Nothing But Net

2009 Internet Investment Guide

Global Internet

Imran Khan[AC]
(1-212) 622-6693
imran.t.khan@jpmorgan.com

J.P. Morgan Securities Inc.

Bridget Weishaar
(1-212) 622-5032
bridget.a.weishaar@jpmchase.com

J.P. Morgan Securities Inc.

Lev Polinsky, CFA
(1-212) 622-8343
lev.x.polinsky@jpmchase.com

J.P. Morgan Securities Inc.

Vasily Karasyov[AC]
(1-212) 622-5401
vasily.d.karasyov@jpmorgan.com

J.P. Morgan Securities Inc.

China Internet

Dick Wei[AC]
(852) 2800-8535
dick.x.wei@jpmorgan.com

J.P. Morgan Securities (Asia Pacific) Limited

Russia Internet

Elena Bazhenova[AC]
(7-495) 937-7314
elena.bazhenova@jpmorgan.com

J.P. Morgan Bank International LLC

Korea Internet

Angela Hong[AC]
(82-2) 758-5719
angela.s.hong@jpmorgan.com

J.P. Morgan Securities (Far East) Limited

Please see our separate notes out today changing ratings for Amazon and Dice Holdings. We also have a separate note out today changing estimates and introducing 2009 price targets for the remainder of our Internet coverage. All data and valuation priced as of 30 December 2008.

See page 332 for analyst certification and important disclosures, including non-US analyst disclosures.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

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Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Note: ValueClick is covered by U.S. Advertising & Marketing Services analyst Townsend Buckles. UOL is covered by Latin American Media & Internet analyst Andre Baggio. RealNetworks is covered by Vasily Karasyov.

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Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 1: J.P. Morgan Internet Technology Universe

$ in millions, except per share data

J.P. Morgan Internet Technology Universe

	Ticker	Rating	Price	Mkt Cap	Ent .Val.	EPS			Y/Y EPS Growth			Cal PE			PEG		
			12/30	12/30	12/30	2008E	2009E	2010E	'07/'08E	'08/09E	09/10E	2008E	2009E	2010E	2008E	2009E	2010E
Search/Advertising																	
Google	GOOG	OW	303.11	96,321	83,789	19.23	21.16	25.26	23%	10%	19%	15.8	14.3	12.0	0.5	0.4	0.3
Yahoo*	YHOO	OW	11.97	16,729	7,857	0.63	0.33	0.32	34%	-48%	-3%	18.9	36.3	37.6	0.8	1.5	1.5
Group Average												**17.3**	**25.3**	**24.8**	**0.6**	**0.9**	**0.9**
Leading e-Commerce brands																	
Amazon	AMZN	OW	50.76	22,131	20,627	1.32	1.20	1.54	18%	-9%	28%	38.4	42.4	33.1	1.9	2.1	1.7
Blue Nile	NILE	UW	23.67	360	333	0.94	0.76	0.95	-10%	-19%	25%	25.3	31.2	24.9	1.3	1.6	1.2
Dice	DHX	N	4.11	271	302	0.35	0.28	0.29	34%	-20%	2%	11.7	14.5	14.2	0.6	0.7	0.7
eBay	EBAY	N	13.96	17,994	13,812	1.35	1.39	1.57	NA	3%	13%	10.4	10.1	8.9	0.4	0.4	0.4
Expedia	EXPE	OW	7.80	2,275	2,753	1.30	1.26	1.40	6%	-3%	11%	6.0	6.2	5.6	0.6	0.6	0.6
InterActive Corp	IACI	N	15.77	2,209	842	0.34	1.02	1.10	NA	NA	7%	46.7	15.4	14.4	4.7	1.5	1.4
Mercadolibre	MELI	OW	15.69	695	632	0.36	0.54	0.75	65%	50%	38%	43.4	28.9	21.0	1.4	1.0	0.7
Orbitz Worldwide	OWW	N	3.65	304	304	(3.63)	(0.27)	(0.30)	NA	NA	9%	NM	NM	NM	NM	NM	NM
Priceline.com	PCLN	OW	70.82	3,460	3,005	5.79	5.64	7.40	43%	-3%	31%	12.2	12.6	9.6	0.8	0.8	0.6
Real Networks	RNWK	N	3.55	504	98	(0.05)	0.02	0.02	NA	NA	39%	NM	NM	NM	NM	NM	NM
Shutterfly	SFLY	OW	6.75	169	129	0.30	0.43	0.64	-38%	42%	48%	22.3	15.7	10.6	1.1	0.8	0.5
Group Average												**24.0**	**19.7**	**15.8**	**1.4**	**1.1**	**0.9**
Enabling Platforms																	
Akamai^	AKAM	NR	14.46	2,589	2,344	1.61	1.71	1.87	7%	9%	0%	8.4	7.7	7.7	0.3	0.3	0.3
Omniture	OMTR	OW	9.85	752	773	0.42	0.61	0.77	NM	44%	26%	NM	16.2	12.8	NM	0.5	0.4
Salesforce.com^	CRM	NR	30.96	3,724	3,194	0.32	0.52	0.85	69%	50%	0%	59.6	39.7	39.7	1.5	1.0	1.0
Websense^	WBSN	NR	14.27	646	720	1.36	1.41	1.52	3%	10%	0%	10.2	NA	NA	0.7	NA	NA
Group Average												**26.1**	**21.2**	**20.1**	**0.8**	**0.6**	**0.6**

	EBITDA ($M)			Y/Y EBITDA Growth			Ent. Val/EBITDA			Rev ($M)			Y/Y Revenue Growth		
	2008E	2009E	2010E	'07/'08E	'08/09E	'09/10E	2008E	2009E	2010E	2008E	2009E	2010E	'07/'08E	'08/09E	'09/10E
Search/Advertising															
Google	9,142	10,210	12,278	32%	12%	20%	9.2	8.2	6.8	15,689	17,597	21,762	35%	12%	24%
Yahoo*	1,779	1,847	1,901	-8%	4%	3%	4.4	4.3	4.1	5,422	5,400	5,877	6%	0%	9%
Group Average				**12%**	**8%**	**12%**	**6.8**	**6.2**	**5.5**				**20%**	**6%**	**16%**
Leading e-Commerce brands															
Amazon	1,398	1,419	1,734	28%	2%	22%	14.8	14.5	11.9	18,711	21,694	26,165	26%	16%	21%
Blue Nile	29	26	34	-4%	-10%	30%	11.6	12.9	9.9	310	293	323	-3%	-6%	10%
Dice	67	64	68	7%	-5%	6%	4.5	4.7	4.5	156	147	154	9%	-6%	5%
eBay	3,101	3,202	3,470	7%	3%	8%	4.5	4.3	4.0	8,690	9,572	10,770	13%	10%	13%
Expedia	781	756	883	7%	-3%	17%	3.5	3.6	3.1	2,964	2,919	3,288	11%	-2%	13%
InterActive Corp	176	234	258	25%	33%	10%	4.8	3.6	3.3	1,476	1,548	1,687	11%	5%	9%
Mercadolibre	40	50	69	70%	27%	36%	15.9	12.5	9.2	138	164	219	62%	19%	34%
Orbitz Worldwide	145	136	143	-1%	-6%	5%	2.1	2.2	2.1	895	865	922	6%	-3%	7%
Priceline.com	365	336	439	60%	-8%	30%	8.2	8.9	6.9	1,851	1,837	2,081	33%	-1%	13%
Real Networks	58	71	72	1%	21%	2%	1.7	1.4	1.4	607	595	609	7%	-2%	2%
Shutterfly	33	49	62	1%	49%	26%	3.9	2.6	2.1	209	224	266	12%	8%	19%
Group Average				**18%**	**9%**	**18%**	**6.9**	**6.5**	**5.3**				**17%**	**4%**	**13%**
Enabling Platforms															
Akamai^	364	409	420	12%	12%	0%	5.7	5.1	5.1	784	882	975	25%	13%	11%
Omniture	59	77	98	164%	31%	26%	13.1	10.0	7.9	296	410	511	107%	38%	25%
Salesforce.com^	159	229	218	31%	44%	-5%	24.3	13.9	14.7	1,083	1,350	1,591	46%	25%	18%
Websense^	138	124	130	126%	-10%	5%	5.2	5.8	5.5	346	354	371	51%	2%	5%
Group Average				**83%**	**19%**	**7%**	**12.1**	**8.7**	**8.3**				**57%**	**19%**	**14%**

Source: Company reports and J.P. Morgan estimates for J.P. Morgan rated companies; Factset/First Call estimates used for non-covered companies. EBITDA = Operating Income + D&A +/- extraordinary charges

Data in this table and this report is priced as of December 30, 2008 close

Key Investment Themes

Macroeconomic Conditions Will Likely Dominate Performance

2008 was an extraordinary year, as the fallout from the mortgage business nearly crippled U.S. financial systems. The financial sector underwent a massive restructuring, with Lehman Brothers filing for bankruptcy, the government seizing control of Fannie Mae and Freddie Mac, the government bailing out AIG, Goldman Sachs and Morgan Stanley reorganizing as bank holding companies, and Bear Stearns, Merrill Lynch, Wachovia, and WaMu, among others, ceasing to operate as independent entities. Financial sector instability and mark-to-market losses almost froze the credit market, leading to cash flow problems for both businesses and consumers. A Zillow.com report estimates that American homeowners will collectively lose more than $2 trillion in home value by the end of 2008. Meanwhile, the U.S. auto industry sits on the verge of bankruptcy without a government bailout. All of these events significantly impacted the overall economy, and we are facing the worst recession since the ’70s.

The Internet industry is not immune from this recession. We expect significant revenue growth deceleration (in some cases negative growth) for Internet companies in 2009. However, we continue to see strong long-term fundamentals with worldwide Internet penetration continuing to rise, newspaper and magazine businesses continuing to lose ad spend market share, and consumer dependence on mobile and Internet devices rising. We believe 4Q’08 and 1Q’09 will be the toughest financial quarters for Internet companies, as we expect limited credit availability, weaker foreign exchange currency rates, low consumer confidence, increased unemployment, and cautious corporate expense control to plague companies. However, we expect to see the economy stabilize in 2Q and modestly improve in 2H’09. The J.P. Morgan economic forecast calls for (1.6)% Y/Y Real GDP growth in F’09, with 2H growth accelerating to (1.0)% Y/Y.

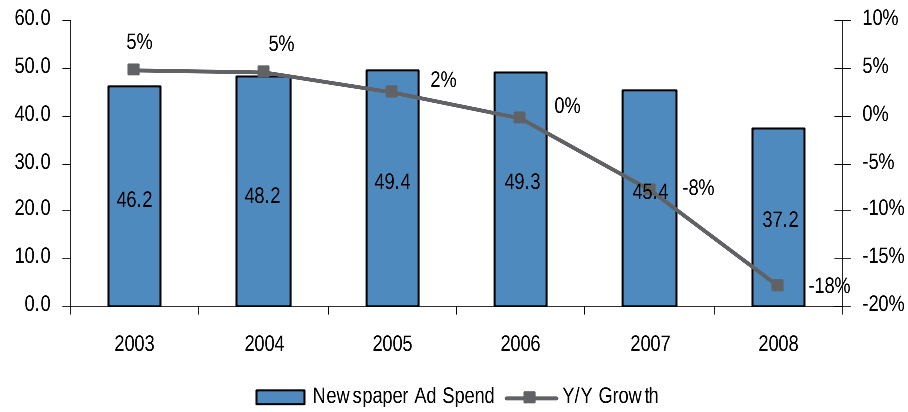
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Newspaper Market Share Losses Should Accelerate

Although we think all advertising mediums will suffer in this economic recession, we expect the environment to have a more adverse impact on newspaper ad revenue.

Figure 2: Newspaper Ad Spend Continues to Decline

$ in billions



Source: NAA.org, J.P. Morgan estimates

In our opinion, newspapers face a significant number of headwinds that will likely contribute to this decline. First, we believe consumer news consumption behavior is changing. Magazines and newspapers usually have a significant lag time between the news occurrence and its publication, as the process of writing, printing, and distribution is complex. Therefore, instead of reading newspapers, consumers are becoming more dependent on the Internet for breaking news.

Secondly, we think newspapers have failed to manage their cost structure. In our view, they try to be the source for all news, and we think this model is unsustainable. We think recent layoffs will hinder newspapers from broadly covering all news and will thus make them even more irrelevant to the hyper-local or vertical-specific blogs and postings on the Internet. Instead, we think newspapers need to allocate more resources to investigative journalism. This would enable newspaper companies to provide exclusive content and more in-depth opinions that could be difficult to glean from citizen journalists.

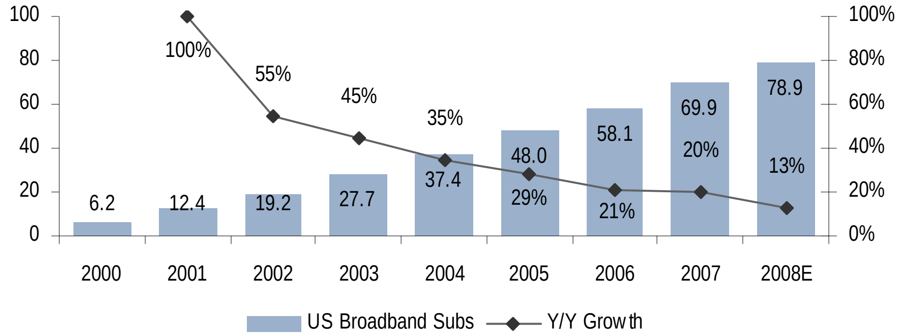
Finally, blogs have existed long enough that they are becoming mainstream, with some bloggers making their living off the blogs. As a result, we think some bloggers and publications have become as trusted a news source and opinion provider as traditional media. Thus, we think that when the economy recovers, newspaper dollar losses will go to the Internet.

Long-term Secular Trends Remain Positive

Although the economic news cycle is largely negative, we believe the longer-term secular trends that are driving the growth of online activity remain quite positive, and we expect these trends to help Internet companies continue growing even as overall economic activity remains sluggish.

In particular, we see growing broadband penetration as a catalyst for more robust commercial Internet activity. As such, we believe the continuing increase in broadband uptake, as well as increases in connection speeds, provide a tailwind for growth at Internet companies.

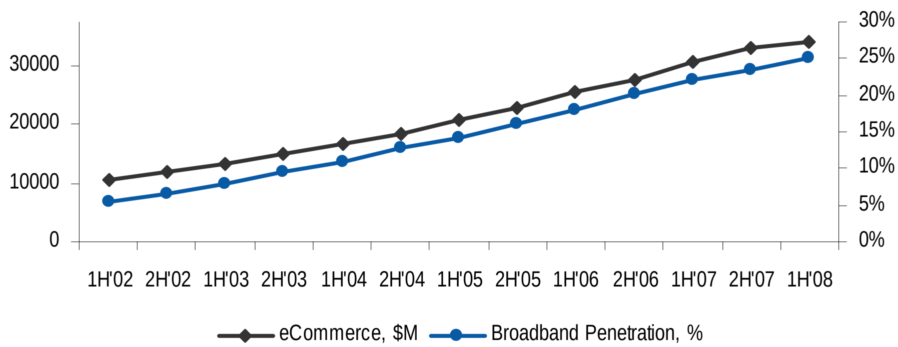
Figure 3: Broadband Penetration in the US Continues to Increase
Broadband subs in millions



Source: OECD, J.P. Morgan estimates

More specifically to eCommerce, we believe the growth of online retail is closely related to increasing broadband penetration; the growth trajectories have closely paralleled each other over the past several years.

Figure 4: eCommerce Growth Parallels Increased Broadband Penetration
Units as indicated



Source: Department of Commerce, OECD, J.P. Morgan estimates
Note: OECD data defines penetration as Broadband subscriptions per 100 people

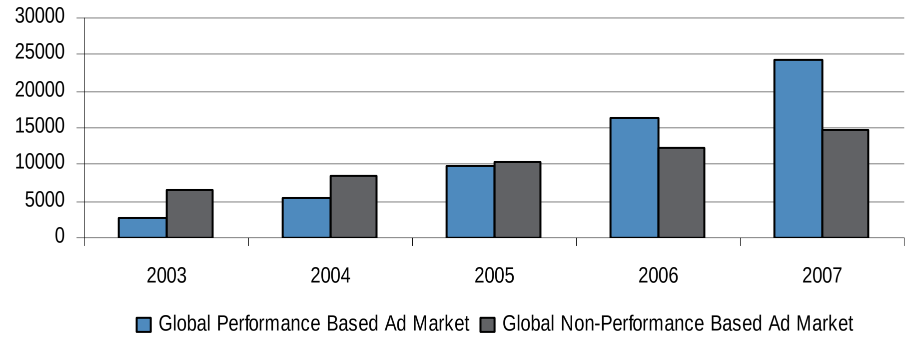
As such, we think continued increases in broadband penetration will be a catalyst for eCommerce continuing to take share away from overall retail sales going forward, providing opportunities for growth even if retail sales as a whole stagnate.

The Internet Is More and More a Performance-driven Model

Over the last five years, performance-based advertising has gained market share over the CPM-based model. This trend is most clearly seen in the U.K., where the online ad market is more mature (~15% of ad dollars are spent online compared to only ~8% in the U.S.). In the U.K. market, we think roughly 85% of total online ad dollars are spent on the performance-based model.

Figure 5: Performance-based Ad Spend Growth Has Outpaced Non-performance Based Ad Growth

$ in millions



Source: J.P. Morgan Estimates, Company Reports, ComScore, Nielsen Net Ratings, IDC, IWS, IAB

We think this trend will not only continue but accelerate in this recessionary environment. We have seen advertisers place higher value on clear ROIs. As such, we believe the shift to performance-based models is only going to accelerate. In 2009, we think the display advertising market will be very tough and faced with declining CPMs. Search will likely still be a winner.

The Online Video Strategy Does Not Appear to Be Working

Although online video usage is a large and rapidly growing medium, no suitable advertising platform has been developed, in our view. Performance-based marketers who are primarily focused on a measurable return on investment have likely been alienated by the cost-per-thousand (CPM) model rather than the CTR models (including cost-per-click or cost-per-action based display). Even brand advertisers have been mostly unattracted to this platform. We think this is due to the inability to guarantee viewership for any specific video the way television does in the upfront model. Often, it is very unpredictable as to which video will be popular. Furthermore, content quality is inconsistent with many video sites plagued with videos of varying quality and copyright violations. As a result, we do not see a highly profitable advertising model solution for online video publishers in the near term.

Brick & Mortar Retail Bankruptcies Could Boost eCommerce

A variety of brick-and-mortar retailers have entered bankruptcy in recent months, and protracted weakness in consumer spending could threaten more operators. We believe such a trend would have two divergent impacts on eCommerce, in the near and longer term.

- **Near term**, we expect B&M bankruptcies and especially store closings to lead to **pricing pressure**, and thus margins pressure on the survivors in both online and offline retail.

- **In the medium to long term**, we think thinning the B&M herd could prove to be a positive for online retailers, which could find it easier to win and maintain wallet share in a marketplace with fewer competitors.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

We think one significant winner is likely to be Amazon, which stands to gain from the decline of players in both its core media arena (given the difficulties for Borders) and in its growing electronics business (Circuit City et al.)

Table 1: Notable Retail Bankruptcies, F'07 – F'08

units as indicated

Company name	Product line(s)	# stores	# stores closing	Bankruptcy filing date
Advantage Rent-A-Car Inc	Car Rental	86	35	8-Dec-08
Boscov's Department Stores	Department Store	50	10	4-Aug-08
Circuit City	Electronics	775	155	10-Nov-08
Friedman's Inc	Jewelry	473	455	4-Apr-08
Goody's	Apparel	355	69	9-Jun-08
KB Toys	Toys	460	120	11-Dec-08
Levitz Furniture	Furniture	76		27-Oct-08
Lillian Vernon	Direct Retailer			20-Feb-08
Linens 'N Things	Housewares	500	120	2-May-08
Mervyn's	Department Store	150	177	29-Jul-08
Movie Gallery	Movie Rental	4600	520	17-Oct-07
Mrs. Fields	Cookies Store	1200		15-Aug-08
Sharper Image	Electronics	96		19-Feb-08
Shoe Pavilion	Shoe	115		16-Jul-08
Steve & Barry's	Apparel	175		9-Jul-08
The Bombay Co.	Furniture	388		15-Oct-07
Value City Furniture	Furniture	100		27-Oct-08
Whitehall Jewelers	Jewelry	375		23-Jun-08
Wickes Furniture	Furniture	43		3-Feb-08

Source: Company reports, press reports, J.P. Morgan estimates

Note: # of stores closing as of the date of announcement of bankruptcy filing; more stores may have closed subsequently.

Net Neutrality Will Become a More Important Public Issue

Recently, the WSJ reported that Google is in discussions with telco and cable companies to establish a potential alliance to ensure high speed delivery services for Google content. Google responded by clarifying that the company remains a very strong proponent of Net Neutrality and is simply looking to upgrade its network through edge caching, which allows for the temporary storage of frequently accessed data on local servers. Edge caching is a common practice used by ISPs and application and content providers in order to improve the end user experience. The WSJ article also reported that Microsoft and Yahoo! have quietly removed themselves from the Net Neutrality alliances.

We think the Net Neutrality debate will move more to the forefront of mainstream discussions in 2009. In our opinion, Net Neutrality is essential for the Internet industry and the openness it offers.

- **Consumers want faster service.** Our checks with industry insiders show that speed is one of the most critical contributors of market share gain or loss. If companies are able to sign exclusive partnerships with telcos and operators, it will likely reduce competition. It will also make it difficult for early stage companies to succeed, thus reducing the innovation that has fueled economic growth and created hundreds of thousands of jobs over the last decade.
- **Large companies already have a speed advantage over smaller companies.** For example, we think Google's data center investments have given it a large advantage over other search engines, which has led to market share gains. As such, creating additional partnerships will likely only hurt small business formation, which is very key to the success of the U.S. economy, in our opinion.

- **There is a risk larger companies will get preferential pricing.** In a sense, preferential pricing is not different than the issue that the oil industry faced in the early 1900s. Using its large and growing volume of oil shipments, Standard Oil negotiated an alliance with the railroads that gave it secret rebates and thereby reduced its effective shipping costs to a level far below the rates charged to its competitors. In 1911, the Supreme Court found Standard Oil Company of New Jersey in violation of the Sherman Antitrust Act because of its excessive restrictions on trade, particularly its practice of eliminating its competitors by buying them out directly or driving them out of business by temporarily slashing prices in a given region.
- **We are sympathetic to the telco and cable companies' overhead.** We recognize that they have to invest heavily in infrastructure to support Internet access. However, we would prefer to see tiered pricing for broadband access over differential treatment of Internet content.

Ultimately, we think it will be extremely negative for the industry as a whole if Internet openness is not protected.

Social Networking Needs a New Monetization Approach

We do not believe social networks can drive sufficient revenue from an ad-based model to grow profits. We do not expect broad adoption of advertising on social networking sites by large advertisers, and we think that, to the extent advertising takes hold on social networking sites, it will more frequently be in the form of performance-driven ads than display.

We believe the near to medium term presents several significant challenges to the ad-based revenue model for social networks that will prevent these sites from reaching their valuation expectations:

- **Ad spending forecast looks weak**. In a weak ad market, with allocations declining to a variety of existing media, we think adding another experimental ad channel could prove difficult.
- **Large advertisers may be put off by environment**. We continue to believe adoption could be particularly slow among traditional advertisers, which may not want to advertise their brand alongside content they can't fully control.
- **Advertising on social networks can be complicated**. Successful advertising on these sites involves more than just an incremental extension of existing campaigns. Some advertisers end up pulling back after an initial lack of success, while others are reluctant to add yet another wrinkle to their marketing approach.

Given the above challenges, we think revenue at social networks will need to come from sources other than display advertising. We see several possibilities, not all of which can apply to each network:

- More **performance-based advertising models**, such as CPA ads or lead generation;

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

- Sales of **virtual goods,** which can further the depth of the user experience on a social site;

- A model that exposes a site to the **classifieds** or **eCommerce** markets, both of which are gaining market share from their offline counterparts; and

- **Paid premium memberships** or selling **a la carte paid features** (such as the ability to post more or higher-quality photos).

