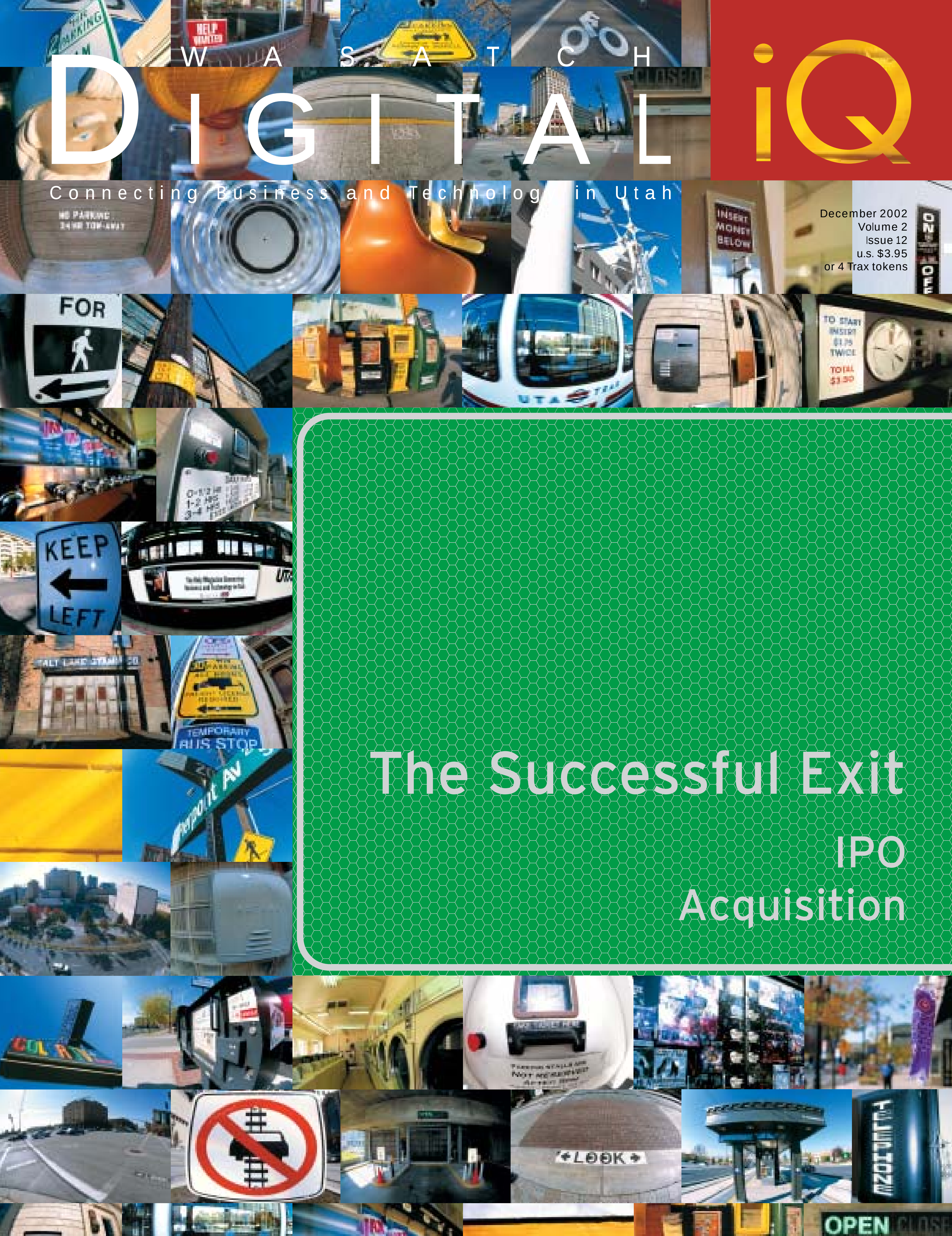

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The Successful Exit

IPO
Acquisition

Overstock.com

An IPO Path Less Taken

By Bill Kerig

Overstock.com CEO, Patrick Byrne

Patrick Byrne didn't take the ordinary path to bring his company, Overstock.com, to the public market. Which isn't a big surprise; Byrne is nothing if not out of the ordinary.

