1995
Dollar Value
$ 1,422.6
1,541.3
1,741.8
2,951.0
1,908.7
3,379.8
2,729.5
2,861.0
2,362.0
—
—
—
—
$20,897.7

October 23, 1995
5.875%
5.426
5.575
5.645
5.757
5.816
5.921
6.073
6.392
4,755.48
585.06
59.69
172.09

CASE 26

eBay Inc. (A)

Gary Bengier, chief financial officer and vice president of operations at eBay, clicked on the send button as he e-mailed the week's financial update to Pierre Omidyar, the company's 31-year old chairman. It was September 15, 1998, and Wall Street was still reeling from a summer of severe market volatility. Much of the market's instability could be traced to bearish worries over a deepening and continuing economic crisis in Asia and other developing markets. Many investors feared that the U.S. economy would be unable to resist what was termed the "Asian Flu," and that economic recession was imminent. Although U.S. interest rates were still low at yields of 4.0 percent for Treasury Bills and 5.6 percent for 30-year Treasury bonds, the S&P 500 Index was down nearly 13 percent from its all time high set only two months earlier. After bottoming out at the end of August, the stock market had regained some upward momentum but with ongoing high volatility. Internet stocks, however, continued to decline in value. The Internet stock index (ISDEX) was off nearly 40 percent from its mid-July high. **Exhibit 1** shows the path of the S&P 500 index and the ISDEX for the past three months, while **Exhibit 2** presents the long-term trends in aggregate market volatility.

Two months earlier while stock valuations were at record levels, eBay had begun the registration process with the Securities and Exchange Commission (SEC) for its first public stock sale. Since the market correction, many other companies with initial public offerings (IPOs), such as Internet firms Barnes&Noble.com, uBid, and netValue, Inc., had either canceled or postponed their issues. In fact, the past few weeks had been the quietest month for IPOs since the mid-1970s. **Exhibit 3** provides the monthly number of canceled and postponed IPOs in 1998, relative to the number of offerings completed. Some investors speculated that eBay was likely to follow suit and either withdraw or postpone its offering.

This case was prepared by Jason Burnett and Professor Michael J. Schill. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

eBAY

The demand for person-to-person trading was traditionally filled by consignment shops, collectible shows, flea markets, classified advertisements, and dealer shops. Sellers were generally required to pay for advertisements and selling space and to bear the full cost of transportation and marketing. These higher costs were passed on to buyers through higher prices. These conventional trading venues suffered from relatively high inventory management costs and restricted market coverage.

The idea for Internet consignment came to Pierre Omidyar when his girlfriend, an avid PEZ candy dispenser collector, expressed her displeasure over the lack of PEZ trading partners in the San Francisco Bay Area. Months later, in an effort to provide an Internet site where PEZ collectors could meet and make transactions, Pierre founded eBay. Through Internet consignment, Pierre was able to gain a much broader market without the high inventory management costs of regular consignment. Buyers and sellers could also access their trading forum 24 hours a day, while the cost of Internet consignment would be considerably less for both.

Traders argued that the time spent searching for items, and the social interaction involved in the process, were an important part of the collecting and trading experience. To attract collectors, Omidyar faced the challenge of recreating the environment and trading experience that buyers and sellers enjoyed. Omidyar added several clever ideas to eBay's web service to stimulate interest. First, he adopted an auctionlike trading format to not only create a sense of urgency, but also allow buyers to follow the bidding status for each item. Secondly, he provided sellers with opportunities to "spice up" their auction pages. Sellers were encouraged to upload pictures of their items or add music. Thirdly, Omidyar created the eBay Community, composed of registered traders sharing in common interests and passions for collectible and tradable goods. eBay listed all participants' e-mail addresses and provided chat rooms, such as the eBay café, where eBay community members could talk about sale items, hobbies, or other non-trading-related topics. Finally, eBay allowed users to discuss the relative quality of items, sellers, and buyers in the eBay community by providing a "Feedback Forum" for community members to interact.

