

Brick Financial Management LLC

Benjamin B. Taylor

Investment Manager

phone: 973 313 1220

fax: 973 313 1230

www.brickfinancial.com

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Re: January 2005 Client Letter

Dear Clients and Friends,

The Relative Value portfolio held up amid downward pressure from the market in January. However, January proved a tough month for our Choice portfolio.

The Choice portfolio had a suboptimal return of -8.37%, substantially lagging the market's return. The returns for both model portfolios versus relevant stock market indices (including reinvested dividends) as of January 31, 2005 follow³:

	Inception Date	January	YTD 2005	2004	2003	Total Return Since Inception
Relative Value¹	12/6/2002	-0.46%	-0.46%	33.54%	44.09%	87.53%
Russell Midcap ¹		-2.48%	-2.48%	20.22%	40.06%	62.41%
S&P 400 ¹		-2.55%	-2.55%	16.48%	35.62%	47.62%
Choice²	4/4/2003	-8.37%	-8.37%	15.31%	22.31%	29.23%
S&P 500 ²		-2.44%	-2.44%	10.88%	32.87%	43.73%
Russell 1000 ²		-2.52%	-2.52%	11.40%	29.65%	40.79%
Russell 3000		-2.66%	-2.66%	11.95%	31.06%	
Dow 30		-2.42%	-2.42%	5.31%	28.26%	
Nasdaq		-5.18%	-5.18%	9.15%	50.77%	

1. The inception date for the Relative Value model portfolio is 12/6/2002. For comparison purposes the S&P 400 is assumed to have an inception date of 12/1/2002 and the Russell Midcap is assumed to have an inception date of 12/6/2002.
2. The inception date for the Choice model portfolio is 4/4/2003. For comparison purposes the S&P 500 is assumed to have an inception date of 4/1/2003 and the Russell 1000 is assumed to have an inception date of 4/4/2003.
3. Notes: The returns of the Relative Value and Choice portfolios represent models each with an initial investment of \$10,000. They do not represent actual trades of client portfolios although client portfolios are based on the model portfolios. The model portfolios are for informational purposes only. Although Brick Financial believes the information and data in this report were obtained from sources considered reliable and correct, we cannot guarantee their accuracy or completeness. Neither this commentary, nor any opinions expressed herein, should be construed as an offer to sell or a solicitation of an offer to acquire any securities or other investments mentioned herein. Persons associated with this firm may own or have an interest in securities or investments mentioned in this presentation. Their positions may change from time to time and they may buy or sell such securities or investments. Past returns are no guarantee of future performance. Model portfolios and charts are maintained at Foliofn.com. The index data comes from several sources including Standard & Poor's, Russell, Barra and Bloomberg.

eBay's performance

The fall in value in the Choice portfolio was primarily due to the fall in price of our eBay position, which happens to be the largest position in the portfolio. After reporting pro forma earnings of 33¢ per share, a penny below analyst estimates, eBay's stock price fell 30% in January. Some may find this unusual, but I was extremely pleased by the occurrence. Now do not misunderstand, I do not like to lose money. But here is a case where the infamous Mr. Market¹ and his panicked behavior, should work for those whose approach is calm and rational. (In case you're keeping notes, we'd be the calm and rational ones.)

Looking under the hood

With each change in a company's circumstance, whether inventory changes, debt issuances, firings, hirings, new competitors, innovative products, or the occasional earnings miss, we try to assess how the *business* of the company is affected. So last month, when eBay announced its penny per share earnings miss, we set out to see if the business had deteriorated at all. Here is some of what we found:

- Quarter to quarter revenue growth of 44% to \$935.8 million
- Year to year revenue growth of 51% to \$3.27 billion; (if eBay were a retailer they'd be the 14th largest in the world)
- Increasing gross margins to 81% (from 80% in 2003) and reported operating margins increased to 32% (from 29% in 2003)
- A strengthening balance sheet with the near elimination of \$125 million of long term debt
- A cash conversion rate² of just over 4 days
- Free cash flow (before adjustments) of \$992 million in 2004, representing a 94% increase over 2003 free cash; additionally free cash was 30% of 2004 revenues, a marked increase over last year when free cash was 23% of revenues
- The international business made up 60% of all new transactions and 45% of global gross merchandise value (GMV)³
- Spent over \$1 billion in mergers and acquisitions yet still increased cash and equivalents by 17% to about \$2 billion
- Return on equity (ROE) increased to 13.4% in 2004 from 10.4% the previous year

All of eBay's trading categories grew at double digit rates, even eBay Motors, the company's largest trading category. So after looking 'under the hood' of the company, all appeared to be in order. The company seems to be working on all cylinders and according to CEO Meg Whitman the company is gearing up for more of the same in 2005 with heavy investment in China. (Ok, no more car analogies. Or is it car metaphors? Let's move on.) Although the company missed *analyst* estimates for revenue and net

¹ Popularized by Benjamin Graham and later Warren Buffett, it is the idea of thinking of the stock market as a single individual (**Mr. Market**), who has some stock in every company and shows up every day willing to buy and sell any number of shares in any company, many times, without the benefit of rational thought.

