Outside Audit:
Overstock's Short Sellers May Have Overdone It

Large Purchase by CEO Squeezes Investors Who Bet The Shares Were Set to Fall

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To judge from recent action, shares of Overstock.com Inc. got overshorted.

The online closeout retailer of brand-name consumer goods has seen its stock rally 54% since mid-February, a move that has lifted its market capitalization by $162 million to $462 million. For investors who bet against Overstock by shorting its shares -- and to judge from February's short-interest numbers, there are plenty of them -- the rally has caused a great deal of pain.

A short seller sells borrowed stock and hopes to profit by buying back the stock once its price has fallen, returning it to the lender and pocketing the difference. If the stock rises instead, however, the short seller faces the prospect of having to buy back the stock at a higher price to make good on the loan. If enough short sellers opt to unwind their short positions, their buying in itself can send the shares higher. This can prompt more shorts to throw in the towel, pushing the stock higher still.

It is called a short squeeze, and it is what the bears in Overstock are caught in. In hindsight, perhaps they should have known better.

In its last monthly reading on short interest, taken Feb. 13, the Nasdaq Stock Market said that nearly 4 million shares of Overstock were sold short -- about a quarter of the total shares outstanding. More important, according to Bill Rhodes, chief investment strategist at Rhodes Analytics, company insiders own so many shares that only a little less than half of Overstock's shares are available for trading.

Thus, with short interest representing half of Overstock's publicly available shares, or float, the stock finds itself ranked fifth in a list of Nasdaq "dangerous shorts" that Mr. Rhodes compiled for February.

With its small market capitalization and a small public float, one big buyer was all that was needed to jack Overstock's shares higher and get a short squeeze going. The big buyer came the day after Presidents Day -- a sleepy day in the overall market, which only served to amplify the move.

On Feb. 17, Overstock Chief Executive Patrick Byrne spent $13 million buying 620,000 shares of his companies stock on the open market, lifting his stake in the company to 40.6% from 37.3% and taking a big chunk of Overstock's public float away. Mr. Byrne's share purchases helped push Overstock shares up 16% on the day. As investors got a gander, via Securities & Exchange Commission filings, at the magnitude of Byrne's stock purchase, enthusiasm for Overstock -- and pain for the shorts -- became more intense.

For his part, Mr. Byrne, speaking via satellite phone during a business trip to Kabul, Afghanistan, said his big buy of company stock was at least partly motivated by another position he had: a short on the stock of Amazon.com Inc.

He said he saw a large valuation gap between Overstock, which had revenue of $238.9 million last year, and Amazon.com, which had revenue of $5.26 billion -- about 22 times Overstock's. At the time of his Overstock purchase, Amazon's market capitalization was more than 60 times Overstock's. Mr. Byrne said his large purchase of Overstock was an arbitrage play on this gap, and that he since has covered his Amazon short. An Amazon spokeswoman had no comment on Mr. Byrne's Amazon short sale.

Mr. Byrne said that it was this arbitrage opportunity, along with company rules that gave him only a narrow window in which he could buy shares, that provoked his stock purchase -- not a desire to hurt the shorts. Still, he was aware of the shorts difficult position.

"That's the thing about markets; if people try to manipulate a stock, they have to crawl out on a branch to do it," Mr. Byrne said. "You've got four million [shares] short out there on a branch and if they want to crawl off the branch it's going to cost them."

Mr. Byrne's share purchase didn't change anything fundamentally at Overstock, say the company's critics -- and they believe the fundamentals are weak.

Overstock's revenue boomed last year, increasing 160%. But as the company noted in its annual report, it has changed the way it reports revenue on items it sells on a commission basis for other retailers.

Through the third quarter of 2003, the company booked these sales on a net basis, just recording the commission it made; it now books them on a gross basis, recording the whole sale. This, according to the annual report, means that revenue recorded from the third quarter of 2003 on to "increase significantly."

Overstock's gross profit in 2003 -- its total revenue minus its cost of goods sold -- rose a more modest 39%. Its net loss for the year ballooned to $11.9 million from $4.6 million. For the busy fourth quarter, Overstock swung to a net loss of $3.1 million from the year-earlier net profit of $1.1 million.

Inventories more than doubled in 2003, rising to $29.9 million from $14 million in 2002. A big chunk of that inventory increase came from $5 million in Franck Mueller designer watches -- a sizeable risk, given that these watches have a much higher price point than what Overstock usually sells. Mr. Byrne said the Franck Mueller purchase was "probably too big a buy," but that it would be worked off by year end.

Still, the biggest problem with Overstock shares right now is that if their big rally mostly has been the result of a short squeeze, then the price level they have reached is, in a sense, artificial. If many of the shorts have been wrung out of it, Overstock's stock could face headwinds.

Meantime, in a filing Tuesday, Overstock's largest outside shareholder, Krevlin Advisors, reported that it had sold 152,250 of the 880,039 shares it owned, putting a substantial amount of stock -- nearly 1% of the shares outstanding -- back on the market. Overstock shares hit a record that day and have fallen 19% since.

More stock looks like it is coming. On Feb. 26 -- nine days after Mr. Byrne's purchase -- Overstock filed to sell up 2.5 million of its shares. The offering would increase Overstock's shares outstanding by as much as 15%.

It also would, at the current price, add $70 million to Overstock's coffers -- $24.6 million more than it would have before Mr. Byrne made his big buy.