TheStreet.com
Real Experts · Real Time · RealMoney

eBay Vote Shows a Return to Complacency

By Troy Wolverton
Staff Reporter
06/30/2003 01:42 PM EDT

With nary a question from investors about a management-enriching stock plan, **eBay** (Nasdaq) concluded its annual shareholder meeting on Thursday in less than 40 minutes.

Almost as quickly, it seems, once-rabid investors have shelved their suspicions that generous benefits for top executives come at the expense of average shareholders. Last week's vote at eBay suggests that typical investors -- no matter how much they complained after the fact about abuses at Enron, WorldCom, Tyco and others -- still vote with their pocketbooks.

If a company's stock is rising, as eBay's surely is, shareholders aren't likely to rock the boat. Their restraint shows the limits of the corporate reform movement that followed a series of high-profile scandals and a long bear market on Wall Street.

With the full approval of its board, eBay is issuing ever-increasing amounts of stock options, transferring an unusually large portion of the company's market value to corporate insiders. And many of these insiders are cashing in, selling hundreds of millions of dollars worth of stock, even as other investors, especially mutual funds, have bought up the shares.

Barely a year ago, Congress, the **Securities and Exchange Commission** and other regulators were rushing to pass legislative and regulatory reforms to stop the practices that are believed to enrich corporate managers at the expense of shareholders. Responding to investor outrage over corporate excesses, accounting scandals and a declining market, the Sarbanes-Oxley Act and other reforms were intended to improve corporate governance and transparency. Pending reforms could limit companies' use of stock options by requiring such compensation to be counted as a regular business expense.

But last week, eBay shareholders overwhelmingly approved a proposal that would increase the number of shares available under the company's stock plan by more than 50%. Now eBay is cleared to give away an estimated $1 billion worth of options, about $250,000 per employee, this year alone. This year's potential handout is more than four times eBay's net income last year.

"This expanded options plan is exactly the kind of plan that got some of the Enrons and the WorldComs of the world in major trouble," said Scott Harshbarger, former Massachusetts attorney general who now heads up the corporate governance practice of Boston law firm Murphy, Hesse, Toomey & Lehane. "This ought to remind you that it takes very little to deflect the winds of change."

eBay representatives did not return calls seeking comment on the proxy vote.

It's understandable that eBay shareholders would favor the status quo. With a business model tailor-made for the Internet, the company has taken and maintained a dominant share of the online auction market and a significant portion of overall e-commerce. Analysts generally consider it the only clear winner among the companies that started in the dot-com boom.

However, the results have not been as good as the company purports.

Hidden Cost of Options

If it had been required to include the cost of stock options in its reporting, eBay would have been unprofitable in three of the past five years. Although the company would have been profitable last year, taking into account options expense, its earnings would have been slashed from its reported $249.9 million, or 85 cents a share, to $62.9 million, or 21 cents a share, according to eBay's own estimates. Meanwhile, Standard & Poor's calculates that eBay's core earnings, which exclude one-time gains and charges, while including stock-based compensation expenses, were just 17 cents a share last year.

In the meantime, much of the cash generated by the company has come from the issuance of stock options, rather than its actual auction business. A tax benefit related to employees selling stock options accounted for about 20% of eBay's operating cash flow last year. Combining this tax benefit with the direct cash the company raised from employees selling options, eBay's total option benefit last year was $346.8 million, a total greater than its free cash flow.

Still, while eBay's profitability might be a matter of debate, the rise of its share price is not. eBay shares are up more than 50% in the year to date. At more than $100 a share, they are within striking distance of their all-time high of $127.50, set in March 2000, immediately before the market crash.

As the stock has raced up, institutional investors have rushed in. In the first quarter of this year alone, institutional investors bought a net 11.8 million shares, a stake now worth about $1.2 billion.

While institutional investors were buying, eBay insiders were selling. Last year, after cashing in options estimated to be worth more than the company's net income, eBay employees sold off some $129 million worth of stock options in the first quarter of this year. That works out to be about $32,300 per employee just for the quarter.

Meanwhile, in the first five months of this year, the company's directors and executives sold about 1.7 million shares of stock or options, reaping some $116.4 million in gains. CEO Meg Whitman alone realized some $57.3 million through the sale of about 685,000 shares.

For weeks, corporate governance experts warned investors that eBay was dispensing an excessive amount of stock options to executives and employees. Last year, for instance, eBay gave out a net option grant equivalent to about 4% of its outstanding shares. That was a far higher percentage than at such companies as **Cisco** (Nasdaq), **Yahoo!** (Nasdaq), **Amazon** (Nasdaq) or **Siebel** (Nasdaq), which were all known for their big option awards.

Stock options have drawn particular scrutiny in the wake of the accounting scandals. Because the options are valuable only if a company's stock price appreciates, critics have linked their use to short-term strategies and accounting gimmicks used to pump up stocks.

Additionally, because many companies don't recognize the expense of stock options, critics have charged that companies have used them as if they were free, in the process diluting shareholders' equity.

Ignored Warnings

In reaction to these concerns, regulators have forced companies to note every quarter how their earnings would look if they had to expense stock options. And beginning next year, regulators are likely to require companies to include options expenses on their reported bottom lines.