Fortune called him the "Renaissance Man of E-Commerce," then went on to write that Byrne "has done more in his 37 years than most do in a lifetime." Indeed, two years later it seems as though he's done more than most would dare attempt.

He holds a Ph.D in philosophy from Stanford, studied moral philosophy as a Marshall fellow at Cambridge, and speaks five languages (including Mandarin). He translated Lao Tsu's, *Tao Te Ching* in his senior year at Dartmouth, and spent a year teaching at the Bejing Teacher's University in China. He has amassed a personal fortune of more than $100 million, flies his own amphibian airplane to business meetings, earned black belts in hapkido and tae kwon do, has bicycled across the United States three times, survived cancer three times, and has an eidetic (close to photographic) memory. He was also mentored by "a funny man who'd come to the house with a beat-up suitcase and off-the-rack suits." The man turned out to be investing legend Warren Buffett.

Sure, Byrne admits that his father's business success (as CEO of GEICO, Fireman's Fund Insurance, and FundAmerica) and being coached by Buffett gave him what he calls "a lot of tailwind in life," but it's hard to know whether to be awed by or skeptical of such a bio. His employees fall into the former category.

As I wait in Byrne's office, a plain triangle of glass and concrete at the tip of the eastern wing of the Old Mill Corporate Center, his executive assistant, Kirstie Burden and local PR man Alan Seko (Selph and Smith) have more than enough Byrne stories to fill the passing minutes. There's the one about how he took a blind date flying in his plane in Florida and had to crash land into the ocean. There are the ones about how he can memorize a deck of cards and recite them back to you, in order, two hours later. And there are tales that involve variations on a theme of the monastic millionaire. He is, evidently, a man with $100 million who doesn't own a house or a car.

Byrne strides into the office in the middle of one such tale. He apologizes for his tardiness and I tell him that Burden and Seko were doing just fine in his stead.

Byrne moves quickly, but not hurriedly. His hair is sandy and disheveled and he wears a safari shirt of the same type that I later see in the Overstock store for $20. Seko and Burden watch him with open amusement. At Overstock Byrne takes on the role of the favorite professor on campus. It would be easy to liken him to some post-modern Indiana Jones, but instead I tell him I feel like I'm about to interview Buckaroo Banzai. He laughs at his own legend.

"It's a tale full of sound and fury," he says.

"But this doesn't seem like 'a tale told by an idiot,'" I reply.

"Good one," he says.

Then I remember the circumstances of Macbeth's famous "tomorrow and tomorrow and tomorrow" soliloquy: He's gained the throne of Scotland through murder and tyranny and his wife has just commited suicide. Sated by his own self-destruction he delivers his oft-quoted nihilistic summation. It's an arresting allusion from an exceptionally well-read CEO who's just taken his company through the cutthroat process of moving onto the public market, but we push on past it into the only slightly less legendary tale of Patrick Byrne.

In his senior year at Dartmouth he was diagnosed with testicular seminoma. It reduced his 6-foot 5-inch frame from 240 pounds to 164. It was this battle, more than anything else, that he says shaped the way he lives and does business.

"From when I was 22 until 25 I was in the hospital, and even after that I was an invalid for a while," recalled Byrne. "I was 28 or 29 by the time I was in the ballgame again. It put me so far off the beaten track that I'd never be able to get back on it again, even if I had wanted to."

Despite the fact that he had no formal business training (Buffett's impromptu lessons and firsthand experience triggered the development of his business acumen), he bought Centricut Corp., a manufacturing company that made consumables for plasma cutting. After stepping in to settle some management difficulties, Byrne quickly found himself CEO. He dug in and took Centricut from revenues of $4 million to $23 million in three and a half years.

Then in 1998 Buffett brought Byrne in as temporary CEO of Fechheimer Brothers, a Cincinnati uniform manufacturer. During his 18-month tenure Byrne made sweeping changes and added to his legend by agreeing to settle a contentious labor dispute with a fistfight.

"We were in this 500-person union hall in Redding, Penn., and everyone wanted to rip my head off," said Bynre. "After the third person threatened me I said, 'Okay, I'll step outside right now, and if anyone can take me, I'll concede this issue."