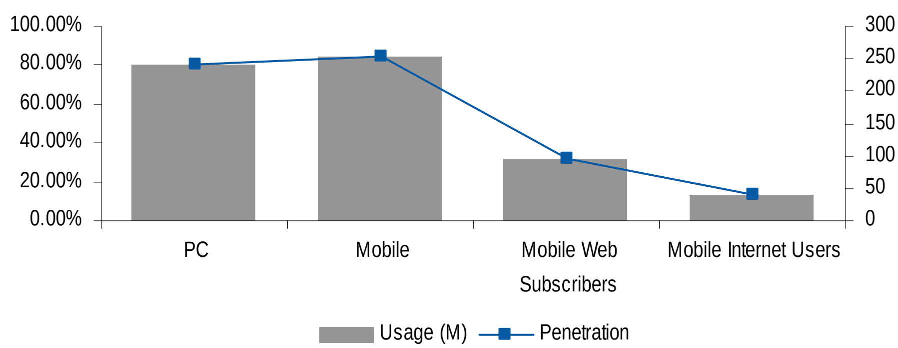
Several sites are already pursuing a variety of these approaches (both LinkedIn and Classmates, e.g., sell premium memberships). We expect much more experimentation as the market continues to mature.

Mobile Is Long-term Interesting, but Near-term Challenging

With 84% of Americans using mobile phones (CTIA), we firmly believe the mobile market is a promising opportunity. Given this level of reach and better mobile Internet technologies and hardware, we think this medium is becoming attractive to advertisers. As a result, Google, Yahoo!, and MSN are strategically focusing on establishing market share in this industry.

Figure 6: Technology Penetration in the US (2008)

as labeled



Source: CIA Government Stats (http://www.cia.gov/cia/publications/factbook/index.html) (Feb 2008); International Telecommunications Union (http://www.itu.int/ITU-D/ict/statistics); CIA Government Stats (http://www.cia.gov/cia/publications/factbook/index.html) (Mar 2008) for Vietnam and Hong Kong mobile phone data, "OECD Broadband Statistics to June 2007", OECD; www.point-topic.com; mybroadband.co.za; Hong Kong and India government statistics; European Travel Commission; www.bezeq.co.il; Santiago Times newspaper; Nielsen Mobile data, JPMorgan Estimates

However, although mobile phone penetration is high, the mobile search market is in the early adoption stage. In 1Q'08, only 15.6% of wireless subscribers were using mobile Internet services, according to Nielsen Mobile data. Even within this small subset of mobile Internet users, usage drastically trails that on PCs. Nielsen Online reports that the PC Internet user visits more than 100 domains per month, whereas mobile Internet users visit 6.4 individual websites per month, on average.

We think mobile Internet adoption will not accelerate until the introduction of better phones and technologies. 3G networks perform up to 6x faster than prior mobile Internet networks (Nielsen), which we think will greatly improve the user experience and make it more comparable to that on a PC. Additionally, new phones such as the iPhone have improved the size and resolution of the screens. However, we note that smart phone technology has not yet become the norm and uptake of mobile Internet likely has a ways to go.

Additionally, we find it unlikely that advertisers will quickly be adopting mobile advertising. In addition to not having the scale and reach of the Internet, mobile advertising is difficult, as it involves dealing with multiple ad networks and mobile service providers and creating ads that can be viewed on small screens. Furthermore, we think advertisers will cut back on experimental models of ad spend in the face of this economic recession.

M&A: Slow in 1H'09, but Could Pick Up in 2H

We believe M&A activity is likely to remain quite slow in the first half of the year as companies and management teams try to understand the scope and length of the economic downturn.

Further, we think sellers are likely to be resistant to sales at reduced valuations, and may prefer stock transactions that expose them to upside in the event of an eventual turnaround.

Additionally, we think companies are likely going to exercise caution in parting with any cash on their balance sheets – whether for acquisitions or for share buybacks.

We have already seen some of this caution manifest itself this year, when the ten largest companies in the Internet/media space (see table below) spent 66% of their TTM Free Cash Flow on share buybacks (compared to the equivalent figure of 126% a year ago.)

The companies remained relatively acquisitive, although two of the largest acquisitions were originally announced in 1H'07 (News Corp.'s $5.1B cash payout for Dow Jones and Google's $3.2B cash payout for DoubleClick). Excluding those deals, cash acquisitions would have been relatively flat Y/Y, at 28% of free cash flow, in line with the equivalent figure a year ago.

For CBS and MSFT, estimates used in this section are from J.P. Morgan analysts Michael Meltz, CFA and John DiFucci, respectively.

Table 2: At Largest Internet and Media Companies, Buybacks Less Popular

$ in millions

	FCF	Cash Acquisitions	Cash Buybacks
GOOG	4,707	72%	0%
YHOO	1,386	60%	22%
AMZN	970	45%	0%
EBAY	2,456	29%	102%
TWX	5,946	52%	14%
DIS	4,767	14%	93%
NWS	2,049	263%	40%
VIA	969	24%	175%
CBS	1,487	137%	3%
MSFT	15,654	19%	103%
Total (3Q'08 TTM)	40,390	49%	66%
Total - year ago (3Q'07 TTM)	38,853	28%	126%

Source: Company reports, J.P. Morgan estimates

We believe some deal activity is likely to recover by the second half of '09, assuming the environment stabilizes somewhat, and management teams feel more comfortable with the outlook.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

To the extent acquirers are willing to part with cash, we expect them to have the resources: large Internet and media companies continue to generate significant cash flows. At the four large-cap Internet companies, we are modeling a significant deceleration in Y/Y FCF growth for F'09: from 36% in F'08E, we expect only 12% Y/Y FCF growth at the four largest Internet firms in our coverage. Including the Media universe, the respective expectations are for 13% growth in '08 and 5% in '09. Including Microsoft, J.P. Morgan estimates call for nearly $40B in FCF generated in the broader Internet space.

Table 3: We Project $10B+ in FCF at Large Internet Companies

$ in millions

	2007	2008E	2009E
GOOG	2,272	4,825	6,086
YHOO	1,352	1,699	1,056
AMZN	1,184	661	1038
EBAY	2,187	2,351	2,472
TWX	4,045	5,135	6,017
DIS*	3,832	3,868	3,588
NWS*	2,802	2,482	1,951
VIA	1,539	1,608	1,705
CBS	1,983	1,324	1,257
MSFT	19,652	15,528	14,831
Total	40,848	39,482	40,002
Y/Y Growth		*-3%*	*1%*
All excluding MSFT	21,196	23,954	25,171
Y/Y Growth		*13%*	*5%*
Large-Cap Internet	6,994	9,537	10,652
Y/Y Growth		*36%*	*12%*

Source: Company reports and J.P. Morgan estimates.

Note: For Disney, News Corp., fiscal year data used rather than calendar year; MSFT CY'08 FCF impacted by a $3.1B cash tax payment.

We continue to see three key factors as motivating factors for M&A activity:

- **Traffic**. Developing high-traffic sites is difficult, and larger companies are often willing to pay for sites that have proven an ability to generate traffic.
- **Technology**. Companies that develop a technology that is difficult or uneconomical to replicate are often targets for acquisitions; such companies may also generate traffic but the technology is often a motivator for the buyer.
- **Transactional**. Companies with a proven track record of revenue and sales generation can make attractive targets, as well; an example of a transactional-focused acquisition is the 2007 purchase of Mezimedia by ValueClick.

We Think an IPO Market Recovery Is More Likely in 2010

The IPO market was virtually nonexistent through most of F'08, with Rackspace as the lone significant deal in the Internet and Internet-related sector; compared to 13 such deals in F'07 (see chart below).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 4: Internet and Related IPOs, F'07 and F'08

Units as indicated

Pricing Date	Issuer Name	Symbol	Amt ($M)	Mkt cap ($M)	% mcap	Offering Price	Price, 12/30	Performance
06/26/07	Comscore Inc	SCOR	101	457	22%	16.50	12.19	-26%
10/02/07	Constant Contact	CTCT	123	433	28%	16.00	12.84	-20%
07/17/07	Dice Holdings Inc	DHX	221	805	27%	13.00	4.11	-68%
03/21/07	Glu Mobile Inc	GLUU	86	327	26%	11.50	0.39	-97%
11/16/07	Internet Brands Inc	INET	48	334	14%	8.00	5.51	-31%
06/07/07	Limelight Networks Inc	LLNW	276	1,192	23%	15.00	2.29	-85%
08/09/07	MercadoLibre Inc	MELI	333	752	44%	18.00	15.69	-13%
07/19/07	Orbitz Worldwide Inc	OWW	510	1,244	41%	15.00	3.65	-76%
07/25/07	Perfect World Co Ltd	PWRD	217	894	24%	16.00	16.68	4%
02/15/07	Salary.com Inc	SLRY	69	158	44%	10.50	2.11	-80%
05/16/07	TechTarget Inc	TTGT	115	508	23%	13.00	3.90	-70%
02/08/07	U.S. Auto Parts Network Inc	PRTS	115	298	39%	10.00	1.37	-86%
03/08/07	Xinhua Finance Media Ltd	XFML	300	883	34%	13.00	0.55	-96%
08/07/08	Rackspace Hosting	RAX	188	1,460	13%	12.50	5.59	-55%

Source: Company reports, FactSet, J.P. Morgan estimates

We think the market climate is unlikely to moderate significantly in the near term in order for the IPO window to reopen soon. Given the lead time involved in most deal activity, we think it is therefore more likely that it will not be until 2010 that the IPO market starts to show signs of a recovery.

Our Top Picks

We think the significant declines in share prices in the stock market create opportunities to buy the best positioned companies at a reasonable valuation. In our coverage universe, we think Google (Price Target $430), Amazon (Price Target $65), Priceline (Price Target $86), Baidu (lead analyst Dick Wei; Price Target $300), and MercadoLibre (Price Target $24) are the best positioned global Internet companies and offer the best risk/reward return for investors. Please see the appropriate company sections for a detailed analysis of our thesis.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Dot.Khan's Top Ten Things to Watch for in 2009

1. Potential search deal likely between Yahoo! and Microsoft
2. Net Neutrality should become an important mainstream issue
3. Performance-driven advertising should continue to rise
4. Challenges in monetizing video advertising should persist
5. Mobile usage should continue its strong growth momentum, but mobile advertising will likely be challenging this year
6. Amazon's low pricing strategy should continue to bring value seeking customers
7. Possible bankruptcies in brick-and-mortar retail should create opportunities for eCommerce companies
8. CPMs should remain under pressure
9. Consolidation activities could potentially resume during 2H'09
10. Promotional activity in the OTA space should increase

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

U.S. Sector Outlooks

2009 Search Advertising Outlook

As macroeconomic weakness bled into the advertising market, we reduced our Search Advertising Market Forecast twice in 2008. We are now further revising our most recently updated estimates (published 11/3/2008). We believe global paid search revenues will reach $33.2B in 2009, down from the $39.6B expected in Nothing but Net 2008. We think the search market growth rate will decelerate given the following factors:

- Overall ad budget weakness;
- Moderation in keyword price inflation; and
- Possible decrease in the volume of highly monetizable searches.

However, in the long term, we think the search market industry will benefit from the changes that result from this recession. We think the rate of adoption of performance-based advertising over more traditional forms, especially newspapers, has recently increased and that these shifts will be sticky. Furthermore, we think Internet users will use search more for comparison shopping and that they will become more comfortable responding to ads.

Global Search Expected to Grow 12% in F'09

On the back of 34% Y/Y growth in F'08, we forecast that global paid search revenues will grow 12% in 2009. From a metrics standpoint, we believe query volumes will grow 24% in F'09, while RPS will decline 9%. We anticipate a climb in search usage as consumers become more price-conscious and engage in comparison shopping; however, we think monetization will be pressured, as decreased ad budgets will likely result in less bidding for keywords. We continue to see personalized search and vertical search as hot topics. Beyond 2008, we expect the global paid search market to grow at a 19% CAGR through 2011.

Table 5: J.P. Morgan's Global Search Advertising Revenue Forecast

units as indicated

Global	2003	2004	2005	2006	2007	2008E	2009E	2010E	2011E	'08-'11E CAGR
Internet Population (M)	710	820	924	1,020	1,113	1,205	1,295	1,380	1,471	6.9%
Queries / Month / User	17	22	29	36	44	53	60	68	74	12.1%
Number of Queries (M)	142,017	220,128	323,827	441,796	585,395	760,474	939,917	1,119,430	1,308,646	19.8%
RPS (per 1,000 searches)	$19.04	$23.42	$28.17	$33.58	$37.58	$38.81	$35.28	$37.00	$37.65	-1.0%
% Coverage	35.3%	38.7%	41.7%	43.9%	44.5%	44.0%	43.8%	43.7%	43.8%	-0.1%
% Clickthrough Rate	16.3%	17.3%	18.8%	20.6%	21.5%	22.0%	22.1%	22.2%	22.8%	1.1%
$ Revenue / Click	$0.33	$0.35	$0.36	$0.37	$0.39	$0.40	$0.36	$0.38	$0.38	-2.0%
Global Search Forecast ($M)	2,704	5,156	9,121	14,835	21,999	29,511	33,158	41,417	49,277	18.6%
Y/Y Growth	123.4%	90.7%	76.9%	62.6%	48.3%	34.1%	12.4%	24.9%	19.0%	

Source: J.P. Morgan estimates, company reports, comScore, Nielsen//NetRatings, IDC, IWS

US Search Expected to Grow 10% in F'09

We are now modeling 10% Y/Y growth in F'09, down significantly from 2008's 23% growth rate. Broken down by metrics, we are modeling US query volume growth of 19% Y/Y in 2009 (a minor deceleration from the 24% we observed in

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

2008), driven by an increase in the number of searches conducted per user and a slight increase of 2.5% in the domestic Internet population.

On the monetization front, we expect the domestic RPS to reach only $75.33 per 1000 searches in 2009, down from $81.59 in 2008 (a 7.7% decline). We expect this RPS decline to be driven by decreases in advertisers' budgets, which should lead to lower keyword bids.

Table 6: J.P. Morgan's US Search Advertising Revenue Forecast

Units as indicated

United States	2006	2007	2008E	2009E	2010E	2011E	08-'11E CAGR
Internet Population (M)	203	211	217	222	227	231	2.2%
Queries / Month / User	47	57	68	79	90	100	13.5%
Number of Queries (M)	114,896	144,080	177,938	211,746	245,626	277,557	16.0%
RPS (per 1,000 searches)	$74.86	$81.65	$81.59	$75.33	$81.84	$84.94	1.3%
% Coverage	62.8%	63.5%	62.0%	62.0%	62.0%	63.2%	0.6%
% Clickthrough Rate	26.2%	27.3%	28.0%	27.0%	27.5%	28.0%	0.0%
$ Revenue / Click	$0.46	$0.47	$0.47	$0.45	$0.48	$0.48	0.7%
US Search Forecast ($M)	8,602	11,764	14,518	15,951	20,102	23,576	17.5%
Y/Y Growth	47.2%	36.8%	23.4%	9.9%	26.0%	17.3%	

Source: J.P. Morgan estimates, Company reports, comScore, Nielsen//NetRatings, IDC, and IWS

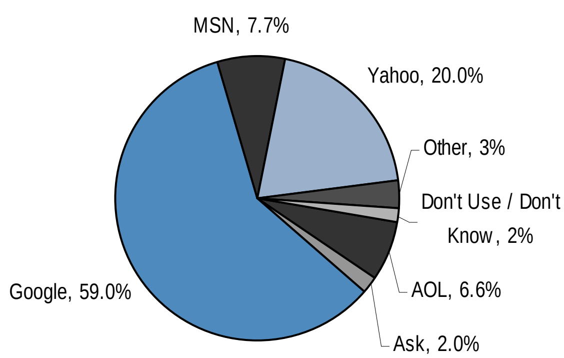
Our Proprietary Research Shows…

Market Share Shifts Are Likely to Continue

In November, the J.P. Morgan Internet Team surveyed 766 US residents to determine Internet usage behavior. Our market research confirmed the trends reported by comScore. Among survey participants, Google was the dominant search engine, with 59.0% of participants listing it as their most frequently used search engine, up from 54.6% in last year's survey. Yahoo! remained second among participants, with 20.0% of participants using it most frequently, down from last year's 21.8% market share among our survey participants. MSN, Ask, and AOL trailed with 7.7%, 6.6%, and 2.0% of participants using them most frequently, respectively.

Figure 7: Most Frequently Used Search Engine

% of participants



Source: J.P. Morgan research

Google Is Most Used by Young, High Income Participants

Although Google dominates all demographic levels, our survey found it had its largest market share among those aged 18-41, and those with incomes over $100K. The majority of Yahoo!, MSN and AOL users in our study fell into the over-42 age group. MSN and AOL had their largest market shares among users with income levels of $50K-$99K, while the market share for Yahoo! was highest among those who earned $49K or less.

Table 7: Market Share by Age and Income Level

% of participants

		Ages		Incomes:		
	All	18-41	42+	$0-$49K	$50-$99K	$100K+
AOL	6.6%	4.8%	8.0%	5.9%	7.3%	6.9%
Ask	2.0%	2.5%	1.7%	2.5%	2.2%	0.0%
Google	59.0%	67.1%	52.2%	55.9%	60.4%	70.1%
MSN	7.7%	5.1%	9.5%	7.4%	7.7%	6.9%
Yahoo	20.0%	18.0%	22.7%	24.1%	17.6%	12.6%
Other	3.1%	2.2%	3.7%	3.2%	2.9%	2.3%
Don't Use/Don't Know	1.5%	0.3%	2.2%	1.0%	1.8%	1.1%

Source: J.P. Morgan research

62% of Respondents Would Be Willing to Consider Switching Search Engines

When asked what improvements by other search engines would cause them to switch from their preferred brand, only 38% of respondents stated that nothing would cause them to switch, as they were satisfied with their current search engine. This was consistent with last year’s survey responses. Again, the most frequently selected improvement was results that better matched the search term, with 45% of respondents stating that this would cause them to switch search engines. Other factors that would cause respondents to consider switching search engines were faster response speeds to searches (28%), the user friendliness of the site (27%), and the ability to preview web content (23%).

Table 8: Factors that Would Cause Search Engine Switching

% of participants

	All	AOL	Ask	Google	MSN	Yahoo	Other
Results that better match my search term	45.0%	42.0%	25.0%	48.6%	33.3%	43.3%	34.8%
Results that include video, web, music and oother forms of information	11.5%	12.0%	18.8%	11.5%	14.0%	9.6%	13.0%
A more uncluttered easy to navigate site	26.5%	20.0%	31.3%	24.9%	36.8%	29.9%	17.4%
The ability to preview web content	22.6%	24.0%	25.0%	21.9%	22.8%	26.1%	8.7%
Faster response speed to searches	27.8%	36.0%	18.8%	25.8%	35.1%	29.3%	26.1%
Other	0.7%	0.0%	0.0%	0.7%	3.5%	0.0%	0.0%
Nothing, happy with current search engine	38.2%	30.0%	31.3%	37.5%	38.6%	41.4%	52.2%

Source: J.P. Morgan research

The Int’l Search Market Is Now Larger than the US Market

We continue to believe the opportunities for paid search in the international marketplace are even more significant than in the US. By our estimate, while the UK is at par or ahead of the US market, the overall international paid search market is still 3+ years behind the US in terms of development.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

The international market is now larger than the domestic market, reaching $15.0B in F'08. As such, we believe the international markets will be a key growth driver in the upcoming year. We think the largest driver will be query growth. While we expect the US to experience query growth of 19% Y/Y, we believe international markets will see a 25% Y/Y lift in the number of queries. However, offsetting these gains are likely declines in foreign currency exchange rates. As such, we see international RPS declines of 8% Y/Y in USD, which should mostly offset the higher query growth.

We are now modeling F'09 paid search revenue growth of 15% Y/Y to $17.2B. Beyond 2008, we expect the international paid search market to grow at a 20% CAGR through 2011.

Table 9: J.P. Morgan's International Search Advertising Revenue Forecast

Units as indicated

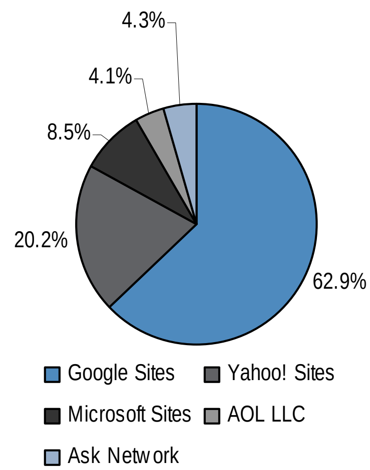
International	2006	2007	2008E	2009E	2010E	2011E	08-'11E CAGR
Internet Population (M)	817	903	988	1,072	1,153	1,239	7.8%
Queries / Month / User	33	41	49	57	63	69	12.2%
Number of Queries (M)	326,900	441,315	582,536	728,170	873,804	1,031,089	21.0%
RPS (per 1,000 searches)	$19.07	$23.19	$25.74	$23.63	$24.39	$24.93	-1.1%
% Coverage	37.2%	38.3%	38.5%	38.5%	38.5%	38.6%	0.1%
% Clickthrough Rate	17.2%	18.4%	19.1%	19.8%	19.8%	20.5%	2.4%
$ Revenue / Click	0.30	0.33	0.35	0.31	0.32	0.32	-3.5%
Int'l Search Forecast ($M)	6,233	10,235	14,993	17,208	21,315	25,701	19.7%
Y/Y Growth	90.1%	64.2%	46.5%	14.8%	23.9%	20.6%	

Source: J.P. Morgan estimates, Company reports, comScore, Nielsen//NetRatings, IDC, IWS

We Think Google Will Continue to Take Market Share

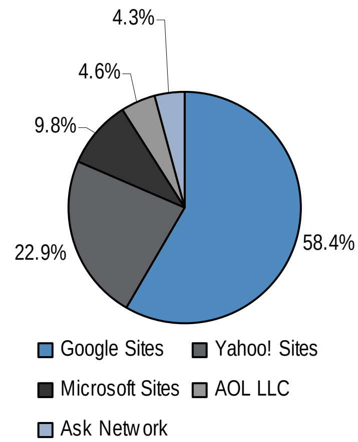
We estimate that Google has a 74% dollar market share currently (including revenues from AOL, Ask, and other affiliates). We believe its share will continue to grow at an accelerated pace in 2009 now that 1) the AOL and Ask TAC rates are locked in under a new multiyear contract, 2) Yahoo! is comping its monetization gains from Project Panama, and 3) we think advertisers are more likely to cut their spend with the other search engines and stick with the leader in a recession. On a query volume basis, we also expect Google to continue to excel in market share gains. 2008 saw Microsoft attempt everything from creating contests to increase search volume to actually paying users to purchase items through Microsoft search ads. Despite this, Google's US core search market share increased to 62.9% in September 2008 from 58.4% in December 2007.

Figure 8: US Core Search Market Share, September 2008



Source: comScore and J.P. Morgan estimates

Figure 9: US Core Search Market Share, December 2007



Source: comScore and J.P. Morgan estimates

Search Advertising Likely to Be Winner in Macroeconomic Aftermath

Although we acknowledge that all types of advertising, including search, will likely be hit by advertising budget reductions in 2009, we think search advertising will be the long-term winner in the reshuffling of budget allocations. We believe the weak macroeconomic environment has forced advertisers to test performance-based search advertising at an accelerated pace. Even after economic strength returns, we think advertisers will stick with their new allocations based on better metrics and higher measurable returns. Specifically, we see newspaper and radio advertisements suffering the most from these budget shifts.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 10: Percent Change in Measured US Ad Spending, 1H'08

MEDIA SECTOR	% CHANGE
TELEVISION MEDIA	-0.40%
· Network TV	-2.40%
· Cable TV	3.10%
· Spot TV	-4.40%
· Syndication - National	10.20%
· Spanish Language TV	-0.10%
MAGAZINE MEDIA	-1.80%
· Consumer Magazines	-1.80%
· B-to-B Magazines	-5.90%
· Local Magazines	-2.80%
· Sunday Magazines	4.80%
· Spanish Language Magazines	7.10%
NEWSPAPER MEDIA	-7.40%
· Local Newspapers	-7.10%
· National Newspapers	-9.50%
· Spanish Language Newspapers	-11.00%
INTERNET (Display Advertising Only)	13.00%
RADIO MEDIA	-6.50%
· Network Radio	3.40%
· National Spot Radio	-7.40%
· Local Radio	-7.50%
OUTDOOR	1.80%
FSIs	2.00%
TOTAL	-1.60%

Source: TNS Media Intelligence and J.P. Morgan estimates

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

2009 Graphical Advertising Outlook

2008 was a difficult year, as display advertising pricing (CPMs) was pressured not only from a non-premium inventory glut but also from lower ad budgets spent on premium slots. Unfortunately, we see these trends continuing into 2009. Specifically, we think 2009 growth will be impacted by:

- Lower ad budgets given macroeconomic weakness and shifts towards performance-based advertising;
- Continued pressure on non-premium inventory pricing as social networks and other non-traditional sites struggle to find a monetization model that works;
- Difficult comps due to the 2008 Olympics and political campaigns; and
- Continued trouble finding an appropriate way to monetize video inventory without alienating viewers.