eBay's first auction occurred on Labor Day 1995. Three years later, with over one thousand categories listed and 70,000 new sale items added daily, eBay had become the largest and most popular person-to-person trading community on the Internet. The goods traded on eBay's web site included: antiques, sports memorabilia, books, toys, cars, computers, dolls, coins, jewelry, electronics, photography, and music. The company neither received goods nor payments for goods, but simply provided an arena for buyers and sellers to interact. To generate revenue, eBay charged sellers a nominal posting fee ranging from $.25 to $2.00 an item and a completed transaction fee ranging from 1.25 percent to 5 percent of the final selling price. **Exhibit 4** provides the fee schedule. Auctions for posted items lasted from a couple of hours to a few weeks. Buyers were allowed to explore the site free of charge. At the close of an auction the seller and buyer were notified by eBay and the transaction was completed without eBay involvement.

eBay was one of the few profitable Internet companies in 1998. For the six months ended June 30, 1998, the company reported operating profit of $2.7 million on total revenues of $14.9 million, representing a 220 percent increase in profit and an 800 percent increase in revenue over the first half of the previous year. eBay's financial statements are provided in **Exhibits 5 and 6.**

COMPETITION

Having pioneered person-to-person trading forums on the Internet, eBay had grown its number of users from 340,000 to 850,000 over the first six months of 1998 and the number of simultaneous auctions had climbed from 200,000 to 500,000 over the same time frame. eBay saw the continuation of such market penetration to be vital to its continued success. eBay expected to expand its services to an international level by taking advantage of increasing worldwide access to the Internet. eBay's growth was currently supported by 76 employees.

Despite eBay's early lead, the market for person-to-person trading on the Internet was destined, however, to attract many of the new and up-and-coming Internet companies, as well as many large and well-established firms. Already the number of direct and indirect competitors was formidable. Currently, Yahoo! Auctions Powered by Onsale, Auction Universe (a subsidiary of Times-Mirror Company), uBid (a subsidiary of Creative Computers), and Excite, together with numerous other smaller specialized electronic-trading services, competed directly with eBay in the person-to-person trading market. In addition, First Auction, ZAuction, and Surplus Auction competed indirectly with eBay in the business-to-person market. Other large established companies, such as AOL, Microsoft, and Amazon.com, as well as QVC, Cendant Corporation, and large newspaper or media companies were expected to play more of a role in the industry in the future. A financial comparison of eBay's direct competitors is found in **Exhibit 7.**

The Internet industry had only recently emerged as a major medium of communication. International Data Corporation (IDC) estimated that the worldwide number of Internet users would grow from approximately 69 million in 1997 to 320 million in 2002. IDC also estimated that Internet commerce was to grow from approximately $32 billion worldwide in 1998 to $130 billion in 2000. Maintaining a competitive position in the surging Internet industry was particularly tenuous. Rapid technological advancements, capacity constraints, web/network infrastructure, and system security were some of the most important competitive issues. The need to provide reliable systems software and hardware was a considerable cost for Internet companies. The rapid pace of technological advancement required access to sufficient capital to implement swift change. System security issues posed the greatest danger for eBay. eBay's Web site relied heavily on systems support by Exodus Communications. A system failure by Exodus could severely damage eBay's own reputation. eBay was also exposed to the security risks of online commerce. If encrypted transmissions were decoded, customer transactions could potentially be altered or erased.

Two weeks ago, AOL had named eBay as its exclusive person-to-person auction service for a minimum of one year. Since the success of an Internet firm relied heavily on its ability to contract with search engines, bulletin board operators, and online access services, all of which provided users access to the firm's site, the AOL agreement substantially solidified eBay's competitive position.

eBAY'S PUBLIC OFFERING

eBay had considered a public equity offering to raise additional capital to repay outstanding debt and to invest in new technologies or businesses that could improve eBay's operations and service. To initiate the IPO process, eBay had selected Goldman Sachs as its lead underwriter, Fenwick & West as its legal counsel, and PricewaterhouseCoopers as its auditor. In the early summer of 1998, this team prepared a registration statement (Form S-1), submitting it to the SEC on July 15th. Over the following few weeks, the SEC examined the adherence to required disclosure requirements and registration compliance, but as required, made no comments on the quality of eBay's financial prospects. Discrepancies discovered by the SEC and cited in the letter of comment were addressed in subsequent eBay amendments to the registration, as is standard under SEC rules. During the SEC review, Goldman Sachs and eBay drew up the contract for distribution of the securities, agreeing to a firm-commitment, rather than a best-efforts offering.[1]