There were plenty of takers, but the president of the Union Hall stepped up and stopped it.

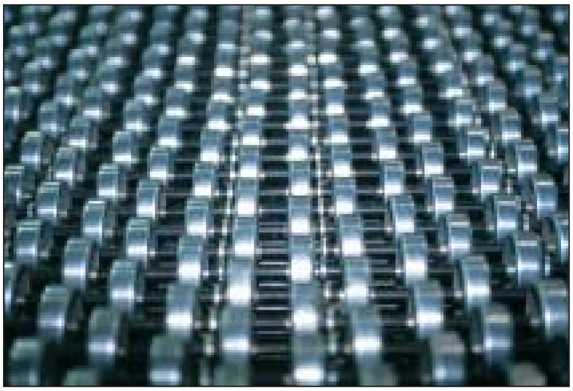
"It was a shame," said Byrne. "Either way it would've saved me a couple months of haggling."

On in Sixty Seconds

"At the time I was getting hundreds of Internet deals across my desk," he said. "And none of them made any sense to me. Most Internet retailers were founded on the concept of stripping distribution costs out of the retail channel, but the retail channel in America is mature; all the fat got squeezed out of it a long time ago."

"These new-economy CEOs were so in love with the technology that the reality that it's more efficient to truck books to the local bookshop and have customers come and buy them than to have individual books Fed-Exed didn't dawn on them. Getting rid of brick-and-mortar businesses didn't make any sense to me."

Then he saw something that did. It was a scheme to use the Internet for liquidation.



"The American retail system is set up to handle vast quantities of identical goods from a small number of suppliers, but it's not set up to handle small lots of disparate products from a highly fragmented supply. The retail system knows how to handle 20,000 TVs but not 20." Yet, on the periphery of the consumer goods landscape there's a little-known group that does know how to deal with small lots.

"I call them the broken-nose crowd," said Byrne as he dropped into a convincing Brooklyn-ese. "They're the badda-bing, badda-boom guys. You know, 'It fell off the truck, and I know a guy who knows a guy...' There are about 400 jobbers who are basically fax jockeys brokering deals to each other."

The weakness of their business model, however, is high information costs.

"The Internet is very good at pulling information costs out of the system," said Byrne. "I realized that all those giblets of retail could be scooped together and put up on the Internet and blown out through a Website. It took me about 60 seconds to decide I wanted to be in on it."

But he didn't just invest; he bought a majority stake in the company and became its CEO.

"Buffett once told me that life throws you pitches and no one is calling balls or strikes. The trick is to wait for the sweetest, fattest pitch and then swing from the heels," he said. "It's the opposite of what business schools teach. They teach diversification — Buffett calls it de-worse-ification — which means you go through life bunting at every third pitch."

So Byrne took his swing at DiscountsDirect. When he took charge of the company there were 26 employees. He fired 22 in the first three months.

"They were either inept or dishonest," he said. "It was one of those situations where I had to go in and s**tcan a bunch of people. It was inevitable, but it wasn't very fun."

Scooters, Not 'Puters

In October 1999, Byrne changed the name to Overstock.com and built a warehouse on the west side of Salt Lake City.

"Amazon spent $30 million on each of their warehouses," he said with incredulity. "We spent $2.5 million, and even that was half a million more than we should've spent. Amazon made so many MBA mistakes.

"Back in 1999 I had venture capitalists tell me I had to spend $10 to $30 million per warehouse," he said. "They were MBAs who'd never run anything, much less a warehouse. If you have a dog's mess of a business, then throwing a bunch of automation at it just makes everything worse. But that's the MBA solution. Most of those guys would've learned a lot more if they'd run 7-Elevens instead of going to business school."

Overstock's warehouse, which could fit eight football fields, is stacked four and five stories high with bins and pallets. Trucks pull up to loading docks and disgorge refrigerator-sized boxes of miscellaneous goods. A team of gloved sorters descends on the piles, labels the sorted stacks with scraps of paper held on by elastic bands, and stores them in plastic bins. When orders come in, these same folks ride little chrome scooters with plastic bins duct taped to the handles and retrieve the goods. Then they scoot them over to the shipping cage where more gloved hands package them into boxes, tape them shut, and send them on their way. The cement floor is striped with hundreds of scooter tracks. There's not a robot or conveyor belt in sight.