Having said this, we see pockets of strength for publishers who provide better targeting capabilities and who effectively use ad networks and ad exchanges to better monetize non-premium inventory.

We Expect the Global Graphical Advertising Market to Grow 6.7% in F'09

We now think 2009 will be a weak year for graphical advertising publishers, as we expect the graphical ad sector to under-perform performance-based advertising in a down economy. On the back of estimated 14% Y/Y growth in 2008, we believe global graphical advertising revenues will grow 7% in F'09. From a metrics standpoint, we believe page views will grow 10% Y/Y while RPMs decline ~3% Y/Y. We expect the global Internet population growth to remain strong at 7% Y/Y, reaching 1.3B in 2009. We expect the global graphical advertising market to grow at an 11% CAGR through 2011.

Table 11: J.P. Morgan's Global Graphical Advertising Revenue Forecast

Units as indicated

Global	2002	2003	2004	2005	2006	2007	2008E	2009E	2010E	2011E	08-'11E CAGR
Internet Population (M)	593	710	820	924	1,020	1,113	1,205	1,295	1,380	1,471	6.9%
Pages Viewed / User / Day	33	34	36	37	38	39	40	41	43	44	2.7%
Total Pages Viewed (B)	7,209	8,897	10,724	12,607	14,275	15,986	17,793	19,590	21,510	23,539	9.8%
RPM (per 1,000 pages)	$1.02	$0.75	$0.81	$0.87	$0.97	$1.07	$1.09	$1.06	$1.09	$1.13	1.2%
Global Graphical Forecast ($M)	7,354	6,674	8,642	10,984	13,829	17,068	19,368	20,670	23,494	26,536	11.1%
Y/Y Growth	-19.6%	-9.2%	29.5%	27.1%	25.9%	23.4%	13.5%	6.7%	13.7%	12.9%	

Source: J.P. Morgan estimates, Company reports, comScore, Nielsen//NetRatings, IDC, IWS, and IAB

US Growth Likely to Mirror the Global Market at 6.3% in F'09

We expect the US graphical advertising market to grow 6.3% in 2009, well below our year-ago estimate of 16.6%. We think that during 1H'09, US graphical advertising revenue will be flat to down slightly Y/Y. However, as the economy stabilizes, we expect 2H'09 display advertising to improve, resulting in our F'09 estimate of 6.3% Y/Y growth. We believe page view growth will slow to 6.5% in

2009 (down from 7.2% in 2008) as social networking sites and blogs begin to mature and reach saturated penetration levels. By our estimates, page view growth will be driven by an increase of 2.5% in Internet users and an increase of 3.9% in usage per Internet user. We are modeling RPMs to be roughly flat in 2009, driven by a 2% decline in sell-through, offset by a 2% increase in CPMs. We expect the US graphical advertising market to grow at a 9.4% CAGR from 2008 through 2011.

Table 12: J.P. Morgan's US Graphical Advertising Revenue Forecast

Units as indicated

United States	2006	2007	2008E	2009E	2010E	2011E	08-'11E CAGR
Internet Population (M)	203	211	217	222	227	231	2.2%
Pages Viewed / User / Day	45	47	49	51	52	54	3.4%
Total Pages Viewed (B)	3,341	3,608	3,868	4,120	4,338	4,563	5.7%
Impressions / Page	0.50	0.60	0.62	0.61	0.62	0.63	0.5%
Total Impressions (B)	1,671	2,165	2,398	2,492	2,689	2,875	6.2%
CPM (per 1,000 impressions)	$3.50	$3.31	$3.32	$3.39	$3.50	$3.62	3.0%
RPM (per 1,000 pages)	$1.75	$1.99	$2.06	$2.05	$2.17	$2.28	3.5%
US Graphical Forecast ($M)	5,847	7,166	7,950	8,449	9,413	10,407	9.4%
Y/Y Growth	23.0%	22.6%	10.9%	6.3%	11.4%	10.6%	

Source: J.P. Morgan estimates, Company reports, comScore, Nielsen//NetRatings, IDC, IWS, and IAB

International Growth Less of a Driver in 2009

International markets will likely suffer not only from lower ad spend due to the macroeconomy but also from lower foreign currency exchange rates. We think this will offset increased broadband penetration and increased ad spend moving online. We think page view growth will hold up and reach 11.1% Y/Y in 2009, down only slightly from 12.5% in 2008. However, we are modeling RPM declines of 3.7% Y/Y. We expect the international graphical advertising market to grow at a 12.2% CAGR from 2008 through 2011.

Table 13: J.P. Morgan's International Graphical Advertising Revenue Forecast

Units as indicated

International	2006E	2007E	2008E	2009E	2010E	2011E	08-'11E CAGR
Internet Population (M)	817	903	988	1,072	1,153	1,239	7.8%
Pages Viewed / User / Day	37	38	39	40	41	42	2.8%
Total Pages Viewed (B)	10,934	12,378	13,925	15,470	17,172	18,975	10.9%
RPM (per 1,000 pages)	$0.73	$0.80	$0.82	$0.79	$0.82	$0.85	1.2%
Int'l Graphical Forecast ($M)	7,982	9,902	11,418	12,222	14,081	16,129	12.2%
Y/Y Growth	28.1%	24.1%	15.3%	7.0%	15.2%	14.5%	

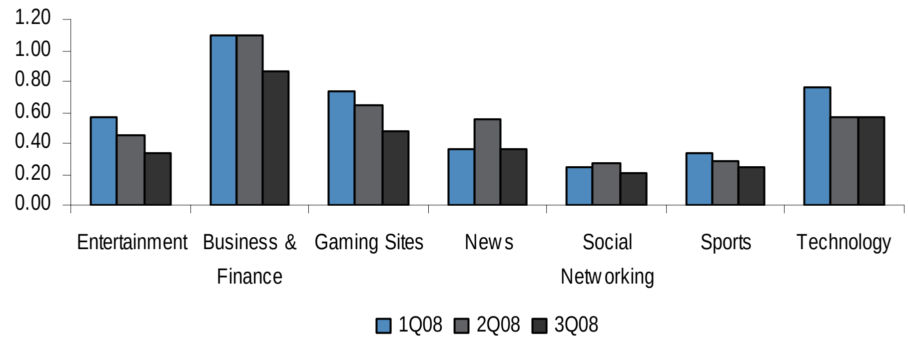
Source: J.P. Morgan estimates, Company reports, comScore, Nielsen//NetRatings, IDC, IWS, and IAB

Ad Prices Are Trending Down

We have seen ad prices fall across almost all categories, at all sizes of publishers, and across all verticals. We think social networks are still the weakest in terms of CPMs, with PubMatic estimating the average CPM at $0.21 at the end of 3Q'08. As we have watched MySpace and Facebook struggle to find a better means of monetization, we think this will be a long process before an efficient marketing plan is established. Thus, we expect the social network vertical to continue to underperform.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

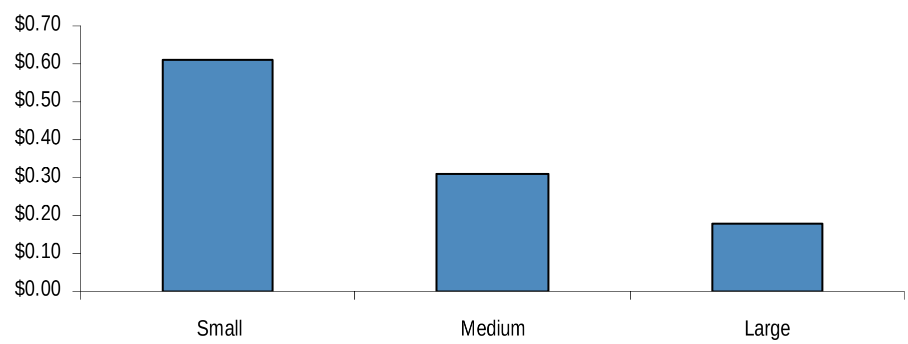
Figure 10: Website Ad Price Averages by Vertical
units in dollars



Source: PubMatic AdPrice Index Quarterly Report Q3 2008

We also think it will take time for generalized non-targeted inventory to catch up to the monetization of targeted premium inventory. PubMatic estimates that the value of ad inventory for small-sized websites (less than 1M page views per month) was more than triple the value of large-sized websites (over 100M page views per month) in 3Q'08, with values of 61 cents and 18 cents, respectively.

Figure 11: Website Ad Price Averages by Publisher Size
units in dollars



Source: PubMatic AdPrice Index Quarterly Report Q3 2008

Aggregators of Traffic May Outperform

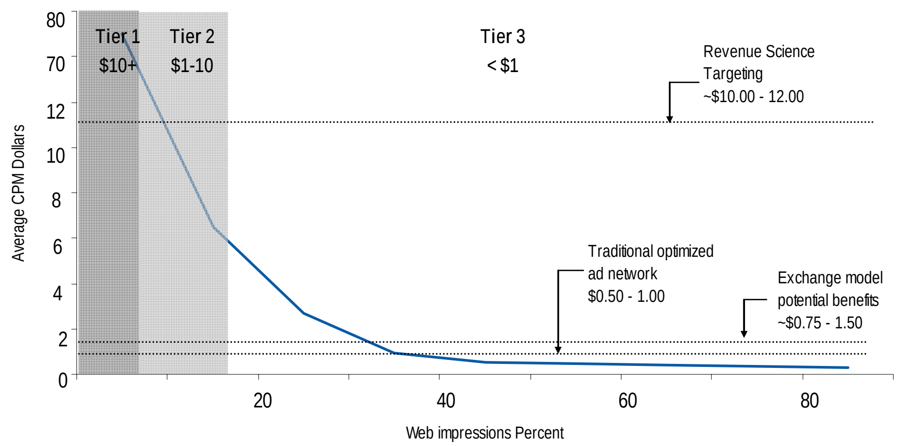
While portals were once dominant, Yahoo!, AOL, and Microsoft only accounted for ~27% of minutes spent online in August 2008, down from 42% in August 2002. Meanwhile online gaming and social networking websites have experienced double-digit Y/Y growth rates in minutes spent online. This fragmented audience not only makes it more difficult for advertisers to reach their target audience through only a few publishers, but it also makes it difficult for publishers to attract advertisers given their limited scale. We believe companies that can aggregate traffic through the development of ad networks or partnerships will be more successful in driving

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

growth in 2009. Additionally, we believe demand for performance-based display advertising will grow in this difficult environment.

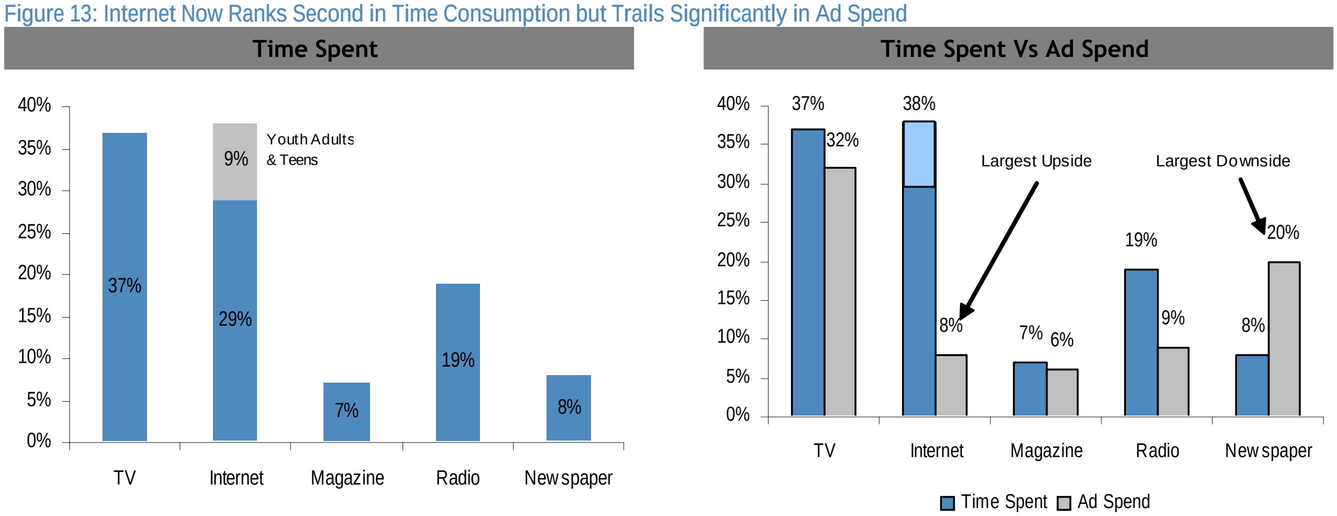
While increasing user reach is half the battle, we recognize that many page views are meaningless to advertisers unless user information can be gathered and ads are targeted. In order to most effectively target the ads, publishers need to have access to user behavior on multiple sites to collect data and to repeatedly show ads to the same user. We believe companies with targeting capabilities will be able to command a premium CPM. Revenue Science estimates that there is a 15x CPM premium for behaviorally targeted ads.

Figure 12: Behavioral Targeting Effects on CPM



Source: Revenue Science Presentation

Figure 13: Internet Now Ranks Second in Time Consumption but Trails Significantly in Ad Spend



Source: After TV: Nielsen Media Research Custom Survey 2008 and Samir Arora Glam Media Presentation

Ad Networks on the Rise

What Are Ad Networks?

We see an ad network defined by the following:

- transacts, serves, tracks and reports the distribution of advertiser ads to publisher pages;
- enables marketers to advertise on multiple publisher sites through one central location;
- publishers enjoy the benefit of advertising revenue without investing in a sales force or as a source to sell remnant inventory;
- varies in the ability to target a specific audience and in methods of payment (CPM, CPC, and CPA); and
- revenues are determined by revenue share agreements.

Lead generation is more vertical specific and performance oriented than ad networks.

The definition of ad networks is fuzzy, with lead generation sometimes included. However, we are differentiating between the ad network and lead generation space. We are defining lead generation as much more targeted and deep into specific verticals. As a result, we believe this commands much higher CPMs. While we believe this is also an interesting ad model, we believe it deserves a more detailed consideration and will thus exclude it from this discussion.

A Significant Market Opportunity

We estimate that the global graphical advertising market as a whole will grow at an 11% CAGR through 2011. The sector should benefit from 1) increased online viewership as more people turn to the Internet as a source of content and 2) increased RPMs as audience targeting improves.

Additionally, increasing keyword prices and the ability of networks to provide response advertising in addition to branding campaigns will likely drive more marketers to ad networks. On the publisher side, as the long tail of information is increasing, more publishers are looking to monetize their content. We estimate that the top 20 ad networks will earn approximately $7B+ in revenue in 2008 (~24% of the display ad market) and are growing much faster than the general graphical advertising industry.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 14: Ad Networks by Page Views

millions

	August Page Views (M)	August Y/Y Growth
Yahoo! Network	210,372	NA
Google Ad Network	201,429	-17.5%
Platform-A	137,660	NA
ValueClick Networks	31,504	38.6%
AdBrite	18,141	-36.4%
Traffic Marketplace	18,513	-27.8%
CPX Interactive	18,730	91.8%
24/7 Real Media	13,445	-0.7%
Tribal Fusion	15,170	40.1%
Kontera	15,248	704.7%
Casale Media - MediaNet	10,720	12.0%
DRIVEpm	8,951	199.1%
Specific Media	9,514	76.0%
Revenue Science	6,408	NA
Pulse 360	5,390	NA
interCLICK	6,165	209.5%
ADSDAQ by ContextWeb	5,252	3.7%
Collective Media	4,439	NA
Burst Media	5,143	37.3%
Vibrant Media	4,412	-13.4%

Source: ComScore and J.P.Morgan estimates

The Future of Ad Networks

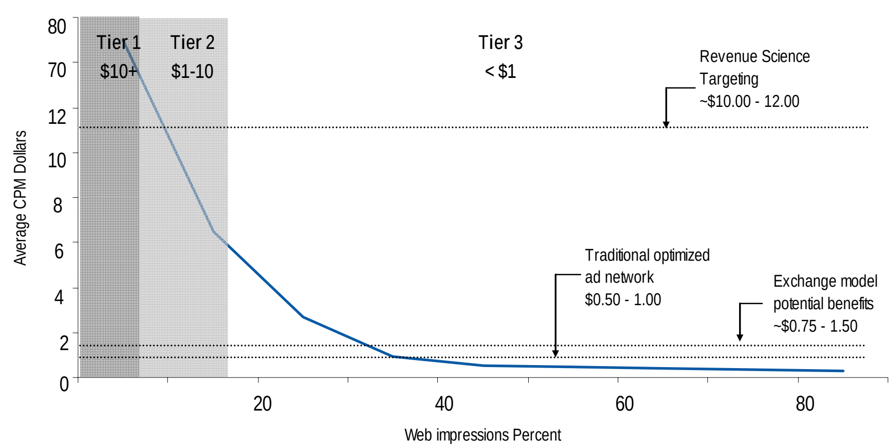
The ad network space is becoming increasingly competitive as new ventures are launched and as Google, Yahoo!, AOL, and Microsoft enter the space through acquisitions. We believe differentiation will be key to success. Following are capabilities that we see important to market leadership.

Behavioral Targeting

Behavioral targeting should increase CPMs and drive volume.

We believe advertisers used to pay for audiences on websites but will now start to pay for specific users. Marketers appear to value targeted advertising, as evidenced by Google's well targeted search ads generating RPQs of more than double Yahoo!'s. We expect this same principal will apply to graphical advertising and note that Revenue Science estimates a 15x CPM premium for behaviorally targeted ads.

Figure 14: Behavioral Targeting Effects on CPM



Source: Revenue Science Presentation

We believe the development of a non-intrusive video ad delivery system with contextual advertising capabilities will be valued by the ad network space.

Video Capabilities

Google's $1.65B acquisition of video sharing site YouTube gives insight into the value placed on video property. Traditional media companies have also moved onto the Internet by offering TV episodes online and with Internet designed webisodes. However, monetization of Internet videos has trailed its growth. Various companies have experimented with pre-roll, post-roll and in-video ads. Google has experimented with in-video ads on select YouTube videos in which the ad is overlaid on the bottom 20% of the video soon after it is launched. If the user does not click on it, it simply disappears. Additionally, Google has experimented with an e-commerce platform with the launch of a new service that allows viewers to buy music and games from selected partners featured on YouTube videos. With this service, YouTube viewers who want to buy, for example, a song featured in a music video can click on an icon that takes them to selected e-commerce partners, including Amazon.com and Apple's iTunes store. YouTube gets a share of the revenues from every transaction. We think this performance-based model is a good move for Google to help monetize YouTube.

Success in mobile ads will be dependent on targeting, non-intrusiveness, and ability to load on slow-loading platforms.

Mobile Ads

An even younger industry is mobile phone advertising. The development of the iPhone and the advent of Google's Project Android have placed a growing interest in the field.

We see payment structures shifting with objectives to include CPA models in addition to CPMs.

Performance-based Advertising

While many graphical ads were originally used for branding purposes with less of a focus on conversion, the developments in behavioral and contextual advertising have put more pressure on ad networks to deliver conversions. Additionally, an abundance of inventory is making advertisers more focused on conversions. We expect this model to gain market share.

We believe marketers will turn to targeted email distribution given its high usage and push vs. pull ad model.

Email Marketing

Ad networks have entered the realm of email marketing by placing advertisements in emails sent by other companies to their customers. As in the other categories, ROI is enhanced by careful pairing of the ad with a related company or email content. Email marketing is a preferred method of advertising with its easy trackability and ROI calculation. Furthermore, unlike other advertisements, email is pushed to targeted customers rather than assuming that specific websites will pull these customers to the ad.

Ultimately, we believe successful ad networks are going to need to be able to provide a diversity of advertising platforms to its marketers with clear targeting capabilities.

Dominant Portals' Role in the Growing Ad Network Market

In 2007 we saw large portals make significant investments and acquisitions to strengthen their foothold in the ad network space. We believe large portals are naturally well positioned, as it is easier for both advertisers and publishers to fulfill all of their needs on fewer platforms, while a consolidated network yields greater leverage of technology and advertiser/publisher relationships. Looking forward, we think the market cannot sustain such a large number of ad networks. We expect larger players to gain share, and we think there may be further consolidation among private companies. We also see some companies likely closing their business.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

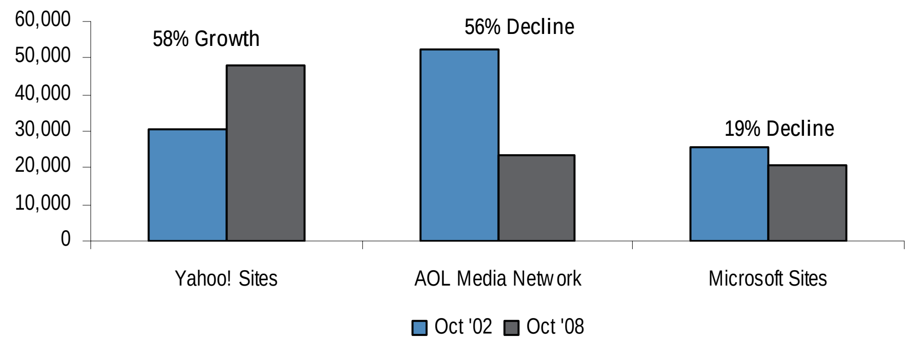
Minutes spent on portals has declined over the last 6 years, despite 30% growth in total minutes spent on the Internet.

Creating Ad Networks Could Be the Answer to an Ever-Fragmenting Audience

While portals were once the dominant source of news and information, Yahoo!, AOL and Microsoft only accounted for ~27% of total minutes spent online in October 2008 vs. 42% in 2002. We believe portals will become more significant players in ad networks as they turn to networks to grow their user reach, leverage user information through behavioral targeting, and leverage their existing capabilities to sell, place, and analyze display ads.

Figure 15: Total Minutes Spent on Portals in October 2002 and 2008

millions



Source: ComScore data and J.P. Morgan estimates

If a company had demographic, search query and web navigation data on a user, we believe it could provide advertising that is more user relevant and could tailor the ads to the user as he/she navigates the web.

User Information Should Lead to Dominance

Accurate and rich user information is among an Internet company's most valuable assets. Additionally, the ability to leverage accurate user information to deliver relevant content to users is the key to increasing conversion rates. We think large cap companies are particularly well suited to running ad networks, as they can lever their user information with that of the publisher network to provide well targeted advertising. This should increase user conversion and monetization capabilities. A combination between any of the search players, a large publisher network, and a company with behavioral targeting capabilities would make sense, in our view.

One Platform for Multiple Advertising Products=Higher Ad Dollar Allocation

From the standpoint of an advertiser, advertising campaign management would be easier with a single ad firm offering multiple products (search, graphical, cost-per-lead, cost-per-action, in-game advertising, mobile advertising, video). Publishers could benefit from the scale of various advertisers across verticals and the higher CPMs accompanying better targeted ads.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 16: Online Advertising Services by Company

Service	AOL	GOOG	MSN	YHOO
Search	✓	✓	✓	✓
Ad Network	✓	✓	✓	✓
Ad Serving***		✓	✓	✓
Traffic Exchange***		✓	✓	✓
Targeting	✓		✓	✓
Lead Generation	✓			
Affiliate Marketing***	✓	✓		
Rich Media	✓	✓	✓	✓
Mobile	✓	✓	✓	✓
Email	✓	✓	✓	✓

***Assumes DoubleClick/Performics acquisition

Source: J.P. Morgan estimates, Company data

Cost Synergies

Entering the ad network space would allow large cap Internet companies to lever their existing sales force, technology, and publisher relationships in expanding their product offering. The sales team could expand its offering of graphical advertising to include properties on the ad network. Technology used to place graphical ads on owned and operated properties and for behavioral targeting could be extended for use on network sites. Finally, search network relationships could be leveraged in building the ad network.

Scale Is Critical to Build a Market-Leading Product

While we have established that the goal of ad networks should be to increase their exposure to an overlapping user base across a variety of properties for targeting, such an undertaking requires scale.

- **Small companies** must choose between generalization across a variety of publishers or going deep into a few verticals. Both options carry risk, as generalization limits targeting capabilities while focusing on limited verticals exposes companies to industry risk (for example, the current mortgage industry weakness).

- **Large cap companies**, however, have the resources to be both broad and deep, offering targeting capabilities while maintaining diversification of risk.

