An Analysis Of Overstock.com (OSTK)

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The greatest risk in any investment is the risk of overpaying. So, the real question is: what is Overstock worth? I think it worth at least $1.5 billion. With Overstock market cap currently sitting around $500 million, my valuation certainly looks far fetched. But, there only one way to know for sure. Let take apart my argument piece by piece, and see if any of my assumptions are unreasonable.

First Assumption: Over the next five years, Overstock will neither generate truly free cash flow nor consume cash. In other words, its free cash flow margin will average 0%. Cash generation in some years will exactly offset cash consumption in other years. Obviously, this assumption is unreasonable, because there is almost no chance the cash flows will exactly offset.

That not a problem if it turns out Overstock does generate some free cash flow over the next five years. In that case, my assumption simply errs on the side of caution. If, however, it turns out Overstock actually consumes cash over the next five years, there is a problem ?possibly a very big problem. So, which scenario is more likely?

Overstock revenues are growing quickly. Gross margins look solid at 13.3% in 2004 and 14.9% over the last twelve months. Overstock unprofitability is the result of its selling, general, and administrative expenses (SG&A) which have been growing exponentially. Will these expenses continue to grow? Yes, but not as fast as revenues. Over the last twelve months, Overstock spending on cap ex has been 5.6% of sales. That number is an aberration. In the long run, spending on cap ex should not exceed 3% of sales. Considering the business Overstock is in and the expected sales growth, the company will, more likely than not, generate some free cash flow over the next five years. Therefore, the assumption that Overstock will be cash flow neutral over the next five years is not overly optimistic.

Second Assumption: Over the next five years, Overstock sales will grow by 15% annually. Is this an unreasonable assumption? Again, I don't think it is. Very few industries are expected to grow as fast as eCommerce. Overstock revenue growth in 2003 and 2004 was over 100%. In the past year, that growth has slowed. However, it is still closer to 50% than it is to 15%. Overstock isn't in a cyclical business. So, there is no reason to believe current sales are abnormally high.

Also, all that spending on advertising is increasing consumers?awareness of Overstock. A review of Overstock traffic data shows it has not only been gaining more visitors; it has also been climbing the ranks of the most popular web sites. While it is a long, long way from the Amazons, Yahoos, and eBays of the world (and will never reach those heights) Overstock is becoming a well known internet destination. This fact was most clearly evident in the weeks leading up to Christmas. Shoppers who visited Overstock during the holiday season obviously know it exists, and may very well return at some other point in the year. Analysts are predicting very high growth rates for Overstock; however, they are also recommending you sell the stock. I don't put any weight in their estimates. But, for the other reasons given, I believe the assumption that Overstock will grow sales at 15% a year for the next five years is not unreasonable.

Third Assumption: Six to ten years from today, Overstock will have a free cash flow margin of 3%. Ten years from today, Overstock free cash flow margin will rise to 4% and remain at that level. Now, of all the assumptions I've made, this one is the most questionable. Sure, Amazon has that kind of free cash flow margin, but Overstock isn't Amazon, and it never will be Amazon. Overstock gross margins are less than Amazon. In fact, Overstock gross margins are less than Wal ?Mart. However, Overstock fixed costs will eat up a much smaller portion of its sales than is the case over at Wal - Mart.

If you compare Overstock to other online retailers, you will see that if Overstock does experience strong sales growth, a 3% free cash flow margin six years from now is not unreasonable. I assumed Overstock sustainable free cash flow margin will be 4%. There a case to be made that 4% is too high. I won't make that case, because I don't believe in it. Remember, that 4% number comes ten years out. That gives Overstock plenty of time to grow sales and thus reduce SG&A as a percentage of sales.

Fourth Assumption: Six to ten years from today, Overstock will be growing sales by 12% a year; eleven to fifteen years from today, Overstock will be growing sales by 8% a year; thereafter, Overstock will grow sales by 4% a year. Let see what this really means. According to these assumptions, Overstock sales will be as follows:

Today: $707 million

2011: $1.59 billion

2016: $2.71 billion

2021: $3.83 billion

2026: $4.66 billion

2031: $5.67 billion

2036: $6.90 billion

Seven billion dollars is not an unreasonable target ?if you have thirty years to achieve it. To put that figure in perspective, Amazon.com currently has sales of about $8 billion. So, even after thirty years, these assumptions don't lead to Overstock reaching the same size as today Amazon. Don't forget these numbers assume some inflation. For instance, if inflation averages 3% a year over the next thirty years, Overstock projected $6.90 billion in sales only translates to $2.84 billion in today dollars. So, these assumptions only lead to a fourfold increase in Overstock real sales over a period of thirty years. I think that pretty reasonable.

If you take these four assumptions together, you get a value of $1.5 billion for Overstock. Today, Mr. Market is offering it for $500 million ?that why I'm writing about an unprofitable internet company.

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