Goldman Sachs assembled the underwriting syndicate and issued the preliminary or "red herring" prospectus.[2] The syndicate members listed in **Exhibit 8** agreed to share the risk of selling their allotted portions of the offering. In return, the underwriters received 7 percent of the total offering proceeds through the underwriting discount. In addition to compensating the underwriters, eBay expected to incur approximately $1 million in direct offering expenses to cover the legal, auditing, printing, and registration fees. Historically, IPOs had been priced such that investors experienced strong positive returns on the first day (see **Exhibit 9**). Such underpricing provided an additional indirect cost to companies going public.

As is customary, the SEC restricted the type of information that eBay or the underwriting team could disclose. Company communication was limited to the preliminary prospectus, tombstone ads in major financial newspapers, and road-show presentations to institutional investors. Despite the market volatility, investor demand expressed at the road shows appeared to be strong.

CONCLUSION

eBay had reached a critical point. Bengier recognized the momentum generated by the IPO process, but was concerned about the implications of a failed offering. He worried that although the firm-commitment offering ensured receiving the contracted proceeds, an unsuccessful offering might have an important impact on access to new capital in the future.

[1]In a best-efforts offering the underwriter only agrees "to do their best" at placing an offering at the agreed upon price and number of shares. If after a period of "selling" the issue (usually 90 days), the minimum agreed upon number of shares had not been subscribed to; the underwriter would cancel the issue. In the more common firm-commitment offering, the underwriter guaranteed that an agreed-upon number of shares would be sold for a negotiated price. In some instances the underwriter might suggest beforehand that the number of shares be increased or decreased, depending on market demand.

[2]The preliminary prospectus is called a red herring because it must have "Preliminary Prospectus" written in red ink on the front cover.

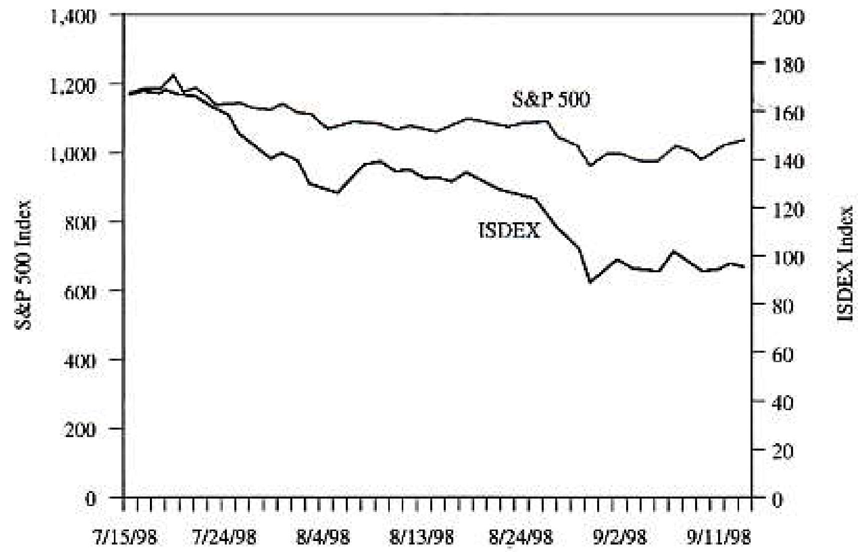
So far in September no other company had dared bring an issue to market. Even Goldman, which had its own IPO in the works, was thinking of postponing its own offering. The last IPO had occurred on August 26, when the Tennessee bank, Bankfirst, had raised $19 million. The last Internet company to go public was the encryption firm, Entrust Technologies, which had raised $125 million over four weeks ago. Today Entrust stock was trading somewhat below its offering price and was not considered a successful issue. In fact, 88 percent of all IPOs for the year now traded below their original prices.[3] Delaying the offering for six months would cost the company less than $1 million in direct expenses, but potentially much more in delaying major investment initiatives.