Google

Becoming More than Just a Search Engine and Search Network

A latecomer to the display advertising field, Google has made recent strides to enter it and, in our view, would be a likely candidate for building its AdSense network to include display advertising. As the leader in search market share, Google has much information about user preferences for hosting behaviorally targeted ads.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 15: US Search Market Share, September 2008

millions

Core Search	Searches Sept-08	Search Market Share
Google Sites	7,422	63%
Yahoo! Sites	2,386	20%
Microsoft Sites	998	9%
Ask Network	510	4%
Time Warner Network	481	4%

Source: ComScore

Strategic Acquisitions Provide Fast-Paced Industry Entrance

Recent acquisitions have positioned it well to quickly gain market share. With the acquisition of DoubleClick, Google gains ownership of two key technologies:

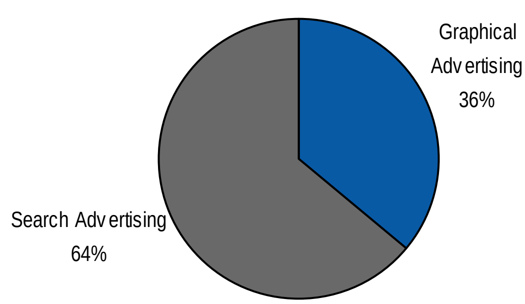
- **the DART suite**: a comprehensive set of technologies that enable advertisers to effectively manage their online advertising campaigns while providing publishers with the ability to dynamically place ads on their sites.

- **the DoubleClick Advertising Exchange**: a platform for buyers to gain immediate access to inventory with goal-based bid rules, defined budgets, targeting, and frequency caps on inventory purchases, while sellers increase overall yield by reducing unsold and undervalued inventory

DoubleClick has relationships with both publishers and advertisers that enable it to serve hundreds of billions of ad impressions per year. In 2004 (the most recent full-year data available), DoubleClick served over 800 billion online ad impressions (we expect it will serve ~2 trillion+ impressions in F'08). Beginning with display advertising tests within the AdSense for Content environment, Google has been exploring the serving of graphical advertisements for a couple of years. But we believe the acquisition of DoubleClick emphasizes the importance that Google places on entering the ad network market.

Figure 17: Graphical Ad Market Will Represent an Estimated 36% of Total in 2010

% of industry revenues



Source: J.P. Morgan estimates, Company Reports, ComScore, Nielsen//NetRatings, IDC, IWS, IAB

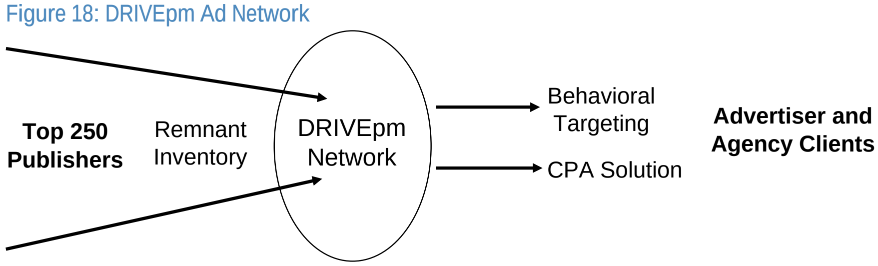
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

MSN

Rich Targeting and Performance-based Advertising Capabilities

With the acquisition of aQuantive, Microsoft obtained the DRIVE performance media platform, which provides premium advertising solutions to aQuantive advertisers and agencies. With selective inventory from only the top 250 publishers, DRIVEpm offers brand protection to its advertisers. The collection of visitor data over several years and CPA payment options allows for behavioral targeting and performance-based capabilities. While the selectivity of the publisher network will likely limit its scale, this premium network will offer a point of differentiation from competitive networks.

Figure 18: DRIVEpm Ad Network



Source: aQuantive reports and J.P. Morgan estimates

AdECN Should Improve Monetization

Microsoft acquired AdECN, which serves as a hub for ad networks to buy and sell display advertising in a real-time auction marketplace. Advertisers will get more access to inventory to enable better matching to their requirements and increasing ROI. Publishers should be able to increase their yield through increased volume of available inventory. With both parties benefiting, AdECN should provide better monetization through higher CPMs for Microsoft remnant and non-premium inventory.

Partnerships Are Growing MSN's Display Reach Outside Its O&O Properties

Agreements to provide advertising on Facebook and Digg have expanded MSN's advertising network beyond its owned and operated properties and have allowed MSN to capitalize on the growing social networking trend. Facebook and Digg are two fast growing social networks. The challenge that we believe Microsoft will face will be providing targeting capabilities sufficient to monetize such a diverse user and content base.

Table 16: Partner Page View Growth, August 2008

millions

	Aug-2007	Aug-2008	Y/Y Growth
Total Internet	474,003	468,006	-1.3%
FACEBOOK.COM	15,260	15,551	1.9%
DIGG.COM	24	27	16.6%

Source: comScore data and J.P. Morgan estimates

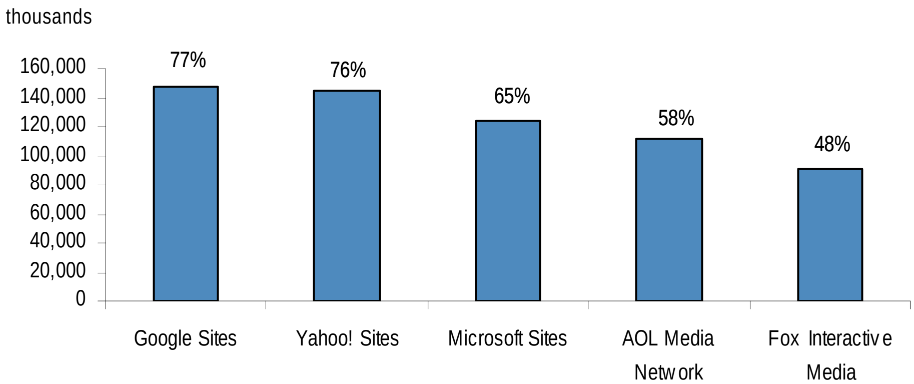
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Yahoo!

A Clear Fit in the Ad Network Space

Yahoo! is particularly well positioned to provide targeted advertising to a network, in our view. As one of the top-ranked websites by unique visitors (according to comScore), Yahoo! has a wealth of information about visitor habits and preferences.

Figure 19: Top Sites by Unique Visitors and % Reach, October 2008



Source: ComScore data

Yahoo! has made strategic acquisitions to build off of its existing assets and to gain dominance in this space.

- Its acquisition of Right Media, in addition to its owned and operated pages, has made it a destination for the buying and selling of inventory.
- The acquisition of Blue Lithium has provided Yahoo! with behavioral targeting technology, visitor information off its owned and operated sites, advanced analytic reporting, and a sales force more accustomed to direct response sales.

These additions should have a smooth integration, as Yahoo! already possesses a sales force accustomed to selling display and contextual advertising, has experience with behavioral targeting with SmartAds, and has entered the ad network arena with newspaper partnerships and agreements with eBay and Comcast. The acquisition of Blue Lithium builds on these earlier efforts and has now made it a significant player in the ad network space.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Ad Exchanges: A New Marketplace

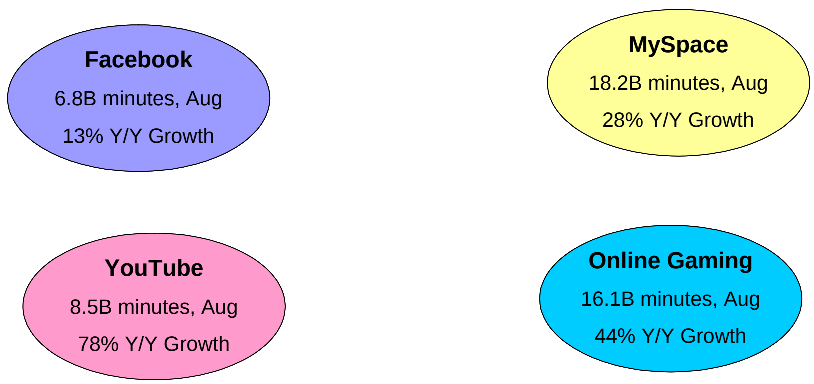
Ad Exchanges: A Response to Audience Fragmentation

One of the largest deterrents to the graphical advertising market has been the increase in the difficult to monetize non-premium inventory. Social networking, blogs, photo sharing, and email have all increased inventory levels but are difficult to monetize given their non-targeted user base and lack of focus on ads. Ad exchanges focus on better monetizing this portion of inventory through aggregation and an open market.

While portals were once dominant, Yahoo!, AOL, and Microsoft only accounted for ~27% of minutes spent online in August 2008, down from 42% in August 2002. Much of this decline can be attributed to audience fragmentation, a result of increases in non-premium inventory. Meanwhile online gaming and social networking websites have experienced double-digit Y/Y growth rates in minutes spent online.

Figure 3: Non-Premium Inventory Growth

Billions



Source: comScore and J.P. Morgan estimates

We believe this audience fragmentation hampered the development of the graphical advertising market, as it resulted in the following challenges:

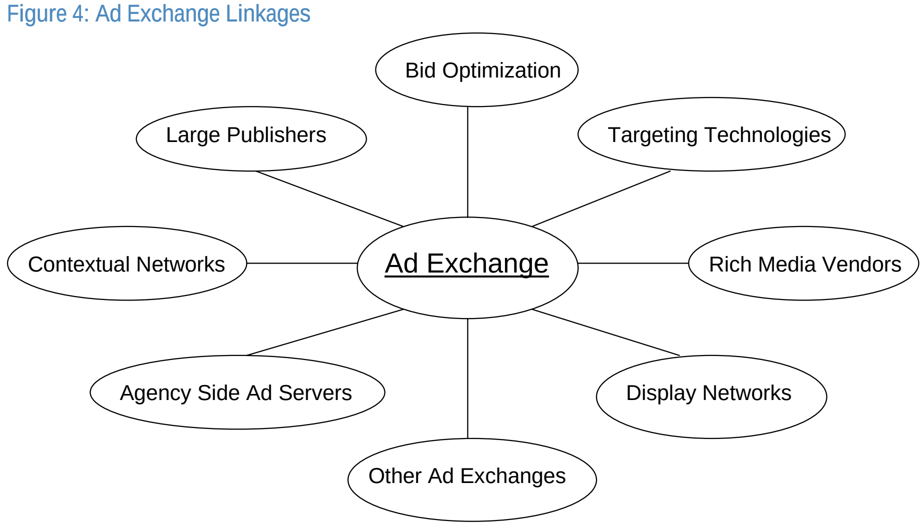
- Audience fragmentation makes it difficult for advertisers to reach their target audience through only a few publishers;
- Small publishers have difficulty attracting advertisers due to limited scale; and
- Monetization is limited due to the difficulty of attracting sufficient advertisers to cover available inventory (purchasing power).

Ad exchanges have emerged as an efficient solution to these new challenges and are gaining traction to alter the landscape for selling and purchasing display advertising inventory.

The Rise of the Ad Exchange

The ad exchange is a real time marketplace with an auction-based system where the participants – advertisers and publishers – transact on a common platform to purchase and sell online graphical advertising. The publishers place remnant inventory on the exchange for the advertisers to purchase through bidding on a user-friendly interface. Network barriers are lowered and all participants interact on a common platform, while the outside relationships are not disturbed. Ad exchanges do not compete with ad networks, targeting technologies, or publishers, but rather serve as another way for the exchange of inventory within these groups.

Figure 4: Ad Exchange Linkages



Source: www.clickz.com (Article: Ad exchanges are the future)

Key features of ad exchanges:

- Transparent and dynamic pricing landscape due to open bidding process;
- Reduced operational friction due to improved clarity of placement of ad serving on a website;
- Enhanced efficiency due to simplification and standardization of business processes;
- Improved liquidity of ad inventory;
- Interests of smaller niche players safeguarded, as existing relationships and budget sizes exert no influence, and each bidder has equal access to the media;
- Increased role of technology to automate and provide a common platform; and
- Elimination of intermediaries and their margins.

The Value of an Ad Exchange

For Advertisers:
An advertising exchange establishes a transparent and automated clearinghouse, easing pricing concerns. The advertiser can place different bids for each ad

impression after evaluation of the perceived value against the buy criteria. Thus, the advertisers gain from:

- Smarter spending;
- Better ROI; and
- Access for inventory for targeting purposes.

For Publishers:
The ad exchange model should usher in more competition and enhanced technologies for targeting. This should drive the demand for inventory upwards, resulting in higher CPMs. The publisher can set a floor price for the impressions to be accepted by the exchange and will gain as yields optimize when highest bids win in a real-time auction. The benefits for the publishers are:

- Better targeting;
- More valuable inventory;
- Higher prices; and
- Better yield.

Key Takeaways

- Exchanges should increase CPMs for publishers, as they provide an open auction market to a large population of advertisers.
- Advertisers should gain easier access to a broad range of inventory, which can be used for targeted advertising.
- The major Internet players should become ad exchange operators as they strive to provide a one-stop solution to all of an advertiser’s needs.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

2009 eCommerce Outlook

2008 saw Amazon, the standard-bearer of eCommerce, continuing to consolidate market share, as the company demonstrated that it remains a formidable competitor, driven by a combination of a broad product selection, low prices and a focus on customer service.

Macroeconomic weakness proved a significant headwind to growth in eCommerce, especially in the second half of the year, and we expect that much of 2009 could see significantly reduced growth as a result of the slowdown in the economy and in consumer spending.

At the same time, we think it is likely that online shopping will continue to take market share away from offline retail channels in the coming year, especially as the retail landscape experiences upheaval and the dislocation of several incumbent players. Additionally, we think broadband penetration will continue to rise, and we see broadband penetration as a key catalyst for the growth of eCommerce.

2009 eCommerce Forecast

We think US growth in eCommerce (including eBay GMV) will experience weaker Y/Y growth rates as economic conditions worsen. At the same time, we expect a greater proportion of retail sales to continue to shift online, driven by (1) increases in product selection, (2) continued Y/Y improvements online for brick-and-mortar retailers, (3) volatility and uncertainty in the offline retail space, and (4) further improved efficiencies from site optimization.

Table 17: US eCommerce Forecast

units as indicated

US eCommerce Forecast	2004	2005	2006	2007	2008E	2009E	2010E	2011E	'08-'11E CAGR
Internet population (M)	186	195	203	211	217	222	227	231	2.2%
Online shoppers	104	117	130	143	153	160	170	176	4.8%
Shopping sessions / shopper / month	2.00	2.03	2.11	2.10	2.11	2.09	2.12	2.24	1.9%
Total shopping sessions / year (M)	2,497	2,847	3,289	3,618	3,878	4,020	4,324	4,724	6.8%
Average price / session	$39.50	$41.25	$43.00	$45.50	$45.00	$45.50	$47.25	$47.75	2.0%
Total eCommerce revenue (US $M))	98,644	117,419	141,437	164,612	174,525	182,902	204,302	225,549	8.9%
Product return rate	10.0%	9.0%	9.0%	8.0%	8.0%	8.0%	8.0%	8.0%	0.0%
Net Revenue	88,780	106,851	128,708	151,443	160,563	168,270	187,958	207,505	8.9%
Y/Y Growth		*20.4%*	*20.5%*	*17.7%*	*6.0%*	*4.8%*	*11.7%*	*10.4%*	

Source: Department of Commerce, Internet World Stats, company reports, J.P. Morgan estimates

Note: includes eBay US GMV

Given the unprecedented global scale of the current slowdown, we are projecting significant slowdowns in eCommerce growth across the world's regions. Further, the Y/Y growth in dollar-denominated volume of eCommerce is likely to suffer due to the stronger dollar; whereas much of F'07 and F'08 benefited from an FX tailwind, the conversion will hurt dollar volume growth rates in F'09. In some places, the impact of the FX tailwind is quite dramatic: e.g., our projection for Korean eCommerce is to post a mid-teens Y/Y rise in local currency terms in F'09, but, assuming current exchange rate levels are maintained through the coming year, the dollar-denominated volume would decline at a low-double-digit rate.

For our international forecast, we expect two main drivers to impact eCommerce growth: (a) a very weak consumer outlook, with historically low consumer confidence in parts of the world, including the UK, and (b) continued shift of wallet share from offline retailers to online sellers.

Both in the US and worldwide, we expect the eCommerce to benefit from several drivers, some region-specific and some general. Of primary importance among these is the growing adoption of broadband, which is much more conducive to eCommerce growth than slower forms of Internet access. Other factors include: (1) continued rises in online shopping penetration in Western Europe, (2) continued investments by online retailers in broadening selection, (3) improvements in shipping infrastructure, (4) improved payment systems and (5) better fraud protection.

Table 18: Global eCommerce Forecast (Excluding Travel)

$ in millions

Global eCommerce Forecast	2004	2005	2006	2007	2008E	2009E	2010E	2011E	'08E – '11E CAGR
US	88,780	106,851	128,708	151,443	160,563	168,270	187,958	207,505	8.9%
Europe	52,430	72,690	96,631	123,698	152,537	140,740	170,942	198,200	9.1%
Asia	31,972	43,054	55,556	69,705	90,585	112,573	127,949	139,617	15.5%
ROW	9,440	13,216	18,502	25,903	34,970	41,963	55,811	73,113	27.9%
Total	182,622	235,811	299,397	370,749	438,655	463,546	542,660	618,435	12.1%
Y/Y Growth		*29.1%*	*27.0%*	*23.8%*	*18.3%*	*5.7%*	*17.1%*	*14.0%*	

Source: Department of Commerce, Internet WorldStats, UK eStats, Forrester Research, Iresearch, Korea National Statistics Office, Japanese Statistics Bureau, eMarketer, PhuCusWright, TIA.org, Jupiter, company reports, J.P. Morgan estimates

Increasingly, It's Amazon vs. Everybody Else

Whereas 2007 saw the large-cap eCommerce companies grow revenue at a faster pace than the US market, in 2008 it was Amazon maintaining its outperformance, while eBay fell somewhat behind, with decelerating sales and GMV growth as the Auctions business appears to be fairly mature; eBay continues to benefit from strong PayPal revenue growth.

Table 19: eCommerce Industry Comparable Table -- Small and Large Cap Revenue Growth Rates

Market cap in $ millions

Company	Ticker	Rating	Price 12/30/2008	Mkt Cap 12/30/2008	'05/'06	'06/'07	'07/'08E
Amazon.com Inc.	AMZN	OW	50.76	21,776.0	26%	39%	26%
eDiets.com Inc.	DIET	NR	3.40	85.5	-9%	-39%	-17%
drugstore.com inc.	DSCM	NR	1.04	100.4	4%	7%	-10%
eBay Inc.	EBAY	N	13.96	17,824.7	31%	29%	13%
1-800-Flowers.com	FLWS	NR	3.55	225.6	17%	1%	5%
MercadoLibre Corp.	MELI	OW	15.69	695.0	84%	64%	62%
Netflix Inc.	NFLX	NR	28.66	1,694.4	46%	21%	13%
Blue Nile Inc.	NILE	UW	23.67	343.7	24%	27%	-3%
Overstock.com Inc.	OSTK	NR	11.51	261.8	-2%	-4%	17%
Shutterfly Inc.	SFLY	OW	6.75	169.2	47%	51%	12%
Stamps.com Inc.	STMP	NR	9.23	177.1	37%	1%	-2%
Group Average					28%	18%	11%
US E-Commerce					21%	18%	6%

Source: Department of Commerce, Company reports, Reuters, J.P. Morgan est. for rated companies, FactSet estimates for other companies. J.P. Morgan ratings: OW = Overweight; N = Neutral; UW = Underweight

Takeaways from the J.P. Morgan Internet Team's 2008 Consumer Survey

In the second half of November, we conducted a proprietary survey of US consumers. The survey had 766 participants, residents of the United States aged 18+. In addition to asking consumers about their shopping plans for the 2008 holiday season, we asked the respondents a variety of questions about their online shopping habits in general, and the key broad takeaways are summarized below:

Price Is Biggest Factor in Choosing a Site

Nearly half of shoppers indicated that price was their top factor when it comes to choosing an online store, with selection also important. Of the options included in our survey, the least popular one, by a wide margin, was, "recommendations from friends and relatives."

Table 20: Price Is Paramount: Factors that Influence Buyers' Choices

% among respondents who indicated they shop online

Factor	#1 factor	#2 factor	In top 5
Price	48.8%	19.5%	91.0%
Selection	12.0%	25.3%	79.1%
Familiarity/experience with store	12.0%	8.7%	57.3%
Payment options	5.0%	10.2%	50.9%
Customer service	5.0%	7.9%	50.0%
Promotions / advertisements	3.7%	9.9%	42.8%
Access to customer reviews / product info	2.7%	5.9%	39.0%
Ability to purchase multiple items	2.7%	4.9%	33.4%
Name recognition	5.8%	5.0%	32.5%
Recommendations from friends / relatives	2.1%	2.6%	21.0%

Source: J.P. Morgan Internet Team 2008 Consumer Survey

Looking at the data on a site-by-site basis does not change the top-line conclusion: price remains the #1 consideration for most shoppers regardless of site, with 46-50% of shoppers at each of Amazon, eBay, Walmart.com, Target.com and Sears.com listing price as their top factor in choosing a site.

Higher-income shoppers look for slightly different things in a site. More shoppers with incomes over $100K listed "Familiarity/experience with store" as one of their top five factors than did those earning less than $100K. Even for the >$100K-income shoppers, price is the biggest factor, but notably fewer respondents chose it as their #1 factor: 38% for the higher-income group, vs. 50% for those with incomes below $100K.

Table 21: Familiarity Matters More to Higher-Income Shoppers

% of online shoppers who indicated factor was one of their top 5 factors in choosing a site

	Income <$100K	Income >$100K	Difference
Price	92.3%	82.4%	9.9%
Selection	79.7%	75.3%	4.4%
Familiarity/experience with store	56.7%	61.2%	-4.4%
Payment options	51.3%	48.2%	3.1%
Customer service	49.7%	51.8%	-2.0%
Promotions / advertisements	42.0%	48.2%	-6.2%
Access to customer reviews / product info	38.4%	43.5%	-5.2%
Ability to purchase multiple items	33.8%	30.6%	3.2%
Name recognition	32.4%	32.9%	-0.5%
Recommendations from friends / relatives	20.7%	23.5%	-2.9%

Source: J.P. Morgan Internet Team 2008 Consumer Survey

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Walmart.com, Target.com Catching Up to Large Online Sites

Third-party metrics indicate eBay and Amazon are the two largest online-only stores in terms of unique users, whereas Walmart.com and Target.com are the two biggest sites belonging to brick-and-mortar retailers.

In ’07, Amazon and eBay drew business from more online shoppers than any other sites we asked about. For the ’08 holidays, our survey reveals no significant change in Amazon and eBay’s reach, compared to double-digit increases in the number of shoppers planning to use Walmart.com and Target.com; the only other site in our survey with a statistically significant Y/Y increase, Sears.com, also belongs to a brick-and-mortar retailer.

Table 22: Online Shoppers Who Used (’07) or Plan to Use (’08) Specific Sites for Holiday Shopping

Site	2007	2008	Y/Y difference significant?
Amazon	50.9%	48.3%	No
eBay	33.6%	32.4%	No
Walmart.com	31.3%	34.7%	Yes, up 11% Y/Y
Bestbuy.com	22.1%	22.4%	No
Target.com	21.7%	26.8%	Yes, up 24% Y/Y
Overstock.com	16.4%	18.2%	No
Circuitcity.com	12.0%	13.6%	No
Sears.com	9.0%	12.3%	Yes, up 36% Y/Y
QVC.com	7.3%	7.0%	No
HSN.com	5.1%	5.1%	No

Source: J.P. Morgan Internet Team 2008 Consumer Survey. Statistical significance at a p<.05 level.

Media, Apparel Top Categories

Books, music and video comprised the top category, with ~65% of online shoppers reporting they had bought such items online within the past year; the number was in line with our survey result a year ago. Apparel and accessories, at 59% penetration, was second, tilted predominantly toward female shoppers. Unsurprisingly, men were more likely to shop in both the Computers and videogames category and the Electronics category.

The results were very similar to those in our 2007 survey, with the top four categories among men unchanged (Toys replaced Health and Beauty at #5). For women, the five most popular categories remained the same, though Apparel leapfrogged over Media into first place, and Toys edged out Computers and videogames for #4.

