eBay Inc (EBAY)

BUY (1)
High Risk (H)

EBAY: PESA Summit Provides In-Depth View of Power Sellers' Challenges

Mkt Cap: **$36,084 mil.**

United States

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INTERNET

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SUMMARY

- Last week we attended the 5th Annual Professional eBay Sellers Alliance (PESA) Summit in San Francisco with over 200 power sellers. PESA collectively represents around 800 eBay power sellers and over $1B GMV.
- Our 9/15 conf. call with power sellers addressed the impact of the fee increase on Store listings (expect a material decline), Core listings (few signs of improvement post fee hike), and provided an update on eBay Express (no material uptake so far though likely too early to tell).
- Our goal at PESA was to dive further into key issues facing power sellers. Here's what we heard: 1) Perceived lack of buyers, declining buyer activity & lower conversion rates; 2) Fraud still a big issue; 3) High non-fee costs of selling (e.g., high cust. svc. burden); 4) Few benefits of economies of scale for power sellers; 5) Perception of rigid approach by eBay to policy enforcement; 6) Concerns re eBay Express; and 7) More feedback on Store fee hike.

FUNDAMENTALS

P/E (12/06E)	25.7x
P/E (12/07E)	21.2x
TEV/EBITDA (12/06E)	14.7x
TEV/EBITDA (12/07E)	10.9x
Book Value/Share (12/06E)	$8.38
Price/Book Value	3.1x
Revenue (12/06E)	$5,808.2 mil.
Proj. Long-Term EPS Growth	20%
ROE (12/06E)	13.2%
Long-Term Debt to Capital(a)	0.0%

EBAY is in the S&P 500® Index.

(a) Data as of most recent quarter

SHARE DATA

Price (9/22/06)	$26.11
52-Week Range	$46.77-$22.99
Shares Outstanding(a)	1,382.0 mil.
Div(E) (Cur/Prev)	**$0.00**/$0.00

RECOMMENDATION

Rating (Cur/Prev)	**1H**/1H
Target Price (Cur/Prev)	**$38.00**/$38.00
Expected Share Price Return	45.5%
Expected Dividend Yield	0.0%
Expected Total Return	45.5%

EARNINGS PER SHARE

FY ends		1Q	2Q	3Q	4Q	Full Year
12/05A	**Actual**	**$0.20A**	**$0.22A**	**$0.20A**	**$0.24A**	**$0.86A**
12/06E	**Current**	**$0.24A**	**$0.24A**	**$0.23E**	**$0.30E**	**$1.01E**
	Previous	$0.24A	$0.24A	$0.23E	$0.30E	$1.01E
12/07E	**Current**	**$0.30E**	**$0.30E**	**$0.29E**	**$0.35E**	**$1.23E**
	Previous	$0.30E	$0.30E	$0.29E	$0.35E	$1.23E
12/08E	**Current**	**NA**	**NA**	**NA**	**NA**	**$1.51E**
	Previous	NA	NA	NA	NA	$1.51E

First Call Consensus EPS: 12/06E $1.00; 12/07E $1.25; 12/08E $1.66

KEY TAKEAWAYS FROM 5TH ANNUAL PESA SUMMIT

Last week we attended the 5th Annual Professional eBay Sellers Alliance (PESA) Summit in San Francisco with over 200 power sellers. PESA collectively represents around 800 eBay power sellers and over $1B in GMV.

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In our 9/15 conference call with ChannelAdvisor and 3 large power sellers, we addressed the impact of the Store fee increase on Store and Core listings and conversion rates, and provided an update on eBay Express. Our goal at PESA was to dive further into key issues facing power sellers, especially in light of the recent AuctionBytes survey results we cited in our Sept. 19th listing note, where 92% of respondents indicated that they sold on eBay but only 38% plan on selling on eBay in 6 months.

Based on our conversations with PESA members, key issues facing power sellers include the following:

1. Perceived lack of buyers, declining buyer activity and lower conversion rates – In our conference call on Sept. 15th, one power seller commented on the lack of new buyers on eBay. Sellers at the PESA Summit seemed to concur, although this varied a lot by category (e.g., lack of buyers is more of a problem in commodity-like categories such as DVDs or areas w/in consumer electronics where you've seen strong increases in the numbers of sellers). Also, many sellers thought buyer activity had steadily declined, and one presentation by an eBay service provider threw out a figure that average buyer spending was down by 17% Y/Y. On conversion rates the majority of sellers we spoke with thought they were trending lower, although this also varied by category. For example, Inflatable Madness (seller of books, CDs, DVDs, & video games) was concerned about lower conversion rates while Africa Direct (seller of African art & jewelry) said that conversion rates were stable. Some power sellers we spoke with pointed to a lack of technical innovation on the core auction site as one possible factor, noting that eBay has been so focused on its new acquisitions/emerging businesses that it may not have been investing as aggressively in improving the core platform.