"This is high-touch, low-tech," said Byrne. "But our cost of moving and handling an item is about 30 cents."

A Kafka-esque Situation

As Byrne was getting Overstock's systems working, he was also looking for more investments.

"In 1999, I walked all over Silicon Valley asking venture capitalists for money," he says. "They were tripping over themselves to give bags of $20 and $30 million to their buddies right out of Stanford Business School who had a business idea and not even a business plan."

As Byrne's sardonic tone suggests, the money-raising tour didn't go so well.

"Thirty-five VCs turned me down," he said. "They said I needed to get a real Internet CEO. I remember scratching my head and saying, 'What the hell does that mean?' It was a Kafka-esque situation. Since then I've liquidated 18 dead dot coms that were funded by the same MBAs who wouldn't give me the time of day."

A smile sweeps over his face, then he catches himself.

"I shouldn't gloat about that," he says, "but nobody's perfect."

Instead of venture capital, Byrne found a New York bank to lend him $28 million by signing promissory notes on all his personal assets (real estate and his holdings in other companies). Then he, too, made some mistakes.

"When I look back, I'm kind of embarrassed," he says. "We burned through $40 million in two years and probably wasted $15 million of it, but we were up against guys who were burning $200 to $400 million. Now we're here and they're not; so maybe we didn't do so badly."

Byrne took $70,000 gross merchandise sales in August 1999 to $1 million in December 1999. The site had 2.7 million unique visitors during the five-week 1999 Christmas season and placed 21st in traffic among e-commerce sites tracked by Media Metrix. But it was still far from profitable.

After steady growth in 2000, it stalled in 2001. In response, Byrne parted company with the entire marketing department. He claimed they weren't doing their job, which was to create more customers. Yet weren't they branding the fledgling company?

"I don't believe in branding," says Byrne. "Branding is what happens when you give a marketing guy a million dollars and your sales don't go up. You ask him what happened and he says, 'Well, I got you some branding.'"

"Patrick doesn't like people with marketing degrees and graphs and theories," said Burden. "He prefers people who think like the normal public.

"Our first quarter without them, the marketing department came in 30 percent up," he said. Nowadays Overstock spends all its money on targeted, measurable, on-line campaigns.

Yet cost-cutting has its limits and although Overstock was verging on profitability, Byrne decided to look for more money. Instead of going back to the venture capital community, he decided to sell 15 percent of the company on the public market.

"I knew another $30 million in the tank would make us the biggest liquidator in the country," he says. "We could step up on any deal and write a $10 million dollar check to close it."

Put Your Finger on the Block

This is the point where most companies start wondering if they have a board and a management team that the market will accept. Byrne had a board of directors that would fly in anyone's book. It included Gordon Macklin, former chairman of Hambrecht & Quist, and the former chairman and CEO of NASDAQ; Garry Kennedy, former president of Oracle USA; and his father, Jack Byrne. Yet his managment team didn't have the same depth.

"An MBA will tell you to change your team right away," he said. "And we did have some of that pressure. A banker from a very fancy bank tried to get us to take a very fancy CFO from a very well-known company. The banker went through all the guy's credentials and we said: 'We dance with the one who brought us. We'll stick with the guy we've got.'"

Which is a call for another Buffettism.

"Buffett says, 'The sure way to failure is to put too much emphasis on what bankers think of you,'" said Byrne. "Run the company the way you see fit and convince bankers with your results, not your resumes."

So with his team in place, Byrne spread the word that his company was looking for investment bankers. In the argot of the IPO, he initiated the "bake-off."

"Each team of bankers presents itself to your board," said Byrne. "They all sent out two or three suits, and they all said, 'Hey this is fantastic, when the market turns we really want to be your bankers.' So I told them, 'When the market turns anyone will be our banker. 'Who's going to put their finger on the chopping block right now? Whoever steps up is our banker.'"

No one stepped up. Why?

"The Wall Street system is corrupt," he said, "and they weren't sure I'd play their game."