Table 23: Media Items Popular with Both Genders: Top Five Categories among Men and Women

%, among respondents who indicated they shop online, that indicated they had made purchases in category

Men		Women	
Books, music, videos and other media	61.5%	Apparel and accessories (includes shoes, handbags and jewelry)	69.0%
Computer and videogames software and hardware	50.5%	Books, music, videos and other media	68.5%
Apparel and accessories (includes shoes, handbags and jewelry)	46.2%	Health & Beauty	41.1%
Electronics (includes television and stereo equipment)	33.2%	Toys	39.7%
Toys	29.6%	Computer and videogames software and hardware	37.5%

Source: J.P. Morgan Internet Team 2008 Consumer Survey

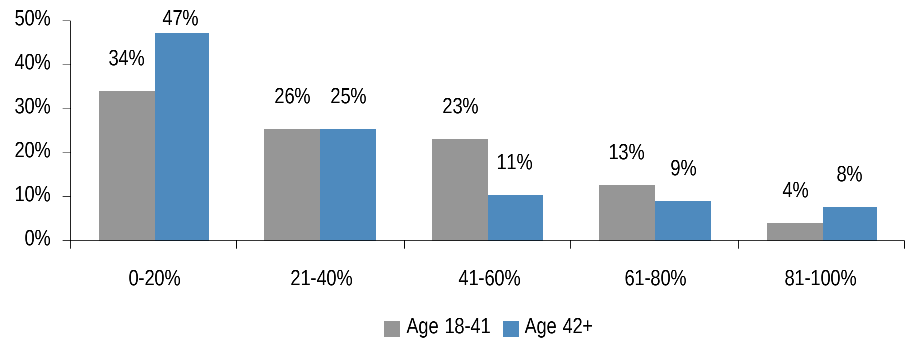
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Younger Users Shop Online More, Use Classifieds More

Among online shoppers, 40% of those aged 18-41 expect to do more than 40% of their holiday shopping online this year, compared to 27% of shoppers aged 42+. Nearly half of the older group plans to do 20% or less of their holiday shopping online. At the same time, the 42+ bracket included almost twice as high a percentage of people who planned to do almost all (over 80%) of their shopping online, 8% vs. 4%.

Figure 20: Expectation of Portion of Holiday Shopping to Be Done Online, Holiday Season '08

% among respondents who indicated they shop online

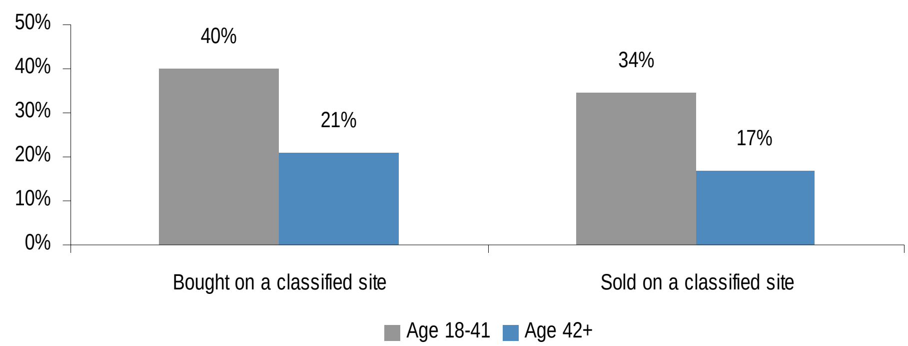


Source: J.P. Morgan Internet Team 2008 Consumer Survey

Younger shoppers also appear to be more open to using classified sites, with significantly higher usage rates. The discrepancy is even more extreme at the edges of the age distribution: 48% of online shoppers 18-25 reported having bought something on a classified site, compared to only 17% of those aged 58 and older. Likewise, more than 41% in the youngest group reported having sold something on a classified site, compared to only 16% of respondents aged 58 and older.

Figure 21: Online Classified Sites Attract a Younger Demographic

% of online shoppers saying they had ever bought/sold on a classified site (such as craigslist)



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Internet Sales Tax: In US, the Action Will Be in the States

In 2008, the state of New York began requiring online retailers to collect sales taxes even if they had no physical presence in the state, so long as members of their affiliate networks (who get paid a commission for driving sales traffic to the site) are present in the state.

Several companies, notably Amazon, have started collecting the NY sales tax while appealing the ruling. Overstock.com, on the other hand, has chosen to drop its NY-based affiliates and not charge the tax.

Given that many states are facing significant revenue shortfalls this year, we expect to see continued efforts by states to collect tax revenue on online sales. While the implementation of state sales taxes can be a slight negative, we do not expect this trend to have a material impact on US eCommerce.

Catalysts for International Growth

We believe the rising tide of increased Internet use across the world is likely to help lift eCommerce globally. However, we see three key challenges to overcome for eCommerce to fulfill its potential:

- **Improvement of shipping infrastructure**. Postal and parcel service in many parts of the world can be unreliable, and a reliable distribution channel is an essential prerequisite for the growth of eCommerce.

- **Improved payment systems**. This is not a world-wide challenge, but rather a slew of country-specific challenges related to the idiosyncrasies of different countries' banking systems and conventions. Even in more developed countries, significant differences emerge: e.g., Germany and Austria have historically seen lower rates of PayPal use than other eBay geographies due to the prevalence of bank transfers as a mode of payment there.

Table 24: PayPal Penetration on Select eBay Country Sites

% of listings that include PayPal

Country	% Penetration
US	99.3%
UK	98.8%
Canada	98.6%
Australia	94.2%
Switzerland	89.4%
Italy	87.6%
Germany	82.2%
France	81.6%
Spain	78.9%
Belgium	42.2%

Source: eBay.com (and country sites), J.P. Morgan estimates, data collected December, 2008

- **Better fraud protection**. The promise of eCommerce has been one of lower prices and/or better selection, with the trade-off that many purchases must be made sight-unseen. The threat of fraud remains present, and structures that insure buyers against fraud should help smooth operations in an eCommerce environment that is not yet fully mature. (An example is eBay's PayPal, which has, over the course of the past year, augmented the level of fraud protection it provides in the US, from $2K per transaction to as much as the full purchase price of the transaction. PayPal uses such protection to create buyer confidence, with transaction loss rates for the PayPal unit of 24-33 bps, as denominated by total payment volume).

We note that the above is not intended to be an exhaustive list of catalysts for international growth – many specific markets can present unique challenges – such as governmental ones – for the operation of eCommerce companies.

2009 Online Travel Outlook

In 2008, online travel agency companies in the US performed relatively well compared to offline agencies, primarily due to some counter-cyclical effects of the weak macroeconomic environment. The companies in our coverage universe moved to push their lowest price or discount offerings and began a variety of promotions to woo travelers to their sites. However, growth in international markets began a significant deceleration, pressured not only by the weak economy but also by weaker currency exchange rates. Furthermore, any positive counter-cyclical effects seen in the US in the first half of the year were overpowered by the negative macroeconomic environment going into the second half of the year.

In 2009, we expect to see the macroeconomic environment and difficult comps have a large impact on both domestic and international growth. We are lowering our estimates from those published in the 2008 Nothing But Net. We are now expecting F'09 total global travel gross bookings growth of (4.7%) Y/Y. We are expecting global online gross bookings growth of 3.9% Y/Y vs. our prior estimate of 15.4%.

Table 25: Global Online Travel Market Forecast

$ in millions

	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2008-2011E CAGR
Total Travel Spend	671,000.0	701,000.0	742,040.0	787,524.4	813,340.6	774,985.4	811,714.9	859,557.7	1.8%
% online	19.1%	22.8%	28.1%	34.5%	40.5%	44.2%	49.9%	53.3%	9.5%
Online Travel Spend	127,960.0	159,830.0	208,228.8	271,927.8	329,233.7	342,199.5	405,074.0	457,955.0	11.5%
Total Travel Spend Growth		4.5%	5.9%	6.1%	3.3%	-4.7%	4.7%	5.9%	
Online Travel Spend Growth		24.9%	30.3%	30.6%	21.1%	3.9%	18.4%	13.1%	

Source: Company reports, PhoCusWright, and J.P. Morgan estimates

Domestic Growth Expected to Slow

We expect a very challenging macroeconomic environment to impede both customer volume growth and pricing in 2H'08 and F'09. Furthermore, we believe online penetration increases will be less effective in offsetting total travel market weakness as penetration increases begin to flatten. We are now looking for F'09 US online travel market growth of 2% Y/Y, well below our prior estimate of 8% growth. We think the total US travel market will decline 5% Y/Y in F'09. This is the slowest growth rate since 2003, when the market declined 8% following the effects of the Sept. 11, 2001 terrorist attacks.

Table 26: US Online Travel Market Forecast

$ in millions

	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2008-2011E CAGR
Total Travel Spend	233,000.0	253,000.0	267,000.0	282,000.0	290,460.0	275,937.0	289,733.9	304,220.5	1.5%
% online	38.0%	41.0%	46.0%	51.0%	54.0%	58.0%	61.0%	63.0%	5.2%
Online Travel Spend	88,540.0	103,730.0	122,820.0	143,820.0	156,848.4	160,043.5	176,737.6	191,658.9	6.8%
Total Travel Spend Growth		8.6%	5.5%	5.6%	3.0%	-5.0%	5.0%	5.0%	
Online Travel Spend Growth		17.2%	18.4%	17.1%	9.1%	2.0%	10.4%	8.4%	

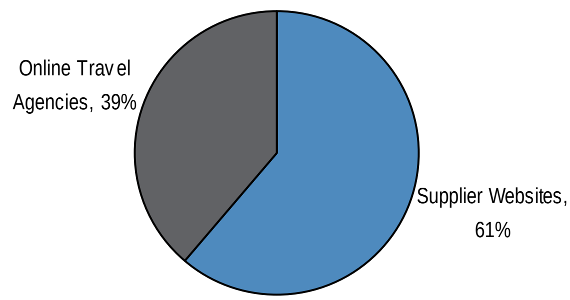
Source: Company reports, PhoCusWright, and J.P. Morgan estimates

OTAs Make US Volume Gains but Pay the Price in Discounts

According to PhoCusWright data, online travel agencies (OTAs) started to benefit from a limited counter-cyclical lift in the second half of 2007 as consumers started to shop for online bargains as airlines continued to raise fares and reduce capacity. According to PhoCusWright's CTTS10, 47% of online travelers cited online travel agencies as their primary shopping method in 2007 vs. 40% in 2006.

However, we think these traffic volume gains made from supplier websites are mostly being offset by pricing discounts. Orbitz, Priceline, and Expedia have all offered promotions and discounts to attract new traffic and conversions. In fact, PhoCusWright data shows that OTAs are attracting more infrequent leisure travelers, who may take just a few trips per year and are more price sensitive. Meanwhile, suppliers are still the preferred destination for more frequent loyal leisure/unmanaged business travelers who may be less concerned with price and more interested in schedule, convenience, and booking with specific suppliers.

Figure 22: Suppliers Accounted for 61% of the Online Market in 2007



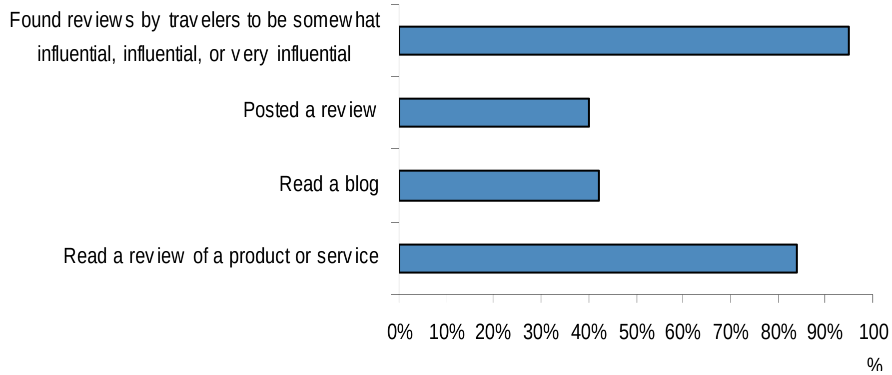
Source: PhoCusWright data

Advertising Revenues Are Becoming More Prominent

With US competition from suppliers for gross bookings, we think many OTAs are turning to advertising as an additional means of monetizing the traffic coming to their sites. Expedia has launched several new online ad initiatives, and Orbitz and CheapTickets began using Kayak-powered search ads on their sites. Expedia launched PasswordAds, an advertising network that attempts to capitalize on downstream traffic. Expedia purchases advertising space on websites that consumers go to after they visit Expedia and serve ads that click directly to the advertiser's website. Orbitz links directly to suppliers and competitors from its search results display by offering a sponsored-link alongside requested travel search results.

It appears that focus is shifting from transactions to more of an emphasis on the broader shopping and decision-making process. In our opinion, there is a large market for this. According to PhoCusWright, more than 80% of travelers who visited at least one website when planning a leisure trip read a traveler review, and 95% of those indicated the reviews were influential. Furthermore, we think travelers are even more likely to spend more time shopping and less time booking in the current economic environment, thus making this revenue stream even more attractive.

Figure 23: Use and Influence of Social Media, 2008 Survey



Source: PhoCusWright Consumer Technology Survey Second Edition

The International Opportunity

Despite macroeconomic weakness impacting total travel spend, we think international markets will continue to benefit from increased penetration trends. According to recent PhoCusWright data, Europe has only a 32% online penetration for leisure/unmanaged business and corporate travel, which is still well below the US rate of 51%. This is a significant growth opportunity for online travel agencies, as the EU27 is more than 60% larger than the US in population size. Additionally, the Asia-Pacific region is only in the very early stages of online travel adoption with an estimated 15% online penetration rate. Thus, we think macroeconomic headwinds will be slightly offset by online adoption forces.

Table 27: Europe Online Travel Market Forecast

$ in millions

	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2008-2011E CAGR
Total Travel Spend	260,000.0	263,000.0	284,040.0	307,524.4	322,900.6	297,068.6	311,922.0	336,875.8	1.4%
% online	9.0%	15.0%	22.0%	32.0%	41.0%	45.0%	53.0%	57.0%	11.5%
Online Travel Spend	23,400.0	39,450.0	62,488.8	98,407.8	132,389.3	133,680.9	165,318.7	192,019.2	13.1%
Total Travel Spend Growth		1.2%	8.0%	8.3%	5.0%	-8.0%	5.0%	8.0%	
Online Travel Spend Growth		68.6%	58.4%	57.5%	34.5%	1.0%	23.7%	16.2%	

Source: Company reports, PhoCusWright, and J.P. Morgan estimates

Table 28: Asia-Pacific Online Travel Market Forecast

$ in millions

	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2008-2011E CAGR
Total Travel Spend	178,000.0	185,000.0	191,000.0	198,000.0	199,980.0	201,979.8	210,059.0	218,461.4	3.0%
% online	9.0%	9.0%	12.0%	15.0%	20.0%	24.0%	30.0%	34.0%	19.1%
Online Travel Spend	16,020.0	16,650.0	22,920.0	29,700.0	39,996.0	48,475.2	63,017.7	74,276.9	22.7%
Total Travel Spend Growth		3.9%	3.2%	3.7%	1.0%	1.0%	4.0%	4.0%	
Online Travel Spend Growth		3.9%	37.7%	29.6%	34.7%	21.2%	30.0%	17.9%	

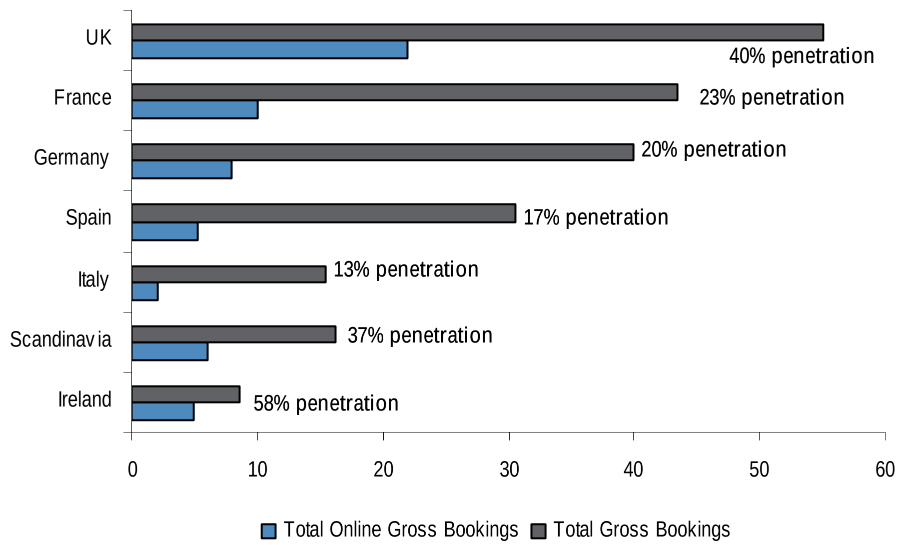
Source: Company reports, PhoCusWright, and J.P. Morgan estimates

For F'09, we are projecting European online gross bookings growth of 1% Y/Y due to macroeconomic weakness and an estimated 6 points of negative impact from foreign currency weakness. We are projecting F'09 APAC online travel gross bookings growth of 21% Y/Y.

Western Europe Growth Flattens Out…
The UK was the largest total and online travel market in Europe in 2007, accounting for over 50B euros in gross bookings. It also had the highest online penetration rate of 40% (excludes corporate travel), according to PhoCusWright data. France and Germany were the second and third largest travel markets in Europe with online penetration rates of 23% and 20%, respectively. We think these markets will be less of a growth driver moving forward as penetration gains slow and euro weakness impacts earnings.

Figure 24: Online Penetration of Key European Countries Leisure/Unmanaged Business Gross Bookings, 2007

billions euros



Source: PhoCusWright reports and J.P. Morgan estimates

…But Eastern Europe Has Attractive Penetration Growth
Eastern Europe is at a much earlier stage of online adoption than its Western counterparts. We think countries in this region have the potential to post strong online travel growth despite macroeconomic headwinds. According to PhoCusWright data, online travel gross bookings increased 52% Y/Y in 2001 in the US, despite an overall travel market decline of 8% due to recession, terrorist attacks and travel fears. As such, we think Eastern European gross bookings may also continue to grow given similarly low penetration rates. We believe online travel agencies with a larger exposure to these regions will outperform the competition.

Table 29: Internet Usage in Eastern Europe by Country, 2007

units as indicated

Country	Population (M)	Broadband Penetration Rate	Households with Internet Access	% of individuals 16-74 who shopped on the internet
Bulgaria	7.3	5.7%	19.0%	3.0%
Czech Republic	10.2	12.2%	35.0%	17.0%
Hungary	10.0	11.6%	38.0%	11.0%
Lithuania	3.6	12.7%	44.0%	6.0%
Poland	38.5	6.8%	41.0%	16.0%
Romania	22.3	6.6%	22.0%	3.0%
Slovakia	5.5	6.9%	46.0%	16.0%

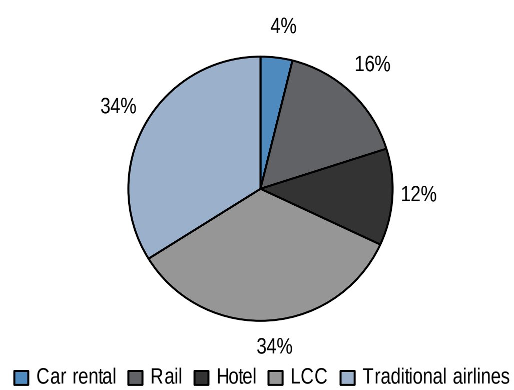
Source: EuroStats, CIA.gov, and J.P. Morgan estimates

OTAs with High International Hotel Exposure Are Likely to Outperform

Online hotel sales have been growing at a considerable pace. According to PhoCusWright data, total 2007 online sales increased over 30% in local currency, aided by higher average daily rates and increased leisure and corporate demand. Hotel growth considerably outpaced website gross bookings growth of traditional airlines which increased only 16% in 2007. Additionally, we think hotel products will continue to have higher revenue margins for OTAs and less of a supplier competition threat given the highly fragmented market. PhoCusWright data shows that hotels account for only 12% of supplier website bookings vs. traditional airlines and LCCs, which each have a 34% share of supplier website bookings. We think both revenue and profitability will grow as OTAs increase their hotel inventories.

Figure 25: European Supplier Website Booking Shares, 2007 Leisure/Unmanaged Business

Percent



Source: PhoCusWright data

We Think the European OTA Market Will See Further Consolidation

In the first half of 2008, Hotel Reservation Services (HRS) of Germany acquired the Austrian company Tiscover, and Expedia announced an agreement to purchase the Italian company Venere. Since almost half of the European OTA marketplace is still composed of small independent players, we think further acquisitions in the space are likely.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 30: Pan-European Online Travel Agency Market Share Changes

units as indicated

	2007	2006
Expedia	16%	17%
Travelocity	14%	15%
Opodo	8%	9%
Priceline	11%	8%
ebookers	4%	6%
Other	47%	45%

Source: PhoCusWright data

* Please note while PCLN has lower overall market share, it has better exposure in hotels and Eastern Europe.

The Mobile Market

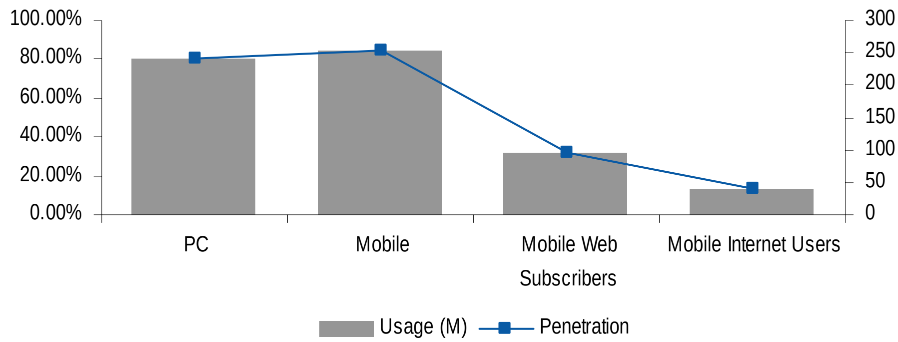
84% of the U.S. Population Has Mobile Phones, but Mobile Internet Usage Trails

The mobile market is a large and quickly growing industry, with Nielsen estimating 254M U.S. mobile subscribers. Mobile phone usage has surpassed PC ownership, which has an estimated 80% U.S. penetration rate. Given this level of scale, it is apparent that the market is attractive to Internet companies.

However, despite the widespread use of mobile phones, mobile Internet use drastically trails it. Nielsen data shows that only 37% of US mobile users paid for access to the mobile Internet and only 15.6% of mobile subscribers actively use mobile Internet services. We think this is due primarily to hardware and technology issues which include slow web page loading times, complex user interfaces, small screens, and low resolutions. We expect mobile Internet penetration growth to accelerate given the recent improvements made to wireless services and phone hardware.

Figure 26: Technology Penetration in the US (2008E)

as labeled



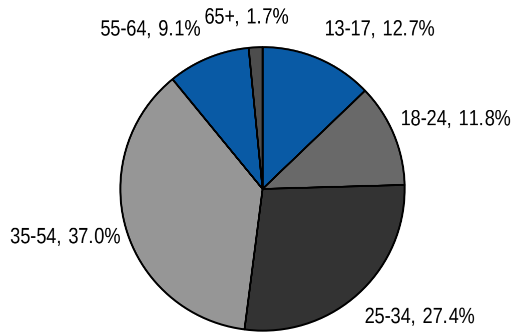
Source: CIA Government Stats (http://www.cia.gov/cia/publications/factbook/index.html) (Feb 2008); International Telecommunications Union (http://www.itu.int/ITU-D/ict/statistics); CIA Government Stats (http://www.cia.gov/cia/publications/factbook/index.html) (Mar 2008) for Vietnam and Hong Kong mobile phone data, "OECD Broadband Statistics to June 2007", OECD; www.point-topic.com; mybroadband.co.za; Hong Kong and India government statistics; European Travel Commission; www.bezeq.co.il; Santiago Times newspaper; Nielsen Mobile data, J.P. Morgan Estimates

The Mobile Internet Has a Broad Demographic Reach

Not only have mobile phones been proven to be a vehicle of scale, they also have a broad reach across various demographic segments. Surprisingly, Nielsen data suggests that mobile Internet usage is prevalent across age groups. As of May 2008, the US mobile Internet audience was about evenly split between those over the age of 35 (48%) and those under the age of 35 (52%).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 27: US Mobile Internet User Age Profile (May 2008)



Source: Nielsen Mobile data

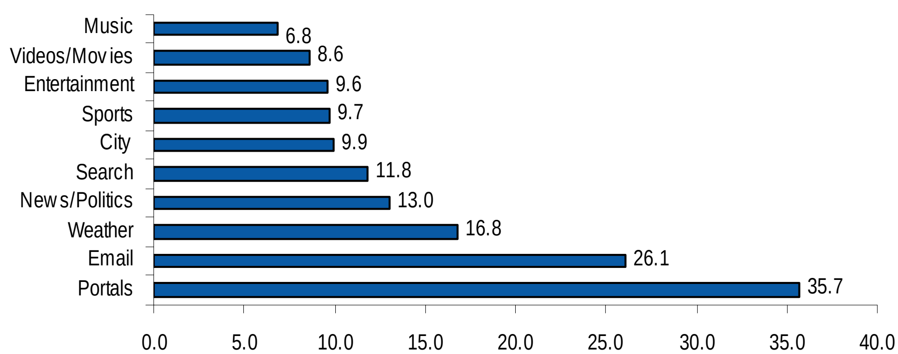
Reach is also found across genders and income levels. Nielsen data shows that 56% of mobile Internet users are male and 44% are female. And, while 24% of mobile Internet users have household incomes of $100K or more, 26% have a household income of less than $50K. We think this reach will broaden the medium's appeal to advertisers.