Bowing to investor distaste and the threat of government intervention, companies such as **Coca-Cola** (NYSE) and Amazon already have begun to voluntarily expense stock options. Other companies, such as Yahoo! and **Intel** (Nasdaq), have pledged to limit their use.

In contrast, eBay has neither expensed stock options nor curtailed its distribution of them.

At last week's annual meeting, eBay shareholders approved a plan that for the third year in a row would greatly increase its pool of available options. The plan adds 14 million shares, equivalent to about 4% of the company's outstanding stock, to its option pool. All told, the amount of shares set aside by eBay's stock plans is equivalent to more than 23% of the company's common stock, according to the Investor Responsibility Research Center.

The vote last week wasn't even close. eBay shareholders approved the option plan by a nearly 4-to-1 margin. Of those shares that were actually voted, 78% were in favor of the option plan.

Some big institutional investors such as the California Public Employees' Retirement System, the nation's leading pension fund, the California State Teachers' Retirement System and the Ohio Public Employees Retirement System, voted against eBay's plan. Mutual fund companies **Fidelity** and **Vanguard** also may have voted against the plan, if they followed their proxy voting guidelines, which discourage dilution to the extent caused by eBay's plan. (Starting in August 2004, mutual funds will be required to announce votes from the previous year. But eBay's vote last week came before the period that requires disclosure.)

Such dissenting investors were in the distinct minority at eBay, however.

Some institutional shareholders, such as the New York State Common Retirement Fund, voted in favor of eBay's plan, saying they didn't see any harm in it. Other investors, such as the New Mexico Educational Retirement Board, followed the advice of leading proxy advisor Institutional Shareholder Services. ISS urged investors to vote for eBay's stock plan, saying that the plan came in under a cap the proxy advisory firm sets on stock plan costs.

Glass Lewis, a rival proxy advisor, has criticized ISS' analysis, noting that as a client of ISS, eBay could use the firm's options formula to calculate the maximum number of options it could grant and still come in under ISS' cap. But that objection wasn't enough.

"[Shareholders] don't need to give up that much dilution, but they can shrug their shoulders," said one hedge fund analyst, who asked to remain anonymous. "Why lead a revolt, given the way management has performed? People believe in the status quo, and management probably knows they can take advantage of that."

That's why the vote at eBay may indicate that the latest round of corporate reform may be coming to an end. With the stock market up broadly, investor optimism has returned -- and with it a willingness to disregard warning signs, portfolio managers say.

Complacency Rules Again

"This is an uphill fight," said Harshberger, who recently served as president of Common Cause. Many investors are in denial about what happened, believing that the disasters at Enron and other companies were a function of the market downturn rather than failures of corporate governance, Harshbarger said. Despite all that's been uncovered about corporate excesses, reformers haven't been able to effect any fundamental changes in attitudes or behavior among investors or managers, he said.

On Monday, Prudential analyst Mark Rowen issued a report that reads like something left over from the dot-com boom. Citing enthusiasm about eBay's just-concluded users' conference and the ability of many sellers to make money on eBay, Rowen reiterated his buy rating on eBay and raised his price targets on the company's shares from $108 to $120. Prudential has no banking relationship with eBay.

Meanwhile, Youssef Squali's view is typical of many market analysts today. Squali, who covers eBay for First Albany, said he takes options dilution into account when assessing the company. But the dilution has been far outweighed by the company's financial performance, he said. Given that, shareholders shouldn't worry too much about eBay's stock options practices, he said.

"It's not something we worry about as long as management is doing a good job of implementing their business strategy and creating shareholder value, as long as they deliver results," Squali said.

That view belongs in fantasyland, said Gary Lutin, an investment banker and longtime corporate-governance critic.

Because eBay does not include stock options -- an important component of its compensation expenses -- on its income statement, most measures of the company's performance and valuation, such as its earnings growth or its price-to-earnings ratio, are built on illusion, he said.

"That's not an investment that bears up under rational analysis," Lutin said.

The danger is that if the stock market continues to go up, investors' tolerance for corporate excesses may increase.

"eBay can be a good example of what can happen more broadly," said Lutin, who led the charge in questioning Amazon's use of pro forma accounting methods during the dot-com boom. "A couple of years ago, this kind of thing was going on at hundreds of companies with what may have been a majority of the investment community."

Meanwhile, others say some pending and enacted reforms could improve the system. The requirement that mutual funds disclose how they vote on proxy statement could focus fund managers' attention on governance issues, said Greg Taxin, CEO of Glass Lewis.

"When bad things happen, people may look back to their voting," Taxin said. "If they were asleep at the switch, it won't be looked fondly upon by regulators or the plaintiffs bar -- or for that matter, shareholders."

More transparency may well help, acknowledged the hedge fund analyst. But then again, investors may choose to ignore what they hear. That seems to be what happened at eBay.

"People are willing to live with the problems," said the analyst. "A lot of people [at eBay] are going to be rich beyond their wildest dreams. But you're not going to hear lot of criticism about that, because [investors] want a shot at that."