² **cash conversion (rate) cycle**: The length of time between the purchase of raw materials and the collection of cash generated in the sale of the final product.

³ **GMV** is the total value of all merchandise sold on eBay's websites during the year.

profit, the company actually *beat* its *own* estimates (guidance) in 2004. The company has a history of underpromising and overdelivering. Way back in 2001, the management of the company projected revenues of \$3.2 billion by 2005. Low and behold, they reached that exact goal in 2004, a year before they were due to make good on their ‘promise’. So, I’ll give management the benefit of the doubt.

eBay’s competitive advantage

After looking at the eBay’s financials we found no evidence of erosion in the business. In fact, the company’s permanence is becoming more evident with each quarter’s results. The three big reasons we like eBay still hold true:

1. eBay has a sustainable competitive advantage: network effects. eBay's person-to-person trading network grows in value and strength with each new user. Sellers attract buyers, more buyers attract more sellers, and the result is a trading network that can not be duplicated. With each new buyer and seller, the incentive to use a competitor’s auction site disappears. Companies like Yahoo, Amazon and Overstock.com are trying, but none are likely to duplicate eBay’s network.
2. The company has the ideal combination of a high-profit, software business and a durable consumer franchise. In Warren Buffett lingo, eBay has a deep and treacherous moat around its enterprise. eBay's software-based trading platform gives it the advantages of high profit margins, no inventory, and unlimited scalability. But eBay is exposed to much lower innovation risk than the typical software company – its main product is not likely to be obsolete in twenty years. High profitability, high scalability, high predictability, and a brand name known around the world make the company’s franchise value hard to beat.

By way of contrast, ‘newly’ public company Google has astonishingly similar financial results to eBay and is growing at a faster rate to boot. But it’s ‘moat’ is less evident in its main business - paid search. Yahoo and Microsoft are big players in this business and pose a consistent competitive threat. Google, though presently the leading search company and making consistent strides toward the being the ‘go-to’ company in their area, does not *yet* have the same competitive advantages as eBay.

3. eBay is a global business with no cultural barriers. The company’s person-to-person commerce platform appeals to all people, as far as the Internet extends. This is the reason eBay is investing \$100 million into the Chinese market.

eBay’s valuation

All that said we still had to assess whether eBay was worth adding to, even after its precipitous price fall. By any traditional measure eBay seems expensive with a price-to-earnings ratio (P/E) at about 65x. Our belief however, is that the P/E is only an indicator of value, not a measure of it. Value is determined by calculating the present value of *future* free cash flow. And as we’ve seen, eBay is beginning to produce goo-gobs of free cash. In eBay’s case, a company that is still in the hyper-growth stage of its business life,

the P/E is especially misleading. Thus, in our estimation eBay is well under its intrinsic value⁴ at its current price in the mid \$70s. So we've added to our position.

Why did eBay's price fall?

Looking at the stellar performance of eBay over the past quarter and year, you might ask why did the price fall so far. Our answer to that question - we have no idea!

The actions of Mr. Market are often unpredictable especially over short periods of time and we have no ability to predict his next move. All we do is try and find good companies, assess what we think the intrinsic value of the company is and then wait for the market to give us an opportunity to buy the stock below that value. Managing investments in this way unfortunately will lead us to months like this one (re: Choice portfolio's -8.37% return). We hope that this short term stumble in the Choice portfolio's performance will lead to long term outperformance of the market. To quote Warren Buffett (Again!? Yes, again.), "we would much rather earn a lumpy 15% over time than a smooth 12%."

Articles of interest

Please look out for our article next week (we will post it on the website and you will receive it by email):

In [Value Investing in Real Estate: A Rebuttal \(part 1 of 4\)](#), we review Dr. Gary Eldred's book and rebut many of his conclusions on the superiority of small property real estate investing vs. stock market investing.

Thank you for your continued confidence in us and our portfolios. As always, we welcome your comments or suggestions. Please don't hesitate to call us at (973) 313-1220 or 1-888-BRICK-10 or email us at info@brickfinancial.com.

Sincerely yours,



Benjamin B. Taylor

⁴ **Intrinsic value:** The perceived actual value of a security, as opposed to its market price or book value.