Internet Visits Scan a Variety of Verticals

Although usage is less frequent than on PCs, mobile Internet visits span a variety of verticals. According to Nielsen Mobile data, 40% of mobile Internet users find sites through search engines, 22% through direct navigation, 18% through their favorite links, and 17% from their carrier's portal. Yahoo! Mail has the largest unique audience with 14M unique monthly users in May, with Google Search and The Weather Channel coming in next with 9M unique monthly users.

Figure 28: Top Mobile Web Categories by Unique Monthly Visitors (May 2008)

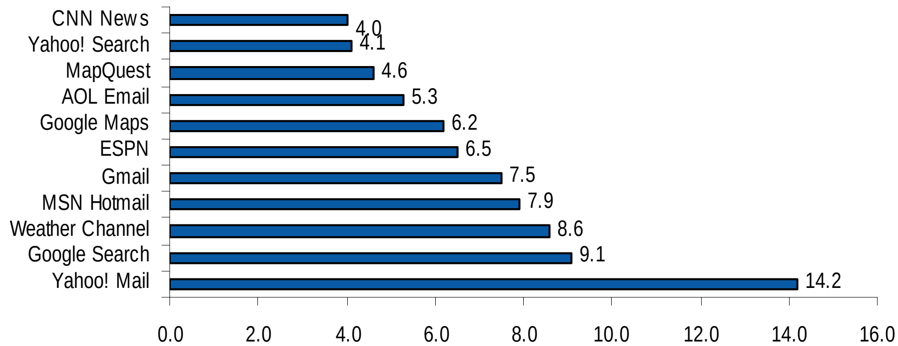
Millions



Source: Nielsen Mobile data

Figure 29: Top Mobile Web Channels by Unique Monthly Visitors (May 2008)

Millions



Source: Nielsen Mobile data

Tech Improvements Likely to Push Mobile Internet Usage

In our opinion, the largest impediment to widespread mobile Internet adoption has been the exceedingly low data transfer speeds. Nielsen Mobile estimates that network quality is the most important driver of satisfaction. Network quality is second only to cost as the top reason former data users canceled their data services. Recently, 3G networks have become more widespread in the US and address low speeds by improving data transfer throughputs by about 6x over 2G and 2.5G networks (Nielsen Mobile estimate). In the US, 28% of consumers have a 3G capable handset.

Phone improvements have also encouraged mobile Internet use. Probably the most recognizable of phones, the iPhone, increased awareness of mobile Internet capabilities. With a handset geared toward improving mobile Internet use, consumers significantly increased their use of mobile Internet services. Nielsen Mobile data shows that 82% of iPhone users access the mobile Internet, making them 5x as likely to do so as the average mobile user.

Table 31: Top Devices Amongst Mobile Internet Users

% of mobile Internet users with device

Device	Percent
Motorola RAZR/RAZR2	10%
Apple iPhone	4%
RIM BlackBerry 8100 series (Pearl)	2%
RIM BlackBerry 8800 series	2%
Motorola Q Series	2%

Source: Nielsen Mobile data

Mobile Internet Usage Likely to Grow at a 37% 3 Yr CAGR

As a result of the improving technology and increased availability of unlimited data packages from ISPs, we think the growth rate of mobile Internet usage will accelerate in the future. Specifically, we are looking for a 37% 3-year CAGR for active mobile Internet users.

Table 32: Mobile Internet User Projections

Millions

	2005	2006	2007	2008E	2009E	2010E
Subscribers	207.9	233.0	255.4	263.1	268.3	271.0
US Penetration	*69.0%*	*77.7%*	*84.0%*	*87.4%*	*89.1%*	*90.0%*
Active Mobile Internet Users	22.4	29.7	40.4	55.8	76.9	104.6
% of Mobile Subscribers	*10.8%*	*12.7%*	*15.8%*	*21.2%*	*28.7%*	*38.6%*
Y/Y Growth						
Subscribers		12.1%	9.6%	3%	2%	1%
Active Mobile Internet Users		32.6%	36.0%	38%	38.0%	36.0%

Source: CTIA, Nielsen Mobile, and J.P. Morgan estimates

The Dawn of Mobile Advertising

With approximately 40M Americans now actively using mobile Internet service, we think the market has reached enough scale to begin to be attractive to advertisers. A Nielsen Mobile survey revealed that 26% of mobile Internet users recalled seeing some form of advertising while using the mobile Internet. However, we believe experimental forms of advertising, including mobile, will suffer the most in the current economic downturn. We have subdivided mobile Internet advertising into 3 categories: Message Advertising, Mobile Display, and Mobile Search.

Table 33: US Mobile Advertising Forecast, 2005-2010E

millions

	2005	2006	2007	2008E	2009E	2010E
Mobile message advertising	43	296	750	1436	2010	2915
Mobile display advertising	1	9	26	78	94	122
Mobile search advertising	1	9	29	99	129	180
Total	45	315	805	1613	2233	3217
Y/Y Growth						
Mobile message advertising		585%	153%	91%	40%	45%
Mobile display advertising		950%	175%	90%	20%	30%
Mobile search advertising		950%	207%	90%	30%	40%
Total		600%	156%	100%	38%	44%

Source: eMarketer, Yankee Group, Strategy Analytics, Nielsen Mobile, and J.P. Morgan estimates

SMS (text) Advertising

We think mobile message advertising is currently the largest medium for mobile advertising, as text messaging usage does not require high data speeds or advanced phone capabilities. Campaigns can include placement in text messages, direct spending on a message campaign, and spending on promotional coverage of end-user messaging costs. We expect this market to reach $2.9B by 2010.

Mobile Display Advertising

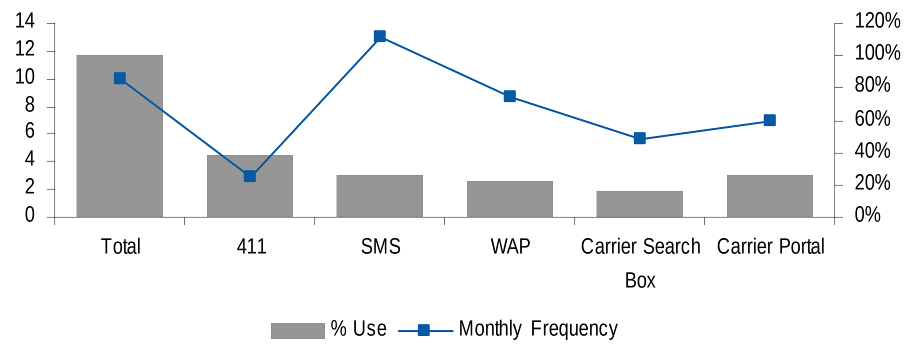
Mobile display advertising includes spending on display banners, links, or icons placed on WAP, mobile HTML sites or embedded in mobile applications such as maps or games and videos. We think mobile display advertising will be a high growth area over the next few years as improvements to data loading speeds and better phones fuel mobile Internet usage. However, we see growth in mobile Internet users and increased advertiser spend slightly offset by declines in CPMs due to available inventory increases. We expect the mobile display market to reach $122M by 2010.

In addition to high growth, we think the mobile display market will also undergo a competitive shift favoring traditional Internet display companies. Early mobile display advertising was dominated by mobile specific ad networks such as Third Screen Media and AdMob, which specialize in delivering ads for phone browsers. However the latest browsers, like MobileSafari on the iPhone, are designed to bypass mobile websites and display full size, hi-fi websites and ads. Thus, the iPhone browser loads an ad the same way a computer does, eliminating the need for a special mobile ad network with different technology. We think the trend toward these advanced phones will favor existing Internet players who already have many advertiser partnerships.

Mobile Search Advertising

Mobile search advertising includes spending on sponsored display ads and text links that appear alongside mobile search results as well as spending on audio ads played to mobile phone callers making a directory inquiry (eg. GOOG-411 and 1-800-FREE411). We think mobile search advertising will be a high growth area given its high volume and starting point status. We are expecting search advertising revenue to reach $180M by 2010.

Figure 30: Search Use and Monthly Frequency by Type

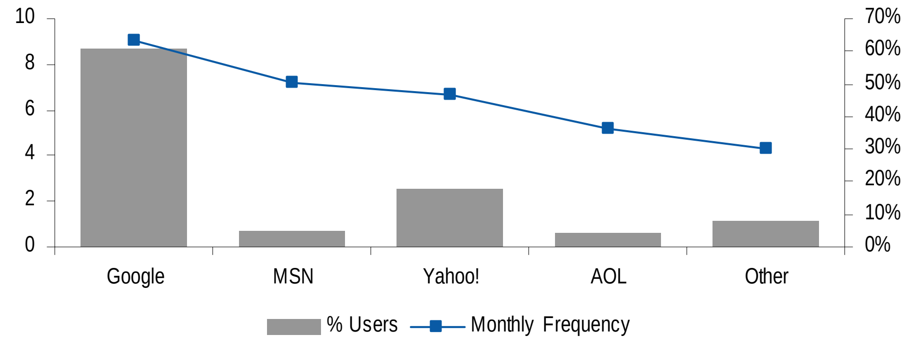


Source: Mobile Q1 2008 Mobile Media Survey and Q1 2008 Device Census

Google Leads in Mobile Search

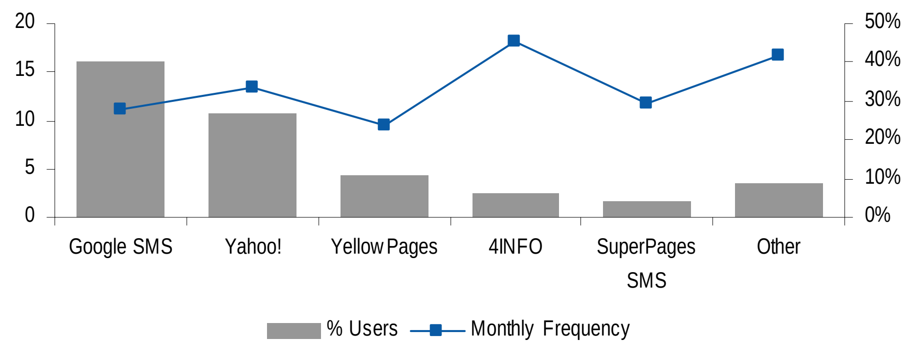
Google has already taken a dominant role in the mobile search market, leading in usage of two of the five search methods. Google is currently the leader in both SMS and WAP searches and, while not being dominant in market share, Google is also the leader in satisfaction among 411 search providers. Currently, Google has a 61% market share of WAP searches and a 40% share of the SMS search market. Yahoo! trails Google with an 18% WAP search market share, while MSN and AOL follow with market shares of 5% and 4%, respectively.

Figure 31: Market Share and Monthly Frequency of WAP Searches by Provider



Source Mobile Q1 2008 Mobile Media Survey and Q1 2008 Device Census

Figure 32: Market Share and Monthly Frequency of SMS Searches by Provider



Source: Mobile Q1 2008 Mobile Media Survey and Q1 2008 Device Census

Company Initiatives

Google Works on Android

Google decided to address distribution difficulties head-on with the creation of the Open Handset Alliance, composed of leading technology and wireless companies committed to the development of an open platform for mobile devices. The Android platform is a fully integrated mobile "software stack" consisting of an operating system, middleware, user-friendly interface, and applications. The first phones based on Android debuted in the fourth quarter of 2008. By bringing the Internet developer model to the mobile market, it is hoped that increased innovation will make the phone features more attractive, affordable, and user-friendly for the consumer.

Despite speculation about the development of a Google Phone or GPhone, we believe it is unlikely that Google will choose to enter the hardware business. First, none of Google's core competencies lies in this business, and it would take much investment in technology, marketing, and people to ramp it up. Secondly, the handset business is a much lower margin business than online advertising. We estimate that operating margins for handset makers range from 10%-20% and are skewed toward the lower end of the range. In contrast to this, we believe Google will achieve an operating margin north of 50%.

Instead, we believe it is more likely that Google will pursue methods to increase the distribution of its products and services, so that they may later be monetized. If the Android open platform is widely rolled out, more consumers would have access to Google features. Google has introduced many mobile products including search, Gmail, YouTube, Picassa, maps, and GOOG-411. We believe Google is well positioned to capitalize on the mobile space with its search dominance. Currently, advertisers can elect to place mobile search or content ads through AdWords.

Yahoo! Emphasizes Mobile

Yahoo! has introduced a comprehensive mobile offering including:

- Mobile Homepage;
- Yahoo! oneSearch, which provides instant answers to any query not just web links;
- Yahoo! oneConnect, an all-in-one communications application offering; and
- Yahoo! onePlace, a content management application.

Similar to Google, Yahoo! has created an open environment that enables developers and publishers to make their offerings mobile. Yahoo!'s Mobile Widget Platform gives developers an easy-to-use XML-based blueprint and instant scalability across all mobile devices that Yahoo!'s own mobile services run on. Yahoo! has promoted uptake of its mobile services through carrier partnerships.

Yahoo! has also begun to monetize the space. The company currently offers mobile display advertising in 23 territories across Europe, Asia, and the Americas. Search marketing solutions are available in the United States, the United Kingdom, and Japan. In addition to being Vodafone's exclusive advertising partner in the UK, Yahoo! announced a strategic partnership in the UK that will deliver the first graphical advertising to appear on T-Mobile's Web'n'walk service. Maxis Communications Berhad in Malaysia and Idea Cellular Limited in India extended Yahoo!'s mobile graphical advertising reach through new partnerships.

MSN Updates Its Mobile Portal and Adds Features

Last year, Microsoft launched MSN Mobile, a redesigned portal providing customers with access to email, news, sports, entertainment, local movie listings, maps and directions, Windows Live Messenger, and Live Search. Like Yahoo!, Microsoft is pursuing strategic alliances. As of February, Windows Mobile runs phones from 50 device makers used by 160 mobile operators. Microsoft software and services, including Windows Mobile, Windows Live Messenger, Hotmail, and Windows Live Spaces, are also used by device makers, including HTC Corp, LG Electronics, Motorola, Nokia, Palm, RIM, and Samsung.

Microsoft now has firm footing in the mobile advertising world. Last spring, Microsoft announced the acquisition of Screen Tonic, a Paris-based company that specializes in delivering location-based ads to mobile devices. ScreenTonic's platform, called Stamp, enables delivery of text or banner links on portals, ads in SMS (Short Message Service) messages and ads in mobile web pages that vary depending on where the reader is located. Recently, Microsoft made two more acquisitions. TellMe provides a voice search recognition platform. Danger provides communication, organization, and information services through real-time mobile messaging, social networking, web browsing, and personal information management applications.

Other Company Initiatives

AdMob
AdMob is a mobile ad network that connects advertisers with mobile publishers. It allows advertisers to create ads, choose landing pages and target their ads to specific sites, audiences, locations, carriers, phone platforms and phone manufacturers. All ads are run on an auction-based pricing system. AdMob clients include ESPN, CBS, Geico and Starbucks.

AdMob offers advertisers a mobile landing page creation called Landing Page Builder for advertisers who want to enter the space but do not have mobile landing pages. AdMob recently launched a new product AdMonitor that shows live data of who is viewing mobile ads around the world.

Amobee
Amobee delivers a unified, telco-grade system for funding mobile content and communications through advertising revenues. Amobee dynamically inserts targeted, interactive advertisements into all types of mobile entertainment and communication channels, including videos, music, messaging, games, and WAP.

Enpocket
Enpocket, acquired by Nokia in 2007, allows brands to plan, create, execute, measure and optimize mobile advertising campaigns around the world. The Enpocket platform is a mobile advertising campaign management and delivery system distinguished by advanced consumer insight, targeting, and measurement. The platform can deliver mobile advertising across multiple formats including SMS, MMS, mobile Internet advertising, and video.

Greystripe
Greystripe's AdWRAP products provide mobile content free to consumers in an ad-supported model through the operation of an in-game mobile ad network and mobile game distribution platform. The ad network takes full screen images, videos, and scrolling banners and dynamically delivers them into mobile games and applications. Recently, Greystripe announced that it is launching an iPhone 3G API for game developers.

JumpTap
JumpTap reaches over 150 million mobile subscribers through partnerships with 17 mobile operators and numerous content publishers, JumpTap's search and advertising solutions enable carriers to maintain a position in the mobile marketing value chain, drive traffic and revenue opportunities to content publishers, and give advertisers access to targeted customers.

Medio Systems
Medio Systems is a provider of mobile search and advertising solutions. Created specifically for mobile, Medio Mobile Search combines a user interface with recommendation and personalization technologies. Using the targeting capabilities of the mobile search platform, the Medio MobileNow Search Advertising Network enables advertisers to identify and reach interested audiences. Through Medio's unique partnerships with mobile carriers and publishers, ads are integrated into the consumer mobile search experience where increased relevance drives response.

Millennial Media
Millennial Media is a mobile media network that specializes in the "millennial" audience. With Millennial Motion rich media for engaging user experiences, the MBrand network for targeted audiences across premium content and Decktrade for performance-driven campaigns, Millennial Media has a broad advertising offering.

MoVoxx
MoVoxx is an interactive advertising agency focused on mobile advertising via SMS/text. Solutions offer traditional and interactive agencies, media buyers and brand managers a quick, silent way to have a 1-to-1 dialogue with mobile consumers. INTXT allows advertisers to append ads to the outgoing SMS messages of MoVoxx Publisher Network traffic, creating a method of instant mobile distribution. Ads can be targeted by geography, daypart, and content channel. INADS enables advertisers to build their own mobile inventory through keyword/shortcode placements within their existing advertisements - print, TV, radio, Internet, or in-venue. This product helps leverage existing ads with an interactive call to action and a method for success reporting.

mSnap
mSnap is a mobile ad network, enabled by a platform for Broadcasters and Advertisers to easily create and manage mobile campaigns. The mSnap Network currently includes over 650 broadcast media partners, with the potential to reach over 200 million mobile users a week. Through exclusive relationships with broadcast partners like Citadel/ABC, the company offers the ability to target mobile ad campaigns locally or nationally, and by numerous demographic and interest-based criteria. Broadcasters can mobilize their programming, making it more interactive, engaging and measurable. SMS traffic can be monetized while increasing listener/viewer engagement and interactivity.

Quattro
Quattro is a mobile ad network that provides targeted, interactive multi-media mobile ad units (Video, SMS, WAP, click-to-call, email, share) all tracked in real time. For publishers, the company offers its proprietary Juicing technology (allows publishers to run wired assets on wireless devices without feeds), handset expertise, and interactive feature sets.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

2009 Online Payment Outlook

2008 proved to be another strong year for online payment platforms, especially PayPal, which saw revenue in the first nine months of the year grow 32% Y/Y, compared to 30% in F'07, with the unit's off-eBay business posting particularly strong growth. Further, in October 2008, eBay acquired Bill Me Later for nearly $1B. In Latin America, Mercadolibre has seen strong growth in its payment business and has rolled out direct payment features in several countries, including Argentina. In China, Alipay has continued to grow rapidly, as well, adding stores and users to its portfolio. We expect growth to continue in 2009, helped by:

- Continued global e-commerce growth, helped by increased global broadband penetration;
- The growing acceptance of payment solutions on third-party platforms, including travel sites;
- Increased use of mobile money transfer platforms helping drive revenues for those with a presence in the market, such as PayPal and Amazon Payment (through its relationship with Textpayme); and
- Increased fee generation from deferred payment plan options, which are particularly attractive in developing markets.

At the same time, we see several challenges to the Payment space, which may cloud the outlook somewhat.

- Although we expect eCommerce to continue to win wallet share from offline shopping, the challenging environment could significantly hamper growth.
- A tough credit environment may likewise dampen the growth in the segment derived from improved financing options.

Key Highlights from 2008

This past year was a successful one for online payment companies. Both PayPal, which benefited from strength in its off-eBay business, and MercadoPago, Mercadolibre's Latin America Payment platform, saw faster revenue growth through the first nine months of F'08 than F'07. Some key events in 2008:

- PayPal continued to add buyer protection features, raising the dollar value of purchases insured for eBay buyers paying with PayPal. The company also bought FraudSciences in January to improve fraud prevention.
- eBay started pushing for mandatory or near-mandatory acceptance of PayPal on its site, including a short-lived attempt to make it fully mandatory in Australia, which encountered regulatory difficulties.
- MercadoPago continued the rollout of its MercadoPago 3.0 platform, with Argentina the most recent and largest geography to begin using the service.
- eBay acquired Bill Me Later for $945M, with plans to integrate the offering more fully into PayPal.

- Alipay announced several sizable merchant deals, including Amazon and Giant Interactive, and reported, as of August, that it had 100M users and processed over 2M daily transactions; over 460K merchants now accept the service.

Global eCommerce Growth Expected to Slow

We expect online payment portals to benefit from eCommerce continuing to take wallet share away from offline channels in 2009 in both the U.S. and global markets; we continue to see rising broadband penetration as a key catalyst of eCommerce growth, and we expect eCommerce growth to flow through to higher usage of online payment services.

While we expect the overall retail environment in the U.S. to remain weak, we expect online retailers to benefit from the continued shift of retail dollars online, driven by (1) increases in product selection, (2) continued Y/Y online sales improvements for brick-and-mortar retailers, (3) volatility in the offline retail space and (4) further improved efficiencies from site optimization.

Our international forecast is driven by (1) continued rises in online shopping penetration, especially Western Europe, (2) continued investments by online retailers in broadening selection, (3) improvements in shipping infrastructure, (4) improved payment systems and (5) better fraud protection.

Table 34: J.P. Morgan Global eCommerce Projections (Excluding Travel)

$ in millions

Global eCommerce Forecast	2004	2005	2006	2007	2008E	2009E	2010E	2011E	'08E – '11E CAGR
US	88,780	106,851	128,708	151,443	160,563	168,270	187,958	207,505	8.9%
Europe	52,430	72,690	96,631	123,698	152,537	140,740	170,942	198,200	9.1%
Asia	31,972	43,054	55,556	69,705	90,585	112,573	127,949	139,617	15.5%
ROW	9,440	13,216	18,502	25,903	34,970	41,963	55,811	73,113	27.9%
Total	182,622	235,811	299,397	370,749	438,655	463,546	542,660	618,435	12.1%
Y/Y Growth		*29.1%*	*27.0%*	*23.8%*	*18.3%*	*5.7%*	*17.1%*	*14.0%*	

Source: Department of Commerce, Internet WorldStats, UK eStats, Forrester Research, Iresearch, Korea National Statistics Office, Japanese Statistics Bureau, eMarketer, PhuCusWright, TIA.org, Jupiter, company reports, J.P. Morgan estimates

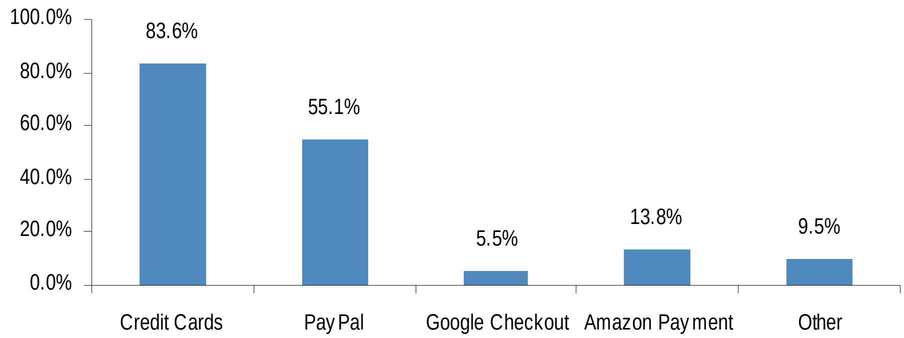
PayPal Remains the Largest Online Player; Still Trails Credit Cards

According to our proprietary survey, 55% of online shoppers use PayPal, compared to 6% who use Google Checkout and 14% who use Amazon Payment. Although the number of people who reported using all three payment services was quite small, among them a 57% majority reported that PayPal was their preferred service.