If eBay went ahead with the offering, Bengier worried that the offering price would be strongly discounted. The emerging Internet stocks had experienced large declines in value recently. Internet stocks faced increased risks due to the uncertainty of the long-term viability of the industry. Fearing the increased uncertainty, investors had moved their capital to safer securities. Goldman had originally encouraged eBay to offer 3.5 million shares at between $14 and $18 per share. The underwriting syndicate continued to be cautious, yet encouraging. Typically IPOs were priced by applying industry market multiples like price-earnings, price-sales, or market-to-book ratios; however, this method had proved difficult in emerging industries like the Internet industry.

Bengier wished he had the opportunity to collect more data, but eBay's scheduled IPO date was only a week away. He felt that if eBay was going to pull the plug on the deal, it needed to make the decision now. If eBay were to go ahead with the offering, he needed to firm up the target price. Since the original agreement was to sell less than 9 percent of the company in the IPO (see **Exhibit 10**), a price of $16 would value the current owners' holdings at nearly $600 million—a tempting proposition.

[3] "Where Are All the IPOs?," CNNfn.

EXHIBIT 1
Equity Market Performance



Source: Datastream, Internet.com.

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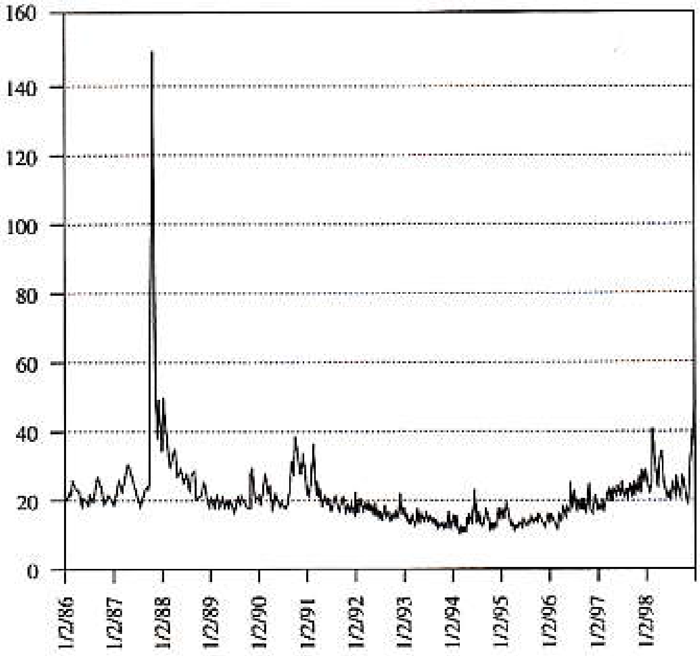
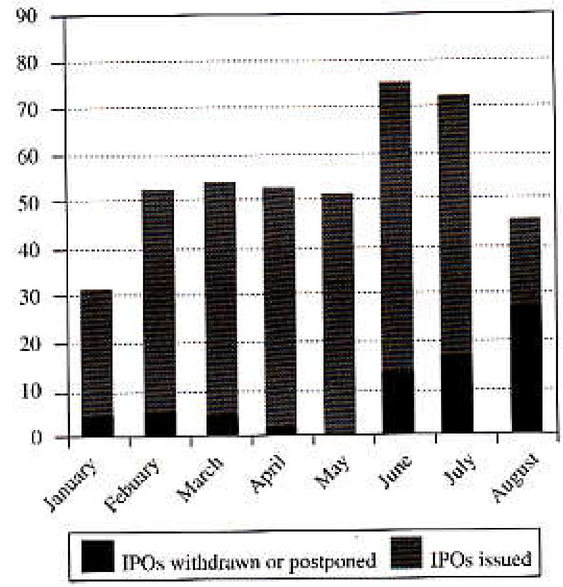
EXHIBIT 2
Implied Equity Market Volatility
(CBOE 30-day Volatility Index for Optionable Stocks)



Source: Chicago Board of Options Exchange.

EXHIBIT 3
IPOs Issued, Postponed, and Withdrawn in 1998



Source: IPO Data Systems.

