

What Keeps eBay Up at Night: A Review of Risk Factors as Reported in the Company's Annual Report

by Jeanne Schinto

My husband and I decided to buy some shares of eBay stock about a year ago. We thought it would be, if not a good investment, then at least a learning experience, since we would be able to track trends and developments via the company's annual report. We could have read the report without investing, of course.¹ But we knew that having a tiny stake in "the world's online marketplace" would make the reading material all that more compelling.

Annual reports are marketing tools designed to attract and keep investors, but the section titled "Risk Factors That May Affect Results of Operations and Financial Condition"—a regular feature of these fiscal roundups—balances the picture, and for that reason, I found eBay's a little unsettling.

In the past, I have been an eBay seller, even a Power Seller, listing mostly vintage stereoviews, as well as antique menus and maps, rare books, ephemera, and other collectibles. And although I know eBay has had its ups and downs—after September 11, my little cottage industry bottomed—I still consider a return to on-line selling to be the fallback position of my writing career. Now I have to wonder if that thinking is sound.

There are 37 declarative sentences in bold-faced print in the report's risks section, ranging from the fairly innocuous ("Our operating results may fluctuate.") to the disconcerting ("PayPal has limited experience in managing and accounting accurately for large amounts of customer funds.")² Not that the report exactly leads a reader through a progression from bad to worst. The statements seem to be arranged in random order, perhaps by design. No sense in building alarm; better to keep the tone reassuring.

One thing eBay clearly worries about is its competitors. *M.A.D.*

readers whose businesses have been harmed or forced to change as a result of eBay's market entry ten years ago may enjoy knowing that their continued participation in the trade is cause for concern in San Jose, California, where the company is based. ("Our industry is intensely competitive.") The report lists both on-line and off-line auctioneers as examples. In a section on "Collectibles" it lists these competitors by name: Bonhams & Butterfields, Bowers and Merena, Christie's, Collectiblestoday.com, Collectors Universe, The Franklin Mint, GoCollect, Heritage, Just Glass, Mastronet, Pottery Auction, Replacements.com, Ruby Lane, Shop At Home, Sotheby's, and TIAS.com. It also names, generally, antiques and collectibles dealers, antiques and collectibles fairs, auction houses, flea markets and swap meets, and independent coin and stamp dealers. And while it's true that many have challenged the veritable King Kong and failed—remember the flashily launched but short-lived sothebys.amazon.com?—those named above have been successful at developing niches and followers, and eBay knows it.

Like any business, large or small, eBay is concerned about lack of growth. ("We may not maintain our level of profitability or rates of growth.") It also frets over the problems that growth brings. ("Our failure to manage growth could harm our business...Acquisitions could result in operating difficulties, dilution and other harmful consequences.") And yet grow it does. "Net revenues outside the United States accounted for approximately 42% of our net revenues in 2004," the report states. More recently, on July 21, 2005, the *New York Times* wrote that the company's earnings rose 53% in its second quarter, driven by growth in international business.

In the newspaper story, eBay's overseas expansion was portrayed as good news, but the annual report notes that the international scene exposes eBay to the vicissitudes of the U.S. dollar's value. ("We are exposed to fluctuations in currency exchange rates.")

Other risks include the "differing levels of retail distribution, shipping, and communications infrastructures" in foreign countries. (Think unpaved roads and iffy postal systems.) Also mentioned is the "cultural ambivalence towards, or non-acceptance of, online trading" in some of those locales. China, eBay's largest investment market in Asia, is particularly worrisome to the company and gets a bold-faced statement of its own. ("Our operations in China are subject to risks and uncertainties relating to laws and regulations of the People's Republic of China.") The PRC is, after all, a society where checks and credit cards are not commonly used.

Although eBay was made technically possible by the Internet, its historical growth and phenomenal success is largely attributable to a primordial communication system: word of mouth. People talk. They also now e-mail, often to their entire address book in one click. Legitimate news, rumors, and falsehoods alike are easily disseminated via the very medium that made eBay possible in the first place. Since consumer confidence is key to eBay's success, anything that hurts it hurts eBay. ("The listing or sale by our users of pirated or counterfeit items may harm our business.") But it hurts it all the more so because lack of confidence now can be conveyed so quickly.