2. Fraud remains a key issue (both buyer and seller fraud) – From our discussions with power sellers, fraud and lack of buyer demand are connected, as sellers believe that bad buyer experiences with fraud on eBay has simply led to buyers moving off of eBay. But fraud has a number of other related effects, including lower ASPs (due to either fewer sales of high ASP items or buyers' refusal to pay a market rate for products on eBay due to fraud risk) and higher customer service burdens on eBay vs. other channels due to buyer skepticism. Non-paying bidders (NPBs) remain a problem as well, and some sellers such as Back To Nature Gifts believed that NPBs were rising.

3. Selling on eBay has high non-listing-fee costs, like customer service – We found a clear consensus that selling on eBay involved much higher customer service demands than other channels like Amazon or sellers' own Website. For example, for large sellers like Eforcity (on of the largest sellers on eBay and #90 on the Inc. 500 list) eBay may represent 40% of sales but 80% of inbound email. (RockBottomGolf's Todd Rath commented on this issue last week on our conference call.) By contrast, sellers said that they received almost no email from Amazon buyers, there are no NPBs on Amazon, and they generally got much higher ASPs for their products on AMZN. eBay's counter-argument here is that eBay provides much higher turns and cashflow to sellers but the high intangible costs of doing business on eBay may be another reason why sellers continue to diversify their distribution channels.

4. Few perceived benefits of economies of scale on eBay (i.e., size doesn't matter – honest) – Power sellers' perception is that eBay's egalitarian approach for sellers (e.g., same fee structure for listings and no preferential placement) means that large sellers don't realize many benefits of scale on eBay. What does this mean? As power sellers scale up, buy and manage more inventory, they have a lower margin of error than smaller sellers and eBay offers them no better fee structure or placement on the Website than any other seller. So sellers are not rewarded by eBay for building thriving businesses with good customer service – they pay the same fees as anyone else. Contrast this with sellers' off-eBay experience where scale matters, either via a direct website or even on Amazon where some large sellers in Amazon's Seller Central program get better placement. (Note: Amazon's Seller Central is by invite-only, some categories like Jewelry and Beauty are currently closed, and AMZN has to approve the seller for participation.) According to service provider Channel Velocity, scale may actually make on-eBay selling more treacherous for some large sellers because any issue, like a temporary suspension or policy change, could have very serious cash flow implications. The trade-off here is that the level playing field may benefit buyers since items are presented on the basis of objective criteria like auction ending time and are not skewed in favor of certain large sellers.

5. Perception of rigid approach by eBay to policy enforcement – This is a familiar refrain, but the power sellers we spoke with expressed concern about what they called eBay's rigid policy enforcement. We heard about this issue most often in response to our questions about eBay's stated desire to eliminate excessive shipping charges (which PESA power sellers support, btw). Power sellers remain concerned about how rules get determined and applied across all the different categories, whether the issue is shipping fees or customer service levels. For fees, power sellers generally seemed to believe that fees and even some fees should vary by category given the very different margin structures and price points. For example, it's much easier to meet a certain threshold of customer support if you're selling $500 custom pieces of jewelry than $5 DVDs. Here, too, we note a trade-off as eBay's policies are designed to benefit buyers.

6. Questions and concerns about eBay Express – In our note on our 9/15 conference call we noted that our panelists had not seen signs of material traction for eBay Express but that it was too soon to tell given that TV advertising only started in early September. At PESA we heard similar comments along with some skepticism that eBay Express will grow to become a meaningful contributor for eBay. One power seller raised the provocative point that eBay's brand is so tightly aligned with used items, and that used items likely constitute the vast majority of GMV, that eBay Express faces big structural-like challenges in terms of consumer adoption (i.e., eBay for new just won't work in a significant way). Sellers also noted that eBay Express simply didn't provide the breadth of products consumers are accustomed to buying on eBay. One possible bright spot is if/when eBay leverages the better search technology of eBay Express to improve the core site.

7. More feedback on the Store fee hike – We addressed the implications of the fee hike in our conference call on 9/15. To recap, for many Store sellers the new fee structure is unworkable due to unit economics in their category (i.e., margins are too thin). On that call we heard that higher Store fees would not encourage Store sellers to move product to Core because Stores work for a different class of item (such as lower ASP, lower turn items). At the PESA Summit sellers like Inflatable Madness expressed their concerns about the number of fee hikes – not just in terms of the absolute costs but also in terms of the sheer number of fee changes and the challenges of planning/building a large viable business only to have the rules of the game change dramatically.