EXHIBIT 4
eBay Transaction Fee Schedule

Posting Fees

Opening Value of Sale Item	**Fee**
$0.01 to $9.99	$0.25
$10.00 to $24.99	$0.50
$25.00 to $49.99	$1.00
Above $50.00	$2.00

Completed Transaction Fees*

Final Selling Price	**Fee**
$0.01 to $25.00	5.00 percent
$25.01 to $1,000	2.50 percent
Above $1,000	1.25 percent

* Completed transaction fees are calculated for each interval. For example a $50 sale would generate fee revenue of $1.88 [$25.00 × 5% + $25.00 × 2.5%].

Source: Preliminary Prospectus.

EXHIBIT 5
Consolidated Balance Sheet for eBay Inc.

	Dec. 31, 1997	June 30, 1998
Assets		
Current assets:		
Cash and cash equivalents	$3,723,000	$10,716,000
Accounts receivable, net	1,024,000	2,846,000
Other current assets	220,000	453,000
Total current assets	4,967,000	14,015,000
Property and equipment, net	652,000	3,584,000
Intangible assets, net	0	2,216,000
Total assets	$5,619,000	$19,815,000
Total Liabilities and Stockholders' Equity		
Current liabilities:		
Debt and leases, current portion	$ 258,000	$ 314,000
Accounts payable	252,000	1,841,000
Customer advances	128,000	390,000
Income taxes payable	169,000	1,033,000
Other current liabilities	317,000	1,634,000
Total current liabilities	1,124,000	5,212,000
Debt and leases, long-term portion	305,000	167,000
Deferred tax liabilities	157,000	157,000
Total liabilities	1,586,000	5,536,000
Series B, mandatory convertible preferred stock	3,018,000	5,157,000
Series A, convertible preferred stock, $0.001 par value	4,000	4,000
Common stock, $0.001 par value	20,000	27,000
Additional paid-in capital	1,482,000	15,211,000
Notes receivable from stockholders	−68,000	−1,536,000
Unearned compensation	−1,399,000	−5,729,000
Retained earnings	976,000	1,145,000
Total stockholders' equity	1,015,000	9,122,000
Total liabilities and stockholders' equity	$5,619,000	$19,815,000

EXHIBIT 6
Consolidated Statement of Income for eBay Inc.

	Year Ended Dec. 31, 1997	Six Months Ended June 31, 1998
Net revenues	$5,744,000	$14,922,000
Cost of net revenues	746,000	1,736,000
Gross profit	4,998,000	13,186,000
Operating expenses:		
Sales and marketing	1,730,000	4,610,000
Product development	831,000	1,548,000
General and administrative	950,000	4,187,000
Acquired research and development	0	150
Total operating expenses	3,511,000	10,495,000
Income from operations	1,487,000	2,691,000
Interest and other income, net	59,000	101,000
Interest expense	−3,000	−25,000
Income before income taxes	1,543,000	2,767,000
Provision for income taxes	−669,000	−2,552,000
Net income	$ 874,000	$ 215,000
Net income per share	$0.11	$0.01

Source: Preliminary Prospectus.

EXHIBIT 7
Comparative Financial Information for Direct Competitors
(for six-months ended June 30, 1998, in millions except for per share and employee data)

	eBay	Onsale	uBid	Excite
Total revenues	$14.9	$91.0	$ 8.8	$ 56.0
Cost of revenues	1.7	82.8	8.1	12.1
Operating expenses	10.5	17.8	2.5	129.2
Net income	0.2	(8.2)	(1.9)	(87.1)
Earnings per share	$ 0.01	$ (0.44)	$(0.26)	$ (1.98)
Shares outstanding	34.2	18.8	7.3	44.0
Current assets	14.0	63.3	N.A.	82.9
Cash & short-term investments	10.7	51.9	N.A.	36.0
Total assets	19.8	66.9	2.7	125.6
Current liabilities	5.2	12.1	N.A.	41.9
Long-term debt	0.2	0.0	N.A.	5.0
Net worth	9.1	54.8	(2.2)	70.6
Recent stock price	N.A.	$ 20	Postponed	$31
IPO date		April 1997	Offering	April 1996
Employees	76	175	30	200

Source: SEC filings, casewriter estimates.

