	11%
2014	8%
2015	6%
2016	5%
2017	3%
2018	3%
2019	3%
2020	3%
2021	3%
2022	3%
2023	3%
2024	3%
2025	3%



Beta	
2005	1.91
2006	1.75
2007	1.60
2008	1.47
2009	1.35
2010	1.24
2011	1.13
2012	1.04
2013	1.00
2014	1.00
2015	1.00
2016	1.00
2017	1.00
2018	1.00
2019	1.00
2020	1.00
2021	1.00
2022	1.00
2023	1.00
2024	1.00
2025	1.00



Appendix D – Overstock.com DCF Model

Overstock.com, Inc.																						
Forecasts ($ Millions)	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**TV**
Growth Rate	107%	80%	60%	45%	34%	25%	19%	14%	11%	8%	6%	5%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%
Total Revenue	$1,086	$1,958	$3,137	$4,553	$6,095	$7,643	$9,099	$10,399	$11,513	$12,439	$13,188	$13,785	$14,252	$14,679	$15,120	$15,573	$16,041	$16,522	$17,018	$17,528	$18,054	$18,596
E-commerce	$68,974	$86,357	$108,120	$135,368	$169,482	$212,194	$265,670	$332,623	$408,066	$491,365	$581,638	$677,809	$778,675	$882,964	$989,394	$1,096,727	$1,203,807	$1,309,587	$1,413,156	$1,513,739	$1,610,706	
Percentage	1.57%	2.27%	2.90%	3.36%	3.60%	3.60%	3.42%	3.13%	2.82%	2.53%	2.27%	2.03%	1.83%	1.66%	1.53%	1.42%	1.33%	1.26%	1.20%	1.16%	1.12%	
COGs	$945	$1,669	$2,621	$3,728	$4,891	$6,114	$7,279	$8,319	$9,211	$9,951	$10,551	$11,028	$11,402	$11,744	$12,096	$12,459	$12,833	$13,217	$13,614	$14,022	$14,443	$14,876
COGs	87%	85%	84%	82%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%	80%
Gross Profit	$141	$289	$516	$825	$1,204	$1,529	$1,820	$2,080	$2,303	$2,488	$2,638	$2,757	$2,850	$2,936	$3,024	$3,115	$3,208	$3,304	$3,404	$3,506	$3,611	$3,719
SG&A	$152	$274	$439	$637	$853	$1,070	$1,274	$1,456	$1,612	$1,741	$1,846	$1,930	$1,995	$2,055	$2,117	$2,180	$2,246	$2,313	$2,382	$2,454	$2,528	$2,603
SG&A	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%
Operating Income (EBIT)	($11)	$14	$77	$187	$351	$459	$546	$624	$691	$746	$791	$827	$855	$881	$907	$934	$962	$991	$1,021	$1,052	$1,083	$1,116
Interest Expense	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4	$4
EBT	($15)	$11	$73	$184	$347	$455	$542	$620	$687	$742	$787	$823	$851	$877	$903	$931	$959	$987	$1,017	$1,048	$1,079	$1,112
Tax (35%)	($5)	$4	$25	$64	$121	$159	$190	$217	$240	$260	$276	$288	$298	$307	$316	$326	$336	$346	$356	$367	$378	$389
Net Income	($10)	$7	$47	$119	$225	$296	$352	$403	$447	$483	$512	$535	$553	$570	$587	$605	$623	$642	$661	$681	$702	$723
Profit Margin	-1%	0%	2%	3%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
+D&A (1%)	$9	$15	$25	$36	$48	$60	$71	$82	$90	$98	$103	$108	$112	$115	$119	$122	$126	$130	$134	$138	$142	$146
-CapEx (3%)	($28)	($50)	($80)	($116)	($155)	($194)	($231)	($264)	($293)	($316)	($335)	($350)	($362)	($373)	($384)	($396)	($408)	($420)	($433)	($446)	($459)	($473)
-Change in WC (1%)	($15)	($27)	($44)	($64)	($85)	($107)	($127)	($145)	($161)	($174)	($184)	($193)	($199)	($205)	($211)	($218)	($224)	($231)	($238)	($245)	($252)	($260)
FCF	($44)	($55)	($52)	($24)	$33	$54	$65	$75	$83	$90	$96	$100	$104	$107	$110	$114	$117	$121	$124	$128	$132	$136
																						$2,040
Discount Factor	1.00	0.88	0.78	0.70	0.62	0.56	0.51	0.46	0.42	0.39	0.35	0.32	0.29	0.27	0.24	0.22	0.20	0.18	0.17	0.15	0.14	0.13
Present Value	($44)	($48)	($40)	($17)	$21	$31	$33	$35	$35	$35	$34	$32	$30	$29	$27	$25	$24	$22	$21	$20	$18	$260
Discounting Information																						
Risk free rate	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%	4.60%
Beta	1.91	1.75	1.60	1.47	1.35	1.24	1.13	1.04	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Risk premium	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Cost of Equity	16.06%	15.10%	14.23%	13.43%	12.69%	12.02%	11.40%	10.83%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%	10.60%
Weight of Equity	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%	86%
Cost of Debt	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%	3.75%
Weight of Debt	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%	14%
Discount Rate	14.39%	13.56%	12.81%	12.11%	11.48%	10.90%	10.36%	9.87%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%	9.67%
Share Price	$29.80	w/ terminal value representing			45%																	

Appendix E – Sensitivity Analysis

		COGs (steady state)				
Risk Premium	*$ 29.80*	*75%*	*77.5%*	*80%*	*82.5%*	*85%*
	4%	$196.41	$124.90	$49.12	($30.23)	($111.91)
	5%	$155.49	$98.70	$37.91	($26.28)	($92.72)
	6%	$125.91	$79.73	**$29.80**	($23.36)	($78.70)
	7%	$103.68	$65.45	$23.70	($21.12)	($68.06)
	8%	$86.50	$54.39	$18.98	($19.35)	($59.73)

		Growth Decline (compounded annually)				
Risk Premium	*$ 29.80*	*-15%*	*-20%*	*-25%*	*-30%*	*-35%*
	4%	$332.58	$103.03	$49.12	$27.90	$17.51
	5%	$249.37	$79.91	$37.91	$21.10	$12.80
	6%	$192.42	$63.32	**$29.80**	$16.16	$9.37
	7%	$151.64	$50.96	$23.70	$12.44	$6.79
	8%	$121.46	$41.47	$18.98	$9.56	$4.78

Important Disclaimer

Please read this document before reading this report.

This report has been written by MBA students at Yale's School of Management in partial fulfillment of their course requirements. *The report is a* ***student and not a professional*** report. It is intended solely to serve as an example of student work at Yale's School of Management. It is not intended as investment advice. It is based on publicly available information and may not be complete analyses of all relevant data.

If you use this report for any purpose, you do so at your own risk. **YALE UNIVERSITY, YALE SCHOOL OF MANAGEMENT, AND YALE UNIVERSITY'S OFFICERS, FELLOWS, FACULTY, STAFF, AND STUDENTS MAKE NO REPRESENTATIONS OR WARRANTIES, EXPRESS OR IMPLIED, ABOUT THE ACCURACY OR SUITABILITY FOR ANY USE OF THESE REPORTS, AND EXPRESSLY DISCLAIM RESPONSIBIITY FOR ANY LOSS OR DAMAGE, DIRECT OR INDIRECT, CAUSED BY USE OF OR RELIANCE ON THESE REPORTS.**