Talk is cheap. Lawyers aren't. Repeatedly, the threat of costly lawsuits is mentioned as a risk in this report. ("We are subject to intellectual property and other litigation.") The company also worries about government regulations in its many forms. ("New and existing regulations could harm our business...We are subject to regulations relating to consumer privacy...Government inquiries may lead to charges or penalties.") It stewes about taxes. ("Our business and users may be subject to sale tax and other taxes.") It's troubled by the possibility of earthquakes, floods, and fires. It fears power losses and telecommunication failures. It dreads geopolitical events, especially war and terrorist attacks. But more than anything else perhaps, eBay worries about the attractive target it makes for "technically knowledgeable criminals"—i.e., hackers. ("Our business is subject to online commerce security risks, including security breaches and identity theft.")

I have experienced hacker-related troubles on three separate occasions while engaged in eBay selling. That number doesn't count the night in 1999 when I logged on to the eBay site, and instead of seeing its home page on my monitor, I found an ugly cartoon face and the caption "HACKED!" staring out at me. (Startled, I instantly logged out. When I returned a few minutes later, the face was gone, and eBay was back to normal.)

On two occasions I was the victim of hijackers who took my eBay identity and my 100% good feedback record and used it for their own purposes for a short period of time before being discovered and stopped. On the third occasion, I had a bad experience with eBay Motors. After I successfully sold our '84 VW Vanagon and '79 Mercedes station wagon, my brother-in-law engaged me to sell his replica Shelby Cobra. At the end of the auction, however, the winning bidder at \$32,000 was revealed to be a hacker who in a weekend spree had bought all manner of cars, boats, and other "toys" with no intention of paying for them. (I incurred no penalties and listed the Cobra again, but the momentum was lost. The car was sold through other channels.)

Lance James, chief technology officer of Secure Science Corporation, based near Carlsbad, California, investigated phishing scams related to eBay while writing *Phishing Exposed*. (For those who need a definition, phishing is the act of sending e-mails in an attempt to trick recipients into surrendering private information—e.g., your eBay password.) "eBay gives phishers an easier target than other targets because it's so interactive," James told me in a phone conversation. "Their links are vulnerable to what are called cross-user attacks. They allow what's called misplaced trust. Phishers can use a legitimate link, change it ever so slightly, insert some poisonous code in it, and enable secret attacks." In his book he lists many other vulnerable sites, including 30 banks. "No one robs banks physically anymore," James said.

Computer security professionals like James are known as white-hat hackers. Being one is akin to being a locksmith, said David Hulton, a James colleague who runs a computer-security firm of his own in San Diego. "The locksmith knows everything about how locks work, but there's this code of ethics, where you don't use your knowledge to break into anybody's house." And while neither James nor Hulton could (or would) speak about how easy or difficult it may be or have been for someone to infiltrate eBay and deface its homepage, a third white-hat hacker, Tim Huynh, Hulton's former business partner, readily admitted that he was impressed by the skill level that was required to do it.

Hackers often do what they do solely for bragging rights. A hacker who successfully gains entry into PayPal, whose users routinely provide credit card and other financial information, would potentially reap concrete rewards. eBay acknowledges that PayPal has "special security needs" because of its "highly automated and liquid payment service." In other words, while its ease of use is its beauty, stimulating impulse purchases for the benefit of eBay sellers, that ease is also its potential danger. (Hint from white-hat hacker James: Don't use your eBay password for other password-activated accounts, including PayPal. "All it takes is one bad system," he said.)

For eBay, owning PayPal is apparently a little like having a teenage daughter. The parent company knows it needs to be protective. "Due to PayPal's special security needs, we house our PayPal equipment in physically secure areas and we tightly control physical access to our systems," the report states. But there are other PayPal-related fears scattered through the report that have nothing to do with thievery. Rather, they relate to the novel nature of PayPal and other Internet payment providers. ("Changes to credit card association fees, rules, or practices or its users' credit card usage rates could negatively affect PayPal's business...If PayPal were found to be subject to or in violation of any U.S. laws or regulations governing banking, money transmission, or electronic funds transfers, it could be subject to liability and forced to change its business practices...PayPal's status under banking or financial services laws or other laws in countries outside the U.S. is unclear.")

PayPal is not a bank, but because it provides a financial service, it must provide telephone customer service. (eBay itself does not. For the record, however, the eBay phone number, as listed on page one of the report, is (408) 376-7400.) That mandate is labor intensive. PayPal processed an average of approximately 929,000 transactions *per day* during 2004. (Italics mine.) Even if only a fraction of them had problems, it would have produced a complaint avalanche. PayPal has in the past received "negative publicity with respect to its customer service" the report states, adding that if it continues to receive it, its ability to attract new customers may be damaged, and its revenues could suffer. In addition, it knows negative PayPal experiences could reflect poorly on eBay as a whole.