AMAZON.COM AND GOOGLE WERE IN THE HOUSE

eBay/PayPal sent approximately 27 people to the PESA Summit, while Amazon sent 9 and Google sent 12. Google and Amazon both made presentations in the main conference room, and both hosted several hours worth of smaller break-out presentations/roundtables. GOOG sessions covered topics such as AdWords, Analytics, Checkout, and Base. AMZN covered topics like Fulfillment by Amazon and its new WebStore offering (for e-commerce merchants who want AMZN to power their own independent store).

Google: Google sessions were well attended and the company presented several times in the main conference hall on AdWords, Checkout and Analytics. Both the presentations and the breakout sessions provided good overviews of Google's suite of products, which was useful because a number of PESA members we spoke with had surprisingly little direct experience with paid search. We also heard that Google is going to integrate Base into core search, allowing users to do product searches from a regular search as opposed to going to Froogle.

Those power sellers who had interacted with Google and participated in Checkout trials generally had good things to say about working with GOOG, although we did hear that Checkout still has some technical kinks to work out and that implementation for power sellers on their own sites may be a challenge for them. (Large power sellers who use ChannelAdvisor and Marketworks get Google Checkout integration as part of their e-commerce store packages.)

One thing that struck us at the PESA Summit is how important Analytics is to Google's goal of acquiring transaction data (there's a snippet of java code that sellers are encouraged to put on their receipt/purchase page so that sellers – and presumably GOOG — can accurately track conversion rates). So Checkout and Analytics are two ways for Google to close the loop on transactional data.

Amazon: Amazon sessions also were well attended. Generally speaking, PESA members we spoke with viewed Amazon as a better neighborhood to sell in than eBay, provided you got into the Seller Central program (an invite-only program that allows sellers to sell directly on Amazon.com as opposed to within Amazon's marketplace). Sellers who weren't in Seller Central presumably do not get nearly the same type of volume. Key benefits for sellers on the Amazon platform include higher ASPs, low customer service burden (no inbound emails), all inclusive price ($40/month and around 15% commission depending on the category, and payment processing by AMZN is included). PESA members were also curious about Amazon's WebStore and Fulfillment Services. We believe the fulfillment services are available for third-party sellers on Amazon but one of Amazon's presenters noted that the company intended to extend the program in the future, hence its presence at PESA.

VALUATION

We arrive at our $38 target price though a combination of P/E and EV/EBITDA analysis. Our P/E analysis generates a $37 PT, while our EV/EBITDA analysis generates a $40 PT. Because we weight our P/E analysis more heavily for eBay we round down to arrive at our target.

P/E: We apply a 30X multiple to our 2007 pro forma EPS estimate of $1.23 to reach a $37 target price. Our target multiple is largely driven off of growth assumptions. For context, we are estimating a long-term compound EPS growth of approximately 20%, so our target multiple implies a 1.5 PEG, which is in-line with the PEGs we use with other leading Internet stocks. For the Internet stocks we cover, the range for PEG multiples on our 2007 estimates is 1.0X to 2.6X with an average of 1.4X. We note that eBay's P/E multiple has ranged from 19X to 46X over the past 12 months, with an average of 36X. Our 30X multiple is below the average over that time period, which we think is appropriate given that our long-term growth outlook assumes some growth deceleration. Note, however, that our 30X target multiple is modestly above EBAY's current 2006 pro-forma multiple (26X), so we are assuming some multiple expansion. However, our target is slightly below the current average P/E multiple for our coverage universe (33X) which we believe is reasonable given our growth outlook. Finally, this target multiple is the third-highest (after Google and Yahoo!) among the Net Leaders, which is consistent with our assumption that eBay's growth outlook is the third strongest (after Google and Yahoo!) in the group.

EV/EBITDA: We apply a 19X multiple to our 2007 EBITDA estimate of $2.8B ($1.94 per share) to reach a $40 target price, adjusting for $5.1B ($3.55 per share) in 2006 year-end cash. Given our long-term growth outlook above, the 19X multiple implies an approximate 1.0 PEG, which is in line with the multiples we are using for other leading Internet stocks.

For the Internet stocks we cover, the PEG multiple range on our 2007 estimates is 0.7X to 1.1X with an average of 0.8X.

We note that our 19X target multiple is above EBAY's current 2006 multiple (15X), so we are assuming some multiple expansion. However, our 19X target multiple does fall well within the recent historical range. By way of context, over the past one-year period eBay's forward EBITDA multiple has ranged from 11X to 28X with an average of 21X. So our 19X multiple is below the average of the recent historical range.