Credit cards remain the preferred method for online shoppers, with 84% stating that they use credit cards to make online purchases; the results were very consistent with the findings of our survey a year ago, when 83% noted using credit cards and 55% noted using PayPal. Unsurprisingly, PayPal's penetration was even higher among those who said they had sold on eBay in the past: 78% of such respondents were PayPal users.

Figure 33: Payments Methods Used by Online Shoppers

% among respondents who stated they shop online



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Online Payment Providers Offer a Viable Alternative to Other Payment Options

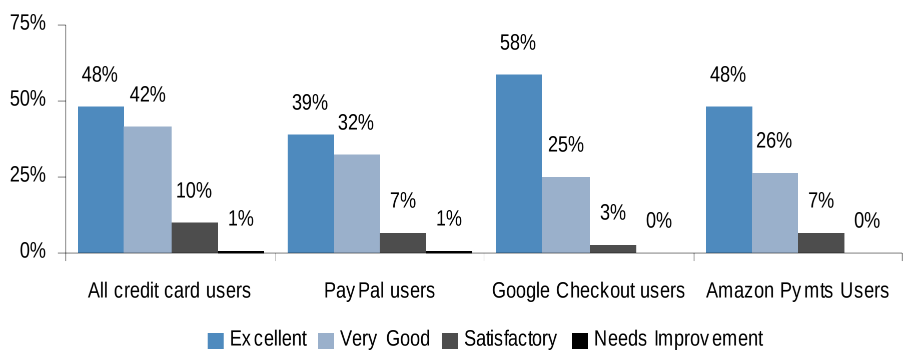
Users Are Still Driven to Online Payment Options Despite Strong Satisfaction with Credit Cards

PayPal, as well as Amazon Payment and Google Checkout, have been able to make inroads into the online retail business despite 89% of online shoppers who use credit cards rating their experience as either excellent or very good.

It doesn't appear that dissatisfaction with credit cards is the catalyst for growth for the third-party online payment platforms. Even users who are happy with credit cards are still choosing other options some of the time. Among respondents who used both credit cards and an online payment service, credit cards received one of the top two ratings ("Excellent" or "Very Good") 90%+ of the time.

Figure 34: Online Shoppers' Satisfaction with Credit Cards for Users of Online Payment Services

% of online shoppers who use the selected payment option



Source: J.P. Morgan Internet Team 2008 Consumer Survey

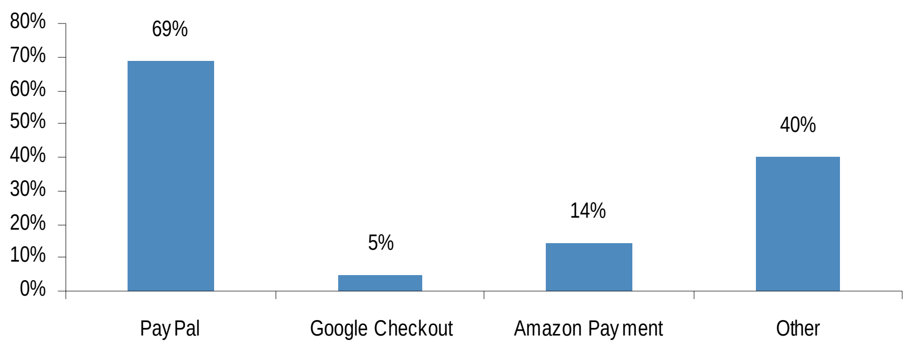
% among all shoppers who use the payment method; may not add to 100% due to online payment users who don't use credit cards.

Among online shoppers who do not use credit cards, PayPal is the prevalent method, with over 70% of those saying they used the service.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 35: PayPal Dominant among Shoppers Who Eschew Credit Cards

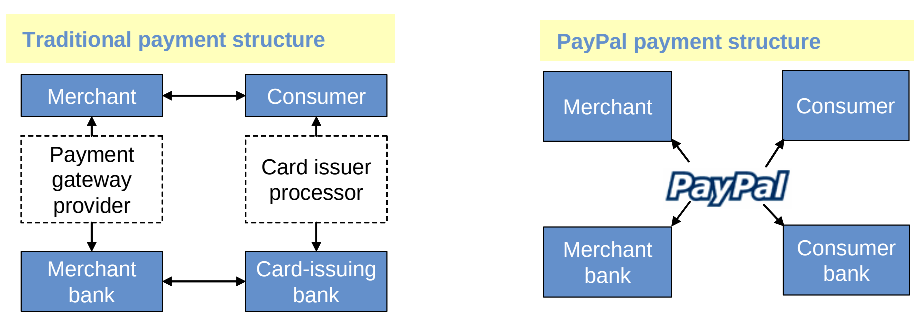
% of online shoppers who don't use credit cards who use the selected payment option



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Given the high level of satisfaction with credit cards, we find it remarkable that online payment services have been able to establish significant footholds online. We believe online payment services offer users security and ease-of-use advantages over credit cards, including eliminating the need to enter credit card numbers. Extending beyond eCommerce shoppers, online retailers can benefit from lower total transaction costs and P2P users benefit from lower costs and the added security benefit from not having to share personal financial information, such as bank account numbers.

Figure 36: Online Payment Providers Simplify the Payment Process



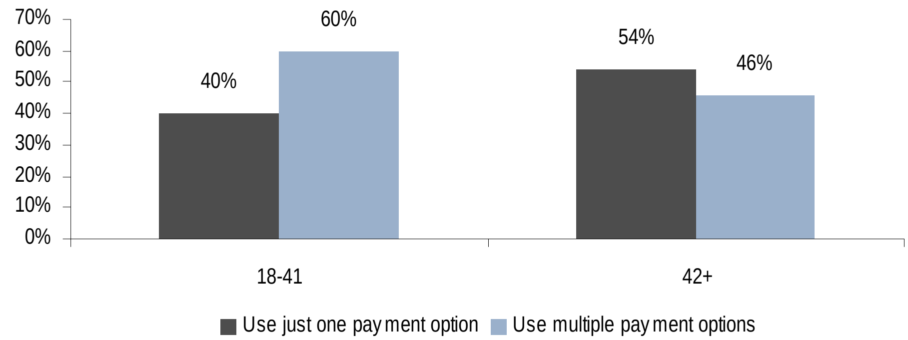
Source: J.P. Morgan.

Younger Users Are More Likely to Use Online Payment Providers

Our proprietary survey revealed that younger users are more likely to be comfortable with more than one method of payment: nearly 60% of online shoppers in our survey between the ages 18-41 reported having used multiple payment choices (e.g., both credit cards and Google Checkout), compared to 46% among those older than 42.

Figure 37: Younger Users Choose More Payment Options

% of online shoppers who selected a single payment provider, vs. those who chose more than one

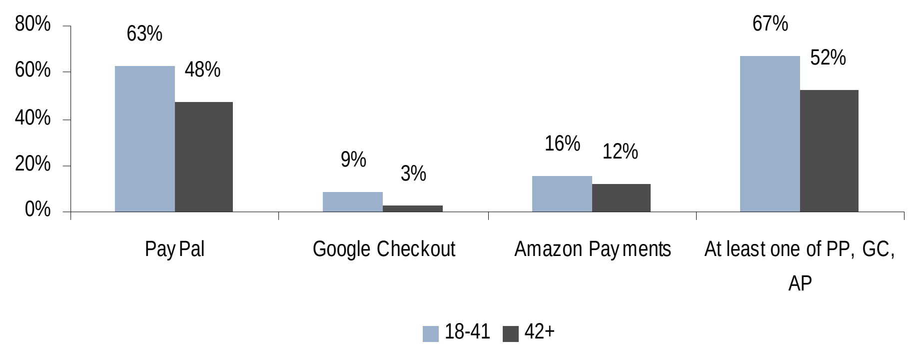


Source: J.P. Morgan Internet Team 2008 Consumer Survey

Additionally, younger users had a higher rate of use at each of the three online payment service providers we asked about, with Google Checkout in particular showing a higher penetration rate among the 18-41 set in our survey, vs. those older than 42.

Figure 38: Online Payment Services Have Higher Penetration among Younger Users

% among online shoppers in each age group



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Key Features of Current U.S. Online Payment Providers

PayPal

PayPal expanded its merchant portfolio in 2008, adding several more airlines such as Delta and JetBlue, as well as new merchants including Blockbuster Video and American Eagle, which ranked 35 and 59, respectively, in Internet Retailer's 2008 Top 500 list. PayPal is now offered by thousands of merchants around the world. PayPal offers a money market account for deposits, financing options and P2P money transfers. Additionally, PayPal made two notable acquisitions in the year, adding FraudSciences to help improve buyer protection – the company now offers unlimited buyer protection for certain on-eBay purchases – and paying $945M for Bill Me Later to add a financing option to its payment portfolio.

In 3Q'08, PayPal for the first time saw more than half of its TPV come off the eBay site, and its Merchant business continues to grow at a faster rate. We expect 2009 to

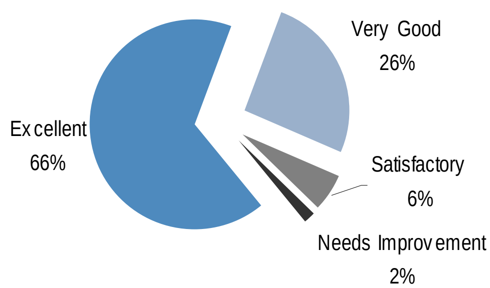
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

be another strong year for PayPal as it grows its international and Merchant businesses and are forecasting transaction volume to increase 18% Y/Y to $72B.

Users in our survey reported a high level of satisfaction with PayPal, with nearly two-thirds of users calling it "Excellent."

Figure 39: Majority of PayPal Shoppers Rate It Highly

% among online shoppers who use the service



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Table 35: PayPal Fee Structure

Description	Personal Account	Premier/Business Account
Fee for a buyer to make a purchase	Free	
Fees for specific actions		
Open an Account	Free	Free
Send Money	Free	Free
Withdraw Funds	Free for bank accounts in the US	Free for bank accounts in the US
Add Funds	Free	Free
Receive payments funded by PayPal Balance, PayPal Instant Transfer or PayPal eCheck	Free	1.9% to 2.9% + $0.30 USD
Receive payments funded by Credit Card, Debit Card or Buyer Credit	4.9% + $0.30 USD (limit of 5 transactions per 12 month period) for domestic or U.S. transactions 2% + applicable Fees for cross border payments 4.9% plus $0.30 USD for card payments received using PayPal on Skype	1.9% to 2.9% + $0.30 USD
Multiple Currency Transactions	Exchange rate includes a 2.5% fee	Exchange rate includes a 2.5% fee

Source: www.paypal.com

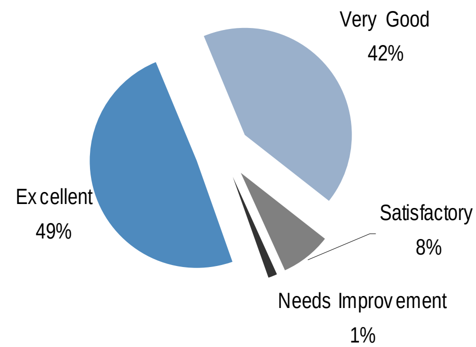
Amazon Payments

Amazon rolled out its Amazon Payments Service in 2007. Amazon Payments offers P2P money transfer options. Amazon Payments is also integrated with Amazon Web Services to help developers accept payments more flexibly.

As with PayPal, an overwhelming fraction of users reported a high level of satisfaction with the service:

Figure 40: More than 90% of Amazon Payments Users Called It "Excellent" or "Very Good"

% among online shoppers who use the service



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Table 36: Amazon Payments Fees

Fees to send payments	Fees		
Sending Payments	No fees		
Fees to receive payments (by payment method)	**less than $0.05**	**$0.05 to $9.99**	**$10.00 and more**
Bank Account	2% of T V + $0.05	2% of T V + $0.05	2% of T V + $0.05
Credit Card	5% of T V + $0.05	5% of T V + $0.05	2.9% of T V + $0.30
International Credit Card	6% of T V + $0.05	6% of T V + $0.05	3.9% of T V + $0.30
Amazon Payments stored funds	20% of T V, minimum fee of $0.0025	1.5% of T V + $0.01	1.5% of T V + $0.01

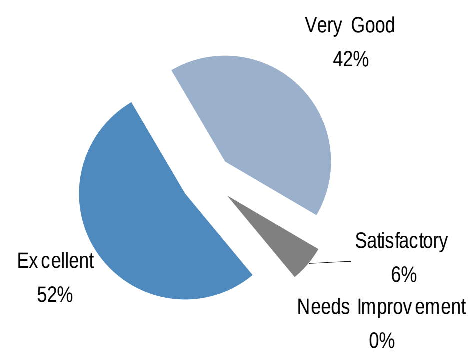
Source: payments.amazon.com

Google Checkout

Google Checkout is now available on hundreds of Internet retail sites. Google AdWords advertisers are offered discounted processing rates. Google Checkout does not currently offer P2P money transfer services.

Figure 41: More than Half of Google Checkout Users Called It "Excellent"

% among online shoppers who use the service



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Table 37: Google Checkout Fees

Description	Fee
Fees to use Google Checkout to process sales	2% + $0.20 per transaction.
AdWords advertisers are also eligible for free transaction processing for some or all of the Google Checkout sales each month.	For every $1 spent on AdWords each month, an advertiser can process $10 in sales the following month for free through Google Checkout.

Source: www.google.com

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

2009 Social Networks Primer

Key Takeaways

- **Runaway usage growth continued in 2008**. Of the major sites, Facebook and LinkedIn posted the most impressive usage growth, and across the group of social networking sites, user minutes worldwide grew 30%+, according to comScore data. And while its overall usage growth was not as rapid, Classmates posted a solid rise in paid accounts, up 37% Y/Y in the most recent quarter.

- **Not a fad – a technology that solves users' problems**. With another year of rapid growth behind us, there remains little doubt that there is very strong demand by users for the kind of interaction offered by social networks. We believe the sites' gains in usage share, partly at the expense of email sites, demonstrate user needs are being better met.

- **Monetization remains tough nut to crack**. Thus far, the problem of how to monetize all that traffic persists; CPMs did not see the hoped-for rise in 2008, and we are skeptical about monetization improvements in the near term. <u>We think social networking sites will need to expand beyond the advertising model in order to successfully drive monetization</u>.

- **Older users remain largely on sidelines.** Our proprietary survey indicates 75% of users aged 18-41 used social network sites, and only 35% among those aged 42 or older. Further, whereas 40% of social network users 18-41 reported visiting the sites at least 20 times a month, older users tend to be occasional users: in the 42+ group, 63% visited the sites 1-4 times a month.

Growth Remains Robust in 2008

The growth of social networks in 2008 remained very strong, with comScore estimating that minutes of usage across all worldwide social networking sites were up 32% Y/Y through the first nine months of the year.

Although the rising tide lifted most boats, Facebook was a particular beneficiary, and is now the leader in terms of worldwide unique users and time spent, both of which were up more than double at the site. In the US, MySpace remains the usage leader; MySpace unique users were 8% higher Y/Y through the first nine months of 2008, while minutes were 24% higher.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 38: Social Networks Users Are Growing Fast, and User Time Is Growing Even Faster

Y/Y growth in first nine months '08 vs '07; select sites

	Worldwide		US	
	Users, Y/Y	Minutes, Y/Y	Users, Y/Y	Minutes, Y/Y
Facebook	170.0%	137.5%	44.8%	31.2%
MySpace	9.7%	16.9%	7.8%	23.8%
Orkut	47.1%	14.5%	84.7%	82.1%
Friendster	57.5%	62.1%	32.5%	-6.7%
Hi5	66.4%	89.4%	22.6%	33.9%
Bebo	45.6%	-29.3%	36.1%	-54.6%
Classmates	-3.1%	13.7%	5.6%	20.0%
LinkedIn	127.3%	121.8%	170.4%	286.4%
All Social Nets	23.9%	32.1%	9.3%	9.3%
All Internet	14.3%	9.9%	5.6%	4.5%

Source: comScore Networks, J.P. Morgan estimates

Key Sites

Some of the notable social networking sites worldwide include:

- **MySpace**. Launched August 2003, the site was acquired by News Corporation in July 2005. MySpace's user base tends to tilt somewhat toward teens and is more US-based than the audience for any of the other big six. Also popular with musicians and bands.

- **Facebook**. Launched February 2004, the site remains independent but in October 2007 drew a $240M investment from Microsoft, which acquired a 1.6% equity stake. Microsoft also sells ads on Facebook. The site became open to non-academic users in September 2006.

- **Orkut**. Launched by Google in January 2004. The site has not taken off significantly in the US but is quite popular in Brazil as well as India and Pakistan.

- **Friendster**. Launched March 2003. In the US, the site has faded somewhat after being an early leader in the space, but it remains quite popular in Southeast Asia.

- **Bebo**. Launched January 2005. The site is popular in the UK and other English-speaking countries, including Ireland, as well as in Poland. In 4Q'07, it announced a partnership with AOL for integration of instant-messenger software; two quarters later AOL acquired Bebo for ~$850B.

- **Hi5**. Launched 2003. The site, though based out of the San Francisco Bay Area, maintains a base of popularity in Latin America as well as in some Asian countries.

- **Classmates.com**. A relative senior citizen in the space, launched in 1995. The site is now part of United Online, and traffic comes primarily from the United States. The site reported over four million paying accounts in 3Q'08, representing 37% Y/Y growth.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

- **LinkedIn**. Launched 2003. LinkedIn is focused on building professional networks, and, as such, the site has a somewhat more up-market demographic and has had somewhat greater success in selling its ad inventory at higher CPMs. LinkedIn also sells premium memberships.

Technology that Fits a Customer Need

We think much of the success of social networks is attributable, at heart, to the fact that they provide a superior technology for filling users' social needs more efficiently. In our 2008 Consumer survey, nearly 80% of social network users indicated that they use the sites to keep in touch with friends, and half noted that they use the sites to reconnect with old friends.

Table 39: Users Overwhelmingly Lean on Social Networks to Keep in Touch

% among users of social network sites; respondents could choose multiple answers

Function	% choosing
Keep in touch with friends	78.1%
Reconnect with old friends	50.5%
Share photographs	36.8%
Meet new people	29.9%
Plan social events	17.7%
Share music / find new music	15.2%
Play games	14.2%
Career networking	10.9%

Source: J.P. Morgan Internet Team 2008 Consumer Survey

When it comes to filling this user need, we believe social networks have two key competitive advantages over alternative methods of keeping in touch:

- **News feeds**. A news feed is a feature that enables users to see updates on their friends' lives, and vice versa, without needing to specifically contact each other. As any social network user updates his/her profile, those updates become visible to that user's circle of friends.

- **Built-in spam filter**. The promise of email is that anyone can contact you, and that has also become its curse. Many proposed spam solutions have focused on attempting to verify that the person contacting you is a friend, but social networks have a built-in verification system that allows one to ensure that the bulk of communication is from confirmed friends.

We continue to think social networks are taking away market share from email sites. Last year, we noted that comScore data suggested Y/Y declines in email usage in absolute terms. Through the first nine months of 2008, minutes spent on email sites are growing, though not as quickly as overall Internet usage:

Table 40: comScore Data Indicates Users Are Spending a Smaller Share of Their Time on Email Sites

Minutes of usage in millions

	Worldwide 9M'07	9M'08	Y/Y	US 9M'07	9M'08	Y/Y
Yahoo	43,565	41,842	-4.0%	21,327	21,256	-0.3%
Windows Live Hotmail	33,758	37,970	12.5%	9,425	10,633	12.8%
AOL Email	12,556	11,852	-5.6%	12,177	11,482	-5.7%
Google Gmail	6,351	7,814	23.0%	1,673	2,287	36.7%
All email	110,265	115,154	4.4%	47,025	48,440	3.0%
	The growth rate of email category is below industry growth rate, both in US and Worldwide					
All Internet	1,160,692	1,275,400	9.9%	310,837	324,762	4.5%

Source: comScore Networks, J.P. Morgan estimates

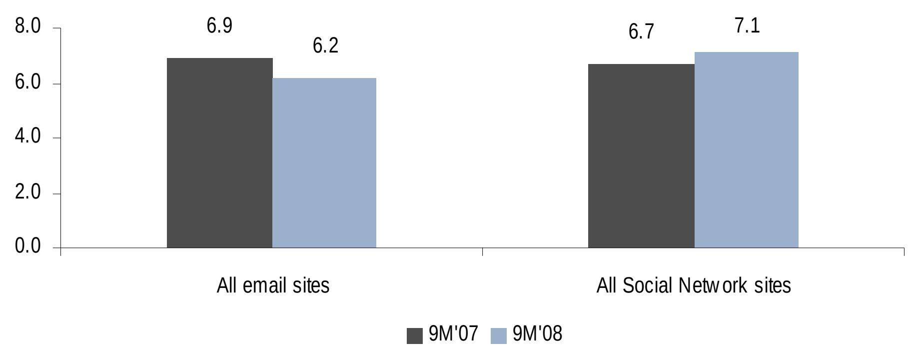
High User Engagement

Social network sites excel in their ability to keep users on the site: comScore data indicates that, across the universe of social networking sites, users spend an average of 7 minutes per day, a number that has grown Y/Y; the trend is headed in the other direction with email sites, which are drawing less user time.

The effect on email may be partly due to a loss of usage share to social networking sites. Additionally, part of the impact could be related to the sites' greater efficiency, driven by newer, Ajax-based email platforms.

Figure 42: Average Time per User Is Growing on Social Networking Sites and Shrinking for Email

Average minutes spent on site, per user per day



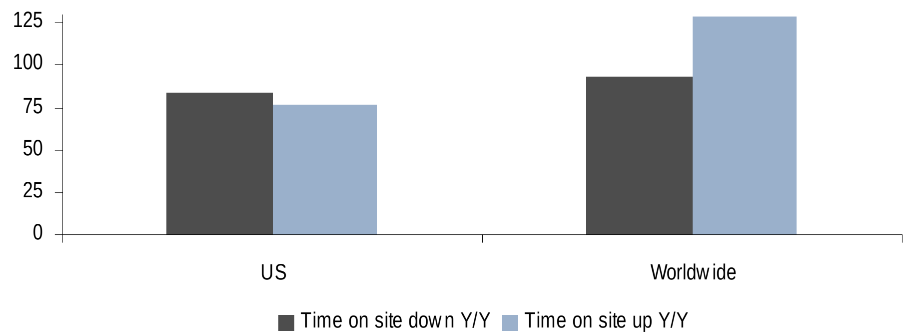
Source: comScore Networks, J.P. Morgan estimates

Space Remains Volatile

The social networking space remains quite volatile, suggesting other winners may emerge, and some current leaders may fade. Of the 220+ social networking sites ranked by comScore with worldwide time spent data from both 3Q'07 and 3Q'08, sites that grew usage Y/Y outnumbered those where usage shrank by a ratio of 4:3 – a surprisingly large number of decliners in a space where total minutes were up 39% Y/Y in the quarter.

Figure 43: Not Everyone's Winning: in the US, Slightly More Decliners than Advancers

Sites with Y/Y declines in total time spent in 3Q'08, among sites with data in both years



Source: comScore Networks, J.P. Morgan estimates

Classmates-style Sites Gain in Popularity in Eastern Europe

ComScore data suggests that some of the biggest gainers in the space were sites that operate on the Classmates metaphor: as sites that help users track down their former school friends.

Such sites appeared to do particularly well in Eastern Europe, with Poland's Nasza-klasa.pl ("our class") and Russia's odnoklasniki.ru ("classmates") seeing multi-fold usage increases; comScore estimates 3Q'08 worldwide time spent at the two sites was up almost 40x and 5x Y/Y, respectively.

In the U.S., where the Classmates model is more mature, the classmates.com site nevertheless appears to be ramping paid usage nicely, with 37% Y/Y growth in 3Q'08 to over 4 million paid accounts.

