eBay's hottest business brings benefits, risks

Alistair Barr, Reuters

"Neither a borrower nor a lender be" is a well-known warning from Shakespeare's "Hamlet."

PayPal, eBay Inc.'s online payment service, heeded that advice for much of its existence, charging fees for processing transactions rather than lending money that may not be repaid.

But Bill Me Later, one of eBay's fastest-growing businesses, is changing that.

BML, as it's known, offers credit to online shoppers, letting them pay typically a few months after purchases.

EBay bought the business for almost $1 billion in the midst of the 2008 financial crisis. Last year, BML accumulated $2.3 billion in loans, up 64 percent from the previous year. Wall Street will be looking for the unit to keep up its hot growth streak when eBay reports second-quarter results on July 18.

BML is a potentially juicy new source of profit growth for eBay. The business also helps other parts of the company - for example, it could make PayPal more profitable by reducing funding costs, analysts say.

"This is one of the most prominent and fastest-growing businesses eBay has, and I think it becomes more prominent going forward," said Gil Luria, an analyst at Wedbush Securities.

"BML is very important because it allows eBay to expand PayPal into a true financial product, as opposed to a purely transactional service," Luria added.

"But PayPal will take on more credit risk as BML expands," Luria warned.

If BML gets big enough and PayPal's growth slows, that could pressure eBay's valuation, he added.

Potent Combo

For now, BML is helping eBay make new waves in the online payment business.

BML was the third most popular alternative online payment service in 2011, ranking behind the leader PayPal and Amazon.com's payment option, according to Javelin Strategy & Research. Consumers used BML 14 percent of the time last year, up from just 1 percent in 2010, Javelin said in a recent research report.

"PayPal and Bill Me Later are a potent payment combo that dominates online

payment alternatives," Kerry Rice, an analyst at Needham & Co, wrote in a recent note to investors. "Growth in popularity of BML should benefit eBay's payments revenue growth."

Scott Devitt, an analyst at Morgan Stanley, expects BML revenue to top half a billion dollars by 2015 - up from less than $200 million last year.

Operating income could be almost $70 million in 2012, and the business will likely get more profitable as it grows, Devitt added in a note to investors earlier this year.

Overseas Cash

One of BML's main benefits is that it gives eBay a lucrative way to use its $7 billion stash of overseas cash. This money has been sitting outside the United States earning paltry interest - and eBay cannot return it to investors in the form of dividends without getting hit with a big tax bill when the money comes back to the United States.

Since September 2010, some of this overseas money has been used to fund BML's loan portfolio - and the standard annual interest rate that BML customers pay is close to 20 percent. As of the first quarter of this year, about half of this portfolio was funded with overseas cash.

"BML is a really productive use of the offshore cash. It earns a lot more than just 1 percent," said John Donahoe, chief executive of eBay, during an interview after the company's first-quarter results in April.

Chief Financial Officer Bob Swan came up with the idea, Donahoe noted.

"He is taking every opportunity to repatriate cash when we can," the CEO added.

Funding Costs

BML also helps reduce PayPal's funding costs, analysts say. Just over half of PayPal transactions are currently funded through debit and credit cards on existing payment networks such as Visa and MasterCard. PayPal has to pay hefty fees in those cases.

But if PayPal customers use BML, PayPal avoids such fees, increasing profit margins.

When BML represents 1 percent of PayPal's total payment volume, PayPal's margins improve by 40 basis points, or 0.4 of a percentage point, Morgan Stanley's Devitt estimated. If BML grows to 10 percent of PayPal volume, margins would likely improve by just over 4 percentage points, he estimated.

Credit Risks

Despite such benefits, BML exposes eBay to new credit risks, Luria and others said.

"It adds another layer of complexity to the company because they are taking balance-sheet risk now," said Sanjay Sakhrani, an analyst at Keefe, Bruyette & Woods.

Lending money, charging interest and waiting for the cash to be repaid is a riskier business than collecting fees for processing payments. That is especially true in the wake of the 2008 financial crisis, when defaults surged and some lenders went broke.

This can be seen in stock-market valuations. Visa, which lends no money, trades at more than 20 times 2012 estimated profit. American Express, which lends money, trades at about 13.5 times 2012 earnings, according to Thomson Reuters data.

Shares of eBay trade at about 17 times 2012 estimated earnings.

Now for the caveat: If BML grows big enough that investors consider eBay to be a lending business, eBay's valuation may suffer.

"If credit risk becomes a meaningful part of eBay's valuation and PayPal growth slows, there could be a risk of their multiple converging with the valuation of other lenders," Luria said.

Regulatory Risks

BML has also attracted new regulatory attention for eBay and PayPal.

"The risk is more on the regulatory side," Sakhrani said.

BML is not a chartered financial institution. It is not licensed to make loans in the United States, so it relies on a bank or another type of licensed lender.

When a consumer buys something with BML credit, the loan is issued by a regulated financial institution. Since September 2010, this has been handled by WebBank, an industrial bank chartered by the state of Utah.

WebBank lends money to the shopper at the point of sale online and makes sure the merchant is paid. BML then buys that loan, or receivable, from WebBank, giving it future interest payments, but also exposing it to a loss if the consumer does not repay the money.

In its latest annual report, eBay warned that limits on WebBank's ability to lend could prevent BML from generating new transactions - or force eBay to get its own bank charter.

That would be "a time-consuming and costly process and would subject us to a number of additional laws and regulations, compliance with which would likely be burdensome," eBay said.

A lawsuit in California district court contends that the WebBank relationship means

BML is acting as the true lender to customers, violating state regulations, including usury laws.

The court dismissed the usury claims in late 2010 and the case was moved to district court in Utah last year. But breach of contract and other claims remain, eBay noted in its annual report this year.

"These allegations are without merit and we intend to defend ourselves vigorously," eBay said. "However, this area of law is uncertain and if the lawsuit is successful, Bill Me Later may be required to change its methods of operations, pay substantial damages and reduce some of its charges and fees, which would likely adversely affect our business."

Bank Valuations

PayPal spokesman Anuj Nayar said PayPal is already a bank in Europe.

"While we have no public plans to change our current status in the U.S., we will consider it if the situation warrants it," he added.

"That's when it would become more impactful to the multiple," KBW's Sakhrani said. "If you own a bank, valuations are often lower."

J.P. Morgan Chase & Co., the largest U.S. bank in terms of assets, trades at 8 times forecast 2012 profit, while Citigroup trades at less than 7 times estimated earnings this year, according to Thomson Reuters data.

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