Some complaints that eBay and PayPal receive are about down time—system failures. ("Our business depends on the development and maintenance of the Internet infrastructure.") eBay's primary Web site has been interrupted for periods of up to 22 hours, the report states. PayPal suffered intermittent unavailability over a five-day period in October 2004. Frequent or persistent interruptions could not only cause users to switch to a competitor, they could also lead to "regulatory inquiries."

The bugs that cause these failures could get worked out, or new technologies could be invented, rendering the old, buggy systems obsolete. That would be good news or bad, depending on who those inventors are. ("We must keep pace with rapid technological change to remain competitive.") The developments could also bring more lawyers' bills. ("We may be unable to protect or enforce our own intellectual property rights adequately.")

In the meantime, eBay must continue to attract new users and hold them. ("We depend on the continued growth of online commerce.") Doing so may be expensive. ("Our growth will depend on our ability to develop our brands, and these efforts may be costly.") Growth may also prove difficult for other reasons. Some people are eBay resistant, and may remain so. They've heard or chosen to hear only the negative stories about eBay. ("Use of our services for illegal purposes could harm our business.")

Holding onto those who do become users remains a continuing challenge for eBay. ("Our business is adversely affected by anything that causes our users to spend less time on their computers, including seasonal factors and national events.") For many, the novelty of eBay quickly wears thin. For others, the real collectors among us, the gaps in collections have been filled in a decade of eBay buying.

Then there are the sellers, like myself, who wax and wane. I don't think my experience is unusual. I became a seller because I had items easily at hand. In a few years' time I cleaned out my house and my relatives' houses. When the old piano rolls were gone, along with the circular slide rules and Beach Boys posters from my husband's youth, I began to buy at auction for resale, but the law of supply and demand is at work against me now. eBay and the other on-line marketplaces it spawned have revealed the true scarcity of certain items—some of them being not scarce at all—and price adjustments have followed.

Sellers unhappy with eBay's price hikes last January are not specifically mentioned in the report, but their outrage was widely reported in the media, along with their vociferous suggestion that eBay be regulated by a governmental or fair-business consortium to prevent what they perceived as price gouging. ("Other companies or governmental agencies may view our behavior as anti-competitive.") Perhaps incidents like that one are included in the disclaimer at the top of the risk factors list, which states: "The risks and uncertainties described below are not the only ones facing us. Other events that we do not currently anticipate or that we currently deem immaterial also may impair our business operations."

Finally, some readers may be wondering if our eBay stock has been a good investment so far. Consider that we bought 100 shares on September 30, 2004, at a price of \$92.15 per share. The stock split on February 17, 2005, so we now own 200 shares. The most recent statement from our stock broker, dated June 30, 2005, shows the stock at \$33.01 per share. At \$66.02 for two shares, that's still down quite a bit from \$92.15. Then, just today, August 3, 2005, as I finished writing this, I checked again and noticed it had risen to \$44.75 per share (\$89.50, doubled). A hopeful sign? Not necessarily, according to one more statement in the risks factors list. ("Our stock price has been and may continue to be extremely volatile.")

For more information about eBay stock, as well as the complete text of all eBay annual reports from 1998 to 2004, see the Web site (investor.ebay.com). Note that the prefix www. is not part of this Web address.

Collectibles Heritage

The company that initially achieved its renown as a conduit for collectibles a decade ago has become a place to buy or sell just about anything today. Hani Durzy, eBay's spokesperson, said that in 2000 "nearly half" of all its U.S. listings were for collectibles; in 2004 only "slightly more than a quarter" were. That doesn't mean listings for collectibles are shrinking. Durzy hastened to say; on the contrary, they are growing slightly. But listings for what he termed "practicals"—everything from teeth whiteners to Toyotas—are increasing at a much greater rate.

Durzy added that eBay takes care never to forget its roots—its collectibles "heritage." That comment provided the right moment to ask if the famous PEZ dispenser story qualifies as truth or legend. "The fact that the wife of [eBay founder] Pierre Omidyar collected PEZ dispensers was certainly a major inspiration for the creation of eBay," he said. "Did he write the code that launched eBay on Labor Day weekend 1995 as a way for his wife to buy and sell PEZ dispensers? No. But it's one of the things he had in mind when he came up with the idea of creating a virtual on-line marketplace."

Note: for the sake of its financial report, eBay doesn't distinguish between antiques and collectibles, and its collectibles category may include new items as well as old ones.