RISKS

Our High Risk rating on EBAY reflects the highly competitive landscape the company faces and the intrinsically high valuation multiples of growth stocks, especially in the Internet sector. These risks are somewhat offset by the company's strong balance sheet, the liquidity of its shares, and its very consistent execution track record. All in, these risks may cause material variance from our projected price target for EBAY shares. Investment risks include: 1) Very significant competition from other companies, including Amazon, Google, Yahoo!, vertical online retailers, comparison shopping engines, and broad multichannel retailers; 2) Significant deceleration in key markets – U.S., Germany and the U.K.; 3) Potentially material margin pressures due to investments, increased operating costs (including online advertising), and revenue mix shifts; and 4) Roll-up risks related to several recent material acquisitions (Skype and Shopping.com).

If the impact on the company from any of these factors proves to be greater than we anticipate, the stock will likely have difficulty achieving our target price.

INVESTMENT THESIS

We rate the shares of eBay Inc Buy/ High Risk (1H) on the belief that the investment positives generally outweigh the risks. Key positives include 1) exposure to ecommerce s strong secular growth; 2) market share leadership and expansion; 3) significant international exposure; 4) new revenue drivers in payments expansion and classified advertising; and 5) a robust business model. Key risks include 1) an increasingly competitive landscape; 2) significant deceleration in key markets; and 3) margin pressures due to investments and rising online ad and customer service costs.

COMPANY DESCRIPTION

eBay Inc (EBAY) is the leading global ecommerce brand. It serves as an online trading platform that enables a global community of buyers and sellers to interact and trade with each other. Listings on eBay cover a very wide range of categories, from Antiques and Computers to Jewelry & Watches and Video Games. eBay's selling formats include traditional auction formats, as well as more retail-like functionality. The company also offers online payment solutions via its PayPal subsidiary. As of June 2006, eBay had 77 million online registered users worldwide (up 20% YoY), generating annualized gross merchandise volume of $51.6 billion. On September 12, 2005, eBay announced that it was buying Skype, a Luxembourg-based Internet communications company, for $2.6 billion in cash and stock. The deal includes a performance-based earn-out of up to an additional $1.5 billion, payable in either cash or stock, with an expected payment date in 2008 or 2009.

ANALYST CERTIFICATION APPENDIX A-1

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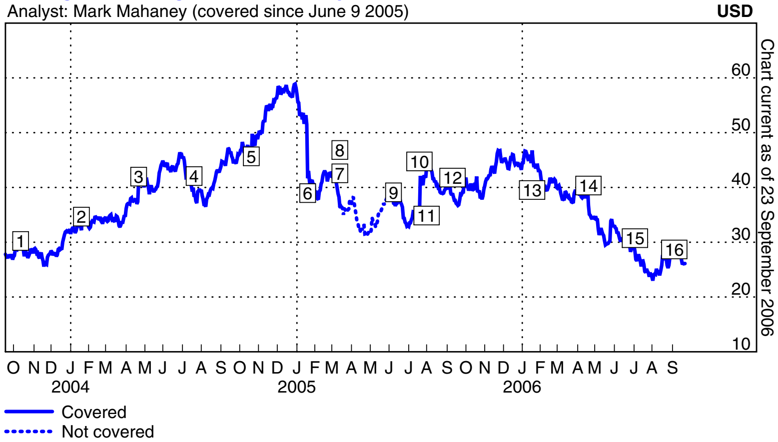
eBay Inc (EBAY)

Ratings and Target Price History - Fundamental Research

Analyst: Mark Mahaney (covered since June 9 2005)



#	Date	Rating	Target Price	Closing Price
1:	12 Oct 03	*3H	*24.00	29.50
2:	21 Jan 04	*2H	*36.00	32.19
3:	22 Apr 04	2H	*42.50	41.30
4:	21 Jul 04	2H	*40.00	38.30
5:	20 Oct 04	*1H	*57.50	45.68
6:	20 Jan 05	1H	*55.00	41.67
7:	14 Mar 05	1H	55.00	36.48
8:	14 Mar 05	Coverage suspended		
9:	8 Jun 05	*2H	*43.00	37.10
10:	20 Jul 05	2H	*45.00	34.87
11:	31 Jul 05	*1H	*51.00	43.61
12:	12 Sep 05	1H	*49.00	38.94
13:	19 Jan 06	1H	*52.00	46.77
14:	20 Apr 06	1H	*51.00	36.77
15:	5 Jul 06	1H	*40.00	28.36
16:	6 Sep 06	1H	*38.00	28.21

*Indicates change.

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% of companies in each rating category that are investment banking clients	45%	43%	34%
Internet -- North America (15)	47%	47%	7%
% of companies in each rating category that are investment banking clients	14%	57%	0%

Guide to Fundamental Research Investment Ratings:

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