You Can't Believe it's America

The "game" Byrne refers to is something he insists is a massive payola scheme for the big players. He described it this way:

"Suppose you drive a $30,000 Lexus and you hire me to go sell it. Then I sell it to Joe and I come back to you and say, 'Sorry I could only get 10 grand for it.' Then you find out that Joe flipped it the next day for 30 grand. Now, have I done a good job for you? Are you happy with me? No.

"You asked me to get a good price for the car and I got a third of what I could've raised for you. Now, suppose it turns out that Joe's actually my cousin and I went over to Joe's and mowed his lawn and he paid me $10,000 for it. Well, now you'd understand what had really gone on. He'd given me a kickback. That's Wall Street banking.

"When a company hires a bank to sell a chunk of itself and the next day the stock triples, why aren't the companies screaming about the money they left on the table?"

Because they're going over to mow Joe's lawn?

"Exactly. They deliberately under-price the stock and shovel it to their friends at certain pension funds who get the quick ride up then flip it in the first week. It's understood they have to shovel 40 or 50 percent back to the investment banks that let them do it. Every time a large bank took out one of the Internet blockbusters you could check a week or two later and find that those same pension funds were trading shares of some unrelated instrument and paying two dollars a share commission. You and I can get on Ameritrade and pay a penny a share per trade, so why are the experts paying excess commissions?"

Because they're paying their kickback?

"Yes. Putting an IPO onto the market at a deliberately undervalued price creates guaranteed profits, and any time you have that set-up you're going to have kickbacks. It doesn't matter if you're in Manhattan or Paraguay. I have yet to meet anyone in the banking industry who will deny that this is the way it works. To fix Wall Street you have to start by fixing the IPO allocation process."

Playing a New Game

Still, Byrne needed money for his company. Enter Silicon Valley pioneer Bill Hambrecht. In February 1999, W.R. Hambrecht launched something called the OpenIPO system, which was an auction-based method of taking companies public.

"His system is basically a Dutch auction," said Byrne. "The main difference is it lets the demand, not the bankers, set the price."

The way it works is as follows: After the presenting company makes its pitch to pension fund managers, it opens the floor for bidding. Each manager commits to an amount and a price that he or she thinks makes sense. At the end of the bidding process, Hambrecht adds up all the bids and takes the ones that fulfill the offering at the highest price.

"You start from highest priced bid and add the number of shares from each lesser bid until you get to the number of shares that you're offering," said Byrne. "Then you draw a line and that's your price. Everyone above the line is happy because they got it cheaper than they thought it was worth and the people below the line don't mind because they didn't think it was worth as much as it priced for. It's an incredibly fair system.

"All the white-shoe guys on Wall Street hate this because there's no guaranteed profit," said Byrne, "and if there's no flip they can't do their trick with Joe."

Byrne liked Hambrecht's philosophy and his terms. A typical investment banking deal calls for a 7 percent commission for the banking firm and a minimum offering of $50 million. Hambrecht's deal called for a 4 percent commission and no minimum offering. In January of 2001 the board of directors of Overstock agreed on a Hambrecht-led plan to take the company public.

Half a Million in Fees and Fun, Fun, Fun

To get its prospectus drafted, Overstock hired PriceWaterhouse Coopers as its auditing firm and Wilson Sonsini to do its legal work.

"PriceWaterhouse just had to come in and do an audit," said Byrne, "so that was pretty painless. But Wilson Sonsini came in and scrubbed the company up, down, and sideways. They did serious due diligence."

In February 2002 Overstock.com filed its preliminary prospectus with the SEC. At the time, the NASDAQ had fallen from 2200 to 1600. About a month later Overstock started to get its filings back from the SEC.

"This is a pretty ugly-three week period," said Byrne. "You start getting comments back from the SEC examiners. These are hard-working young lawyers, and they have a very legitimate job trying to protect the public from fraud, but man, they are sure picky. We said we are the leading on-line closeout retailer, and they'd require that we write, 'We are an on-line closeout retailer.'"

The IPO team then changes the document to suit the SEC.

"There were 10 to 15 people around a table every day for three months," said Byrne. "We had the bankers and their lawyers, the accountants and their lawyers, and the company executives and our lawyers. They sat in that room projecting the documents on the wall and talking through every sentence, over and over."