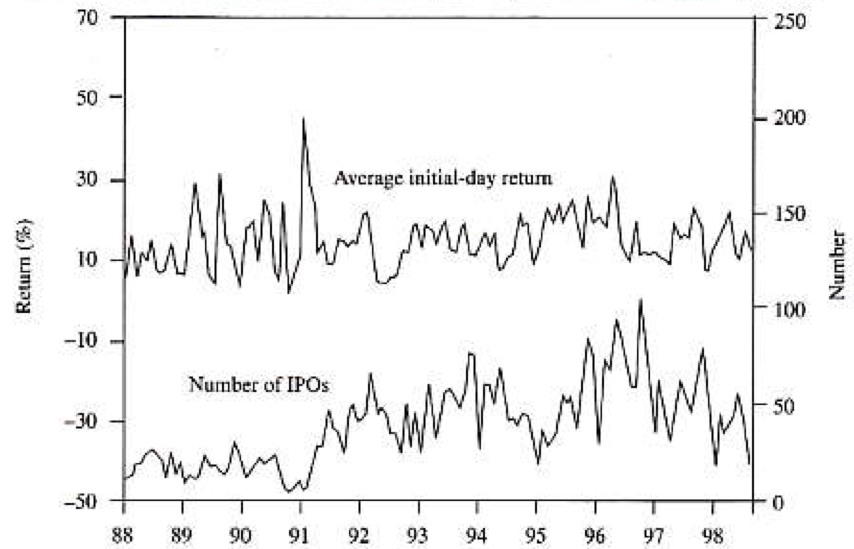
EXHIBIT 8
Participation in Underwriting Syndicate

Underwriter	Number of Shares*
Goldman, Sachs & Co	1,190,000
Donaldson, Lufkin & Jenrette	595,000
BancBoston Robertson Stephens	595,000
BT Alex Brown	595,000
Dain Rauscher Wessels	175,000
E*TRADE Securities	175,000
Volpe Brown Whelan & Company	175,000
Total	3,500,000

* Members of the underwriting syndicate maintain the option to purchase additional shares up to 15 percent of their allocation at the offer price, less the underwriters' discount of 7 percent.

Source: Preliminary Prospectus.

EXHIBIT 9
Average Initial-day Returns for All U.S. IPOs by Month (January 1988 to August 1998)



Source: Jay Ritter, University of Florida.

EXHIBIT 10
Current and Prospective Ownership Structure

Name of Beneficial Owner	Shares Beneficially Owned prior to Offering		Number of Shares Offered	Shares Beneficially Owned after Offering	
	Number	Percent		Number	Percent
Pierre M. Omidyar, Founder and Chairman	15,229,445	42.0%		15,229,445	38.3%
Jeffrey S. Skoll, VP Strategic Planning and Analysis	10,200,000	28.1		10,200,000	25.7
Robert C. Kagle, Benchmark Funds	8,791,836	24.3		8,791,836	22.1
Margaret C. Whitman, President and CEO	2,400,000	6.6		2,400,000	6.0
Scott D. Cook, Director and Founder of Intuit	257,250	*		257,250	*
Howard D. Schultz, Director and Founder of Starbucks	257,250	*		257,250	*
Community Foundation Silicon Valley**	107,250	*	10,725	96,525	*
All directors and executive officers	34,796,925	94.8		34,796,925	86.6
All existing stockholders	36,260,523	100.0		36,249,798	91.2
New investors			3,489,275	3,489,275	8.8

* Represents beneficial ownership of less than 1 percent.

** eBay had established a charitable fund, the eBay Foundation, to make donations to charitable organizations. The fund was capitalized through the company's donation of 107,250 shares of common stock to the Community Foundation Silicon Valley (CFCV). CFCV planned to sell 10,725 shares with the initial offering on behalf of the foundation. The eBay Foundation was expected to become an integral part of the eBay Community, with members helping to allocate charitable donations.

Source: Preliminary Prospectus. Assumes underwriters' over-allotment option to purchase additional shares is not exercised. Also does not include 7,564,500 existing stock options held by executives.

CASE 27

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