"Fortunately my CFO, Jason Lindsey, rode roughshod over the whole process. They must've had 100 serious objections, but he never took no for an answer. He just fixed it and fixed it and kept fixing it."

After three months and $500,000 in legal fees, Overstock got notice that said it was one draft away from being approved. The draft that the SEC approves is called a red herring because it has a red stripe down the side. Though not final, it was good enough to mail out to 10,000 potential investors.

Take That Show on the Road

Byrne and Lindsey hit the road to give face-to-face presentations to the top pension fund managers in America. They gave themselves three weeks to do it.

"The road show is three weeks of ham sandwiches and body odor," he said. "It's meeting after meeting and you're making the same pitch over and over. It's like childbirth: one long blur of pain that I wouldn't do again."

In the first week, they presented to fund managers in Salt Lake, Toronto, Boston, Denver, San Diego, and L.A. Over the course of three weeks, they had 82 meetings. In a standard IPO the meetings end with the company being given its valuation.

"That's when the banker gets you in a room and says, 'I know we told you at the beginning that we'd get $13 a share but the market is a little soft and there are jitters about war in Asia and the sun is rising in the east and we can only get you $7 per share.' Then there are hours of people arguing and shouting at each other and 99 out of a 100 times the company falls for this bait-andswitch and they say yes. What's really going on is the bankers are setting themselves up to mow Joe's lawn."

That didn't happen with Overstock.

"We went into the room at Hambrecht's office at five o'clock on a Wednesday and put all the bids up on the screen and bang, there was the price," he said. "We signed off on it, and at six we went to dinner to celebrate."

The next morning, Overstock went public at $13 per share. On Monday, Byrne received a wire for $29 million dollars.

"Over the years, we had times when people told us there was no way that this thing would work, and I admit there were a few gut checks along the way; but I kept looking at this thing on paper and I kept thinking this should work. Now I'm positive. With $27 million in the bank I can confidently say, 'This company really, really works.'"

Byrne recently added John Fisher, who was formerly with Hambrecht & Quist, and Allison Abraham, former COO of iVillage.com and CEO of LifeMinders.com to the Overstock board. In October, the company reported $15 million in gross merchandise sales for Q3 of 2002, which makes it profitable for the quarter. This year customers will buy $150 million worth of goods from Overstock and the company is currently employing about 200 people.

"We burned $40 million to hit operating profitability," said Byrne. "And we're showing 172 percent growth. Amazon has burned $3 or $4 billion and still shows a $30 million dollar loss."

Byrne has used the success to launch a division of Overstock that he hopes will better little corners of the world. He named it Worldstock.com.

"We realized that the infrastructure we built for liquidation was perfectly suited to market the work of small and disadvantaged artisans throughout the world," said Byrne. "Again, we were looking at very small quantities of highly varied goods from a fragmented supply. That's what we know how to handle."

Launched in September 2001, Worldstock uses the IT infrastructure and marketplace created by Overstock to sell hand-made goods from Third World artisans, Native American producers, and domestic programs with a social mission. It supports more than 2,500 small producers by creating a global market for their products. But the program's director, Marilyn Garson, doesn't think of it as charity.

"Worldstock takes a five percent commission on all the transactions it participates in," she said. "If it's a money loser it can't survive on a long-term basis. Five percent is high enough for Worldstock to fund its own growth without having to reach into Overstock's pocket every month, but it's low enough to present real values to consumers and create a market for goods that can make a real difference."

She cited an example of a group of furniture makers in Peru who had never exported any products before they got hooked up with Worldstock.

"Their network was fragmenting for lack of demand, so we made a small order to see if their pieces would move," she said. "The products moved quickly, and they created a $20,000-a-month business on Worldstock. There are 30 new jobs in Peru now, and they show no sign of slowing down."

"I don't want to sound like a do-gooder," said Byrne. "I'm a rapacious capitalist 23 hours a day, but for one hour a day I'd like to do something good. It's the first time I've ever been able to match up the business side up my life with the philosophy I spent years studying. Worldstock lets me synthesize my fractured interests." iQ


Patrick Byrne hangin' around the warehouse.