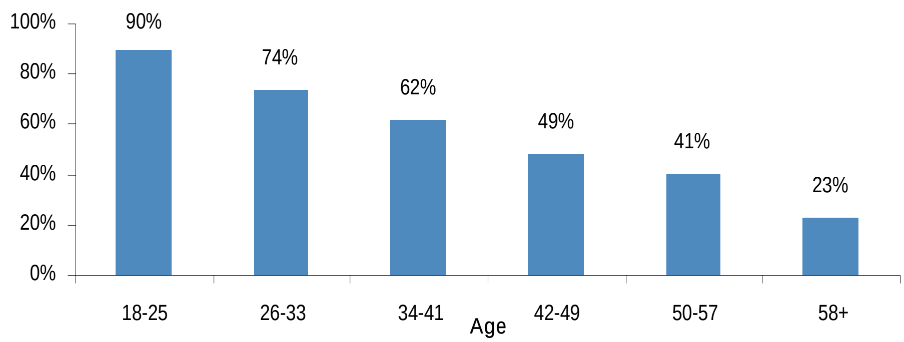
Survey Results: Older Users Remain on the Sidelines

Our November 2008 proprietary survey of consumers' Internet usage patterns reinforced the idea that social networking sites remain primarily the province of younger users. 90% of users aged 18-25 reported visiting a social networking site at least once a month, while only 35% of users 42 or older went to such sites. The results nevertheless represented an increase from the results of our 2007 survey, when only a quarter of users 42 or older reported visiting social networking sites.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 44: Younger Users More Likely to Visit Social Network Sites

% of users, in each age group, that reported visiting a social networking site at least once per month

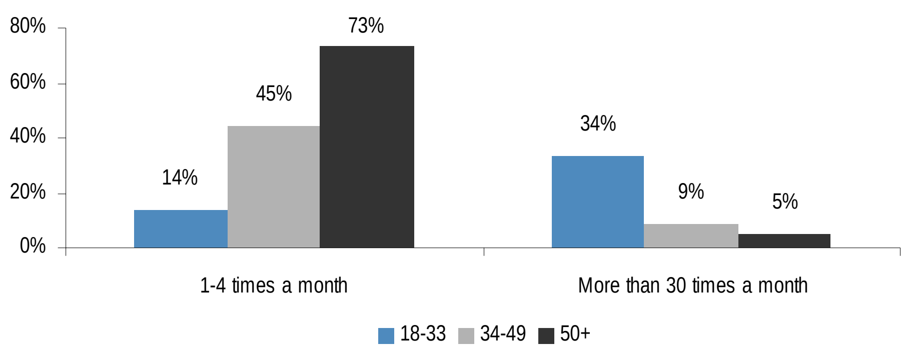


Source: J.P. Morgan Internet Team 2008 Consumer Survey

The age distribution tilts even more heavily to the younger segment due to different usage patterns. Even among the relatively smaller number of older users who reported visiting social networking sites, the majority visited them very occasionally. Among respondents aged 18-33, on the other hand, a third of those who said they visited social networking sites reported visiting once a day or more.

Figure 45: Younger Users Tend to Be Heavy Users; Older Users More Likely to Check in Occasionally

% among those who report visiting social networking sites



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Further, we note that our survey did not include users younger than 18, an age group that, on the whole, tends to be a very heavy user of social networking sites.

Privacy Concerns Overblown

Many social networking sites, especially Facebook, have faced public criticism for their use of user information. Whether or not these criticisms have merit, from an operational standpoint we believe concerns about privacy are unlikely to hamper the growth of sites. We think history suggests that users are willing to give up incremental information in exchange for features they find useful.

Additionally, we think the history of the rollout of news feeds on Facebook is extremely instructive: In September 2006, when the feature was first introduced, it was met with an uproar from users who cited concerns about privacy. In response, Facebook emphasized that users have the ability to opt out of the feature. A year later, the news feed is one of the central aspects of the Facebook interface, and other sites, including MySpace and LinkedIn, have added similar features.

We believe such flare-ups are likely to re-occur. Nevertheless, we believe the track record of social sites' development suggests users have a strong desire for expression and for an avenue to share what is going on in their lives – and the desire to share is stronger than the desire to hide. Features that meet users' need for expression are likely to catch on, in our opinion, even if they carry with them an incremental erosion of users' privacy.

Outside of Niche Sites, Monetization May Take Some Time

Social networking sites, as a group, have not been able to command very high advertising rates for their page view inventory; the supply of "bulk" page-view inventory from social networks was a contributing factor to the stagnating CPMs for graphical ads over the last two years, and we do not believe demand has yet caught up with this supply.

Further, despite a significant degree of effort expended to improve monetization, improvements have been hard to come by, and one of the most successful monetization strategies appears to be to get a guarantee from a search partner, such as MySpace's $900M partnership with Google. We doubt this can be a successful long-term strategy, however. Google may not offer similarly favorable terms when the deal comes up for renewal in April 2010.

As time goes on, we think social networks will develop better targeting and monetization of their page view inventory. Given the wealth of personalized information available to the sites, there is a road map for improved monetization. Nevertheless, the technology remains fairly nascent, and we think the current environment is quite unfavorable for sites without a proven track record to try to attract graphical advertising.

Although both MySpace and Facebook have had success generating display ad revenue ($341M in CY'07 display revenue at FIM; press reports put total '07 revenue at Facebook of $150M), we continue to expect these sites to have trouble growing their effective CPMs over time.

Alternatives to the Ad Model May Prove Fruitful

Beyond the continued (and thus far minimally effective) push to raise CPMs, we think several other alternatives to the ad-based model exist for social networking. Several sites have pursued one or more of these:

- Virtual goods. A site can sell "items" that users send to one another, e.g., a virtual bouquet of flowers on Valentine's Day or a virtual balloon for graduation. Such goods are also popular on some virtual world sites.

- Paid Premium memberships. Sites like LinkedIn and Classmates.com offer these; at LinkedIn, paid accounts have greater access to users outside their immediate network, whereas at Classmates the premium memberships entitle users to have greater communication privileges with other members as well as a variety of other perks. As of 3Q'08, subscription revenue represented ~64% of the total revenue for UNTD's Classmates segment.

- Classifieds. Unlike a normal classified site, the level of trust can be higher because buyer and seller can see the link between them. In our 2008 Internet survey, social network users were users of classified sites at a higher rate than those who had not used social network sites. Classified advertising is rapidly migrating online from newspapers, and the NAA estimates the newspaper classified market, over $14B in F'07, declined 28% Y/Y through the first nine months of F'08.

- eCommerce. Sites may try to use the personal data available to them for better-targeted eCommerce. Even though we are usually skeptical of the salience of privacy concerns, we think direct sales could prove difficult. Further, "Recommendations from friends/relatives" has been the least popular factor driving shoppers to pick a store in both years of our Internet survey, with only 21% ranking it in their top 5 factors in 2008. That said, even a small sliver of the eCommerce market, which we project at $460B worldwide in F'09, could be valuable.

- A la carte paid features. Sites may offer the ability to, e.g., post a limited number of photos for free, and a large quantity (or at a higher quality) for a paid membership.

- Lead generation. For users who have uploaded photos, a site may try to form a partnership with a printer to enable quicker ordering of prints. A site may partner with iTunes or Amazon to enable users to buy MP3s shared by their friends.

- Paid applications. Thus far, social networks have welcomed apps onto their platforms in order to build user engagement. In the future, social sites may try to charge the operators of the apps for access to the networks' superior stream of traffic. Alternatively, they may make the applications paid-for by users, and split the revenue with the app developers.

Online Music Primer

Online music landscape changed in '08

As iTunes continued to dominate online music distribution, some of its competitors appeared to have re-thought the attractiveness of the stand-alone subscription-based model. In the course of '08, Yahoo! discontinued Yahoo! Music, and Napster introduced DRM-free downloads and subsequently was acquired by Best Buy. The other significant remaining player, Rhapsody America, the joint venture between RealNetworks and MTV Networks, remained committed to growing its online subscription music business and stepped up promotional spending.

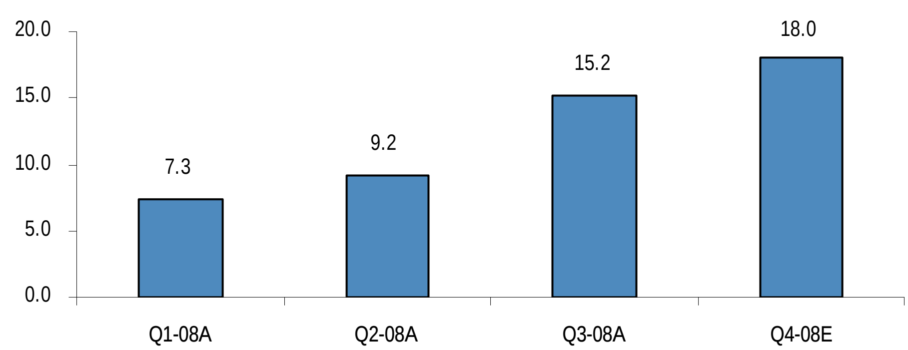
Yahoo! Music Discontinued
The service, which was launched on May 11th, 2005, was discontinued on September 30th, 2008. Yahoo! Music subscribers could choose to transfer to a Rhapsody America subscription. However, as RealNetworks commented on its 3Q'08 earnings call, the number of subscribers actually migrating to Rhapsody was below expectations.

Napster Acquired by Best Buy
Napster added DRM-free downloads to its subscription offering in May '08. On September 14, 2008, Best Buy and Napster signed a merger agreement; the acquisition closed on October 30, 2008.

Rhapsody America Remains Committed to the Business Model
Rhapsody America, the joint venture between RealNetworks and MTV Networks, remained committed to the online music subscription model. As Yahoo! Music was discontinued and Napster agreed to be acquired by Best Buy, Rhapsody increased promotional spending aimed at growing its subscriber base.

Figure 46: RealNetworks Continues to Spend on Promoting Its Subscription Offering

$ in millions



Source: Company reports and J.P. Morgan estimates. Represents advertising on MTV Networks.

Launch of MySpace Music Shifts Focus to Social Networks

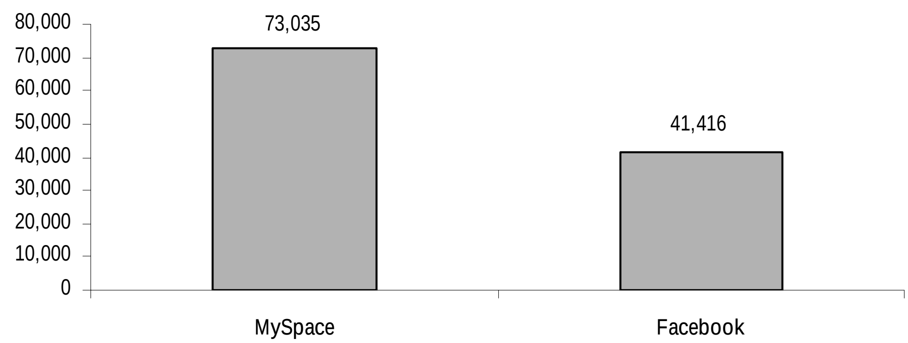
On September 25, 2008 MySpace launched MySpace Music, a joint venture between MySpace and four major music labels, including EMI Music, Universal Music, Sony BMG and Warner Music. The offering includes free unlimited streaming and song

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

downloads to own through Amazon MP3. Free streaming music will be monetized by selling advertising.

We believe the launch of MySpace Music will put additional competitive pressure on subscription-based offerings, particularly on Rhapsody America, as availability of a free substitute to a large potential user base will impact subscriber acquisition (Rhapsody offers 25 free streams a month to Facebook users before requiring a subscription).

Figure 47: MySpace Music Reaches 73 Million Monthly Unique Visitors in the US



Source: comScore Media Networks.

Pure Play Music Distribution Model Will Likely Continue to Face Challenges in '09

We remain cautious on the outlook for pure play subscription music offerings in the coming year:

- We continue to believe hardware as opposed to software is where margin gains will be seen, as illustrated by a positive margin for iPod and near breakeven profitability of iTunes.

- Launch of MySpace Music with its advertising supported unlimited streaming adds another competitive headwind in the market which already is dominated by iTunes.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Online Music Distribution Landscape

The table below contains main online music offerings as of year-end '08.

Table 41: Online music offerings

Company	Description
AllOfMP3 & MP3Sparks	AllOfMP3 and MP3Sparks are prepaid online music download store operated by Mediaservices, Inc. Since June 17, 2008, the original AllOfMp3 site has been closed and replaced by a blog due to certain legal issues, but the MP3Sparks is still a fully operational music download store.
Amazon MP3	Amazon MP3 is a music download service offering DRM-Free MP3 formatted over 5 million songs and albums.
Audio Lunchbox	Audio Lunchbox is a music download service, with more than 2 million songs, all in DRM free MP3 format. Each album page includes the artist, label, genre and release.
BuyMusic	BuyMusic is a music download service, with 1 million songs in catalog.
eMusic	eMusic is a subscription-based music download service that offers more than 4.5 million DRM-Free MP3 formatted titles. Unlike most subscription services, the songs you download can be used anywhere you like. Even if you cancel your subscription, there is no expiration date on your music.
Facebook Music	The Facebook Music Service was launched in August 2007 but was quickly slated. However, according to press reports, Facebook is talking to a number of song-streaming services and music community sites that own licenses to distribute music or have a proprietary service, including Rhapsody, iMeem, iLike and Lala, about an outsourcing deal that would more deeply integrate their music experience into Facebook.
IMeem	IMeem is a music download service. Users, once registered, can stream as many on-demand songs as they want for free without running into any sort of playback limitations.
iLike.com	iLike is a website that allows users to download and share music, a website still in a beta version, but is open to anyone.
iTunes	iTunes is a music download service. It has a free software application for Mac and Windows with most of its music downloaded coming in an AAC format, which only plays on the iTunes Digital Jukebox or on an iPod. Although Apple is in negotiations with the music studios to open their file formats, their current selection of MP3 DRM free music, known as iTunes Plus, is limited.
Lala	LaLa offers music download service; users can play any song only once by registering. After the song has been played once, they must purchase it to play it again.
MSN Music	MSN's music purchasers are being redirected to either the Zune Marketplace or to RealNetworks' Rhapsody site, starting November 14, 2006.
Myspace Music	MySpace Music is a new digital service joint venture between MySpace and big four media companies - EMI Music, Universal Music, Sony BMG and Warner Music - announced on April 3, 2008. MySpace Music offers 5 million songs for free web streaming or for purchase.
Napster	Napster offers download and subscription service with more than 6 million DRM free MP3 formated songs. On Sep 15, 2008, Best Buy acquired 90% stake in Napster for $121 million
PayPlay.FM	PayPlay.FM is an independent music download site that offers DRM protected WMA and DRM free MP3 titles. PlayPlay specializes in independent music and has about 2 million songs.
Puretracks	Puretracks is a music download site. It has about 1.3 million songs in WMA and MP3 formats, and many of the albums do not include biographies. Originally a Canadian site, but now offers in U.S.
Rhapsody	Rhapsody offers subscription and download options. The newest addition to the Rhapsody family is the MP3 Store. All tracks and albums sold in the MP3 store are DRM-Free and can be used anywhere. Rhapsody has more than 5 million titles in its library.
Wal-Mart Music	Wal-Mart Music Store is a music download service. It offers more than 2.5 million MP3 formatted tracks. Wal-Mart's MP3 model ensures all popular media players will work with its service, including iPod and Zune.
Yahoo Music Unlimited	Yahoo! Music Unlimited was an on-demand, online music service launched on May 11, 2005 and provided by Yahoo! Music. The service was discontinued on September 30th, 2008. Existing subscribers are being migrated to Real Rhapsody.
Zune Marketplace	Zune Marketplace offers subscription and download options with more than 3 million songs. Most songs are available in protected ZPL format, meaning they are only compatible with Microsoft's Zune player. Zune does have a small selection of DRM-Free tracks.

Source: Company websites, Wikipedia, music-download-review.toptenreviews.com.

The Challenges for Online Video

Online video, like social networking, is an Internet medium that has taken off in terms of consumer usage but has left publishers and advertisers struggling with how to monetize it. We think both performance-based marketers and brand advertisers are looking at three variables in determining their investment: reach, content quality, and performance measurability. Current video advertising formats do not appropriately address the three variables, in our view.

Performance-based Marketer Interest Is Limited
Performance-based marketers are solely focused on a measurable return on investment. However, most video ads follow the cost-per-thousand (CPM) model rather than the CTR models (including search or cost-per-action based display). As such, many performance-based advertisers tend to avoid video advertising, and we think investment in the video platform will be very limited throughout this economic recession. Additionally, we expect Google to invest in a performance-based model to monetize YouTube.

Video Presents Many Challenges for Brand Advertisers
Online video viewing is large and still growing at a very rapid pace, with 16.5B minutes spent viewing videos on the top 10 video sites in September 2008, and organic growth of minutes viewed at the top 10 sites reaching 38% Y/Y (this excludes Hulu and Turner Network, as we had no historical information). In fact, as of September 2008, the Top 10 online video sites accounted for over 5% of total minutes spent online.

Table 42: Top Ten Video Properties by Minutes Viewed, Sept. 2008
minutes in millions

		Jul-2007	Aug-2007	Sep-2007	Jul-2008	Aug-2008	Sep-2008	3Q Y/Y Growth
1	Google Sites	6,698	7,105	7,175	12,758	12,655	12,139	79.0%
	YOUTUBE.COM	6,253	6,710	6,830	12,493	12,375	11,979	86.2%
2	MEGAVIDEO.COM	...	73	159	609	804	745	829.1%
3	HULU.COM (hybrid)	...	...	...	489	537	686	NA
4	Fox Interactive Media	846	825	674	516	465	567	-34.0%
5	Viacom Digital	777	719	860	456	472	476	-40.4%
6	ZSHARE.NET	112	106	145	208	483	437	210.7%
7	Yahoo! Sites	1,013	1,112	935	501	415	418	-56.4%
8	Microsoft Sites (hybrid)	353	330	312	471	463	402	34.3%
9	Turner Network	...	...	...	339	373	385	NA
10	VEOH.COM	662	521	556	323	266	227	-53.1%

Source: comScore data

However, publishers have a difficult, if not impossible, time guaranteeing viewership for any specific video the way television does in the upfront model. Often, it is very unpredictable as to which video will be popular. This makes it difficult for publishers to determine pricing and for brand advertisers to strategically invest in videos to meet their content quality requirements, demographic profiles and reach targets.

Content Quality Is Inconsistent

Many video sites are plagued with videos of varying quality and copyright violations. Perhaps best known of these is YouTube, which faced a $1B lawsuit by Viacom and

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

is also known for its home video quality blooper videos. We think the spottiness of video quality is severely limiting advertiser interest. In the case of copyrighted material, advertisers must wait to access this inventory until agreements are reached between the publisher and third-party websites over use and monetization arrangements.

On non-copyrighted videos, we think advertisers are too concerned about the quality of content and untargeted nature of the videos to advertise. For example, the Top 10 YouTube videos viewed as of December 1, 2008 included clips such as Britney Spears, Akon, PreGame Lobby LOL, and Wal-Mart Worker Trampled to Death. As we believe brand advertisers are very cautious to have their brand placed next to content that clearly reflects the brand identity and message and conveys brand values, we find it unlikely that brand advertisers would be attracted to these videos despite the reach.

Table 43: Top 10 Most Viewed YouTube Videos, December 1, 2008

Most Viewed YouTube Videos, 12/1/2008
Real HQ - Britney Spears Womanizer live at X-Factor
Akon - Right Now (Na Na Na)
See You Again
PreGame Lobby LOL of the Day 6
Gundam 00 S2 Episode 9 2/3
Wal-Mart Worker Trampled to Death?!?!
Michael Hirte - Ave Maria
Pablo Banila Parody
Runescape - Soloing Tormented Demon
Das Supertalent 2008 - Michael Hirte - Stille Nacht

Source: YouTube

Performance Measurement Is Difficult

Many online video sites have experimented with video pre-rolls, post-rolls, advertising breaks in the video, and advertisements running concurrent with the video at the bottom of the screen. So far, no advertising format seems to be widely accepted by users, publishers, and advertisers. Additionally, we think most of the ads are shown on a cost per thousand (CPM) basis.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Widgets: Popularity Is Growing, but Can It Be Monetized?

Ever since the opening of the Facebook platform, there seems to have been an explosion of widgets available to Internet users. According to comScore, more than 81% of Internet users in the US viewed widgets in November 2007. So what exactly are widgets? Widgets are simple, short pieces of code that can easily be dragged onto a desktop or pasted into a personal page. The code allows the user to aggregate data from multiple sites in one place, where the information is updated regularly. Widgets range from Slide and RockYou, which allow users to create a slide show of photos complete with special effects and music and then paste it onto their own site, to simple widgets that update weather and stock quotes on users' computers.

Fragmentation Fuels Widget Demand

Historically, portals served users' need for aggregation of content in one place. On Yahoo!, MSN, or AOL, a user could obtain the latest in news, sports, email, and entertainment. However, users' Internet savvy has greatly increased since the advent of the Internet, and today's users want to personalize their web experience and find deeper more relevant information to suit their needs. This trend has led to the creation of a multitude of niche sites, blogs, and social networks. This fragmentation is apparent in how users are spending their time online. In September 2003, users spent 39% of their time online looking at the top 3 websites. However, in 2008, the top 3 websites' share of minutes online fell to 27% as users began surfing the long-tail.

Table 44: The Top 3 Websites Account for 12% Fewer Minutes Online from 2003-2008

millions

	Sep-03	Sep-08
Yahoo! Sites	28,898	44,336
AOL LLC	47,898	22,080
Microsoft Sites	19,229	20,899
Total Top 3 Properties	96,025	87,315
Total Internet	244,121	321,067
% of Total Min	39%	27%

Source: comScore data and J.P. Morgan estimates

Widgets allow users to aggregate data from web sources of their choosing onto their own personalized web page through the pasting of simple code snippets into the web page code.

Volume Is Attractive to Advertisers…

Widget usage is reaching a level of scale which has begun to attract advertiser interest. MySpace.com widgets had the widest audience in November 2007, reaching 32% of the total US Internet audience. Slide.com ranked second with 39.2M viewers and Google had the sixth widest widget-viewing audience with more than 19M viewers, according to comScore data.

Table 45: Top US Web Widget Viewing Audiences, November 2007

units as indicated

Widget	Unique Viewers (000)	Penetration of US Internet Audience
Total US Widget Viewers	147,904	81.1%
MySpace.com - Widget	57,747	31.7%
Slide.com - Widget	39,213	21.5%
Clearspring.com - Widget	39,159	21.5%
RockYou.com - Widget	32,557	17.9%
Photobucket.com - Widget	26,434	14.5%
Google.com - Widget	19,436	10.7%
BunnyHeroLabs.com - Widget	16,123	8.8%
MusicPlaylist.us - Widget	15,844	8.7%
MyPlaylist.org - Widget	15,586	8.5%
BlingyBlob.com - Widget	14,967	8.2%

Source: comScore Widget Metrix and J.P. Morgan estimates

Widgets are also uniquely suited to use on mobile technologies, given that their form factor is a fit for small screens. Widset has over 6M registrations and offers a selection of 4,500 widgets. Opera and Yahoo! also offer mobile widgets.

…But Ad Monetization Is Difficult

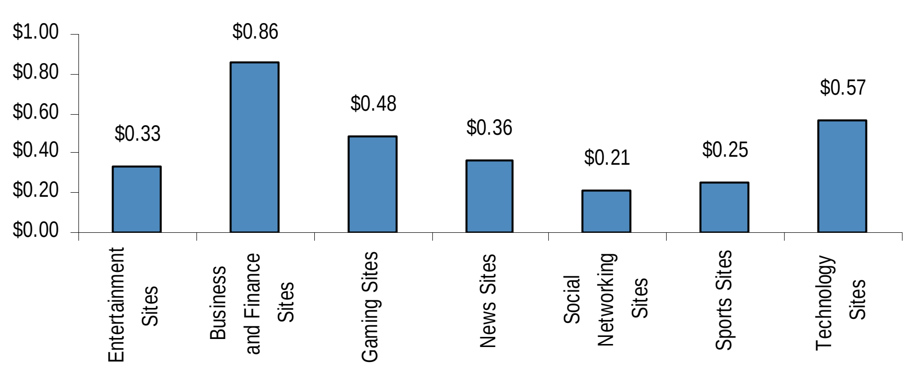
Although we expect the use of widgets to be a long-lasting fixture in the Internet space and see a healthy growth rate for widget adoption going forward, we think monetization of these gadgets through "widget networks" will prove to be difficult for a number of reasons. In the following sections, we will take a closer look at the impediments to monetizing this space. Additionally, we think the difficult macroeconomic environment could force advertisers to flee to what they view as safer platforms.

User Focus

We think widget users are primarily focused on entertainment and page customization rather than investing in the purchase of a product or service. As such, we think widget advertisements would command a much lower CPM or CPC value than other online advertising forms. Data from the quarterly PubMatic ad price survey indicates that CPMs on social networking sites are the lowest out of all vertical categories, trailing the highest category by more than 4x. We expect that widgets would command a similar discount in pricing given their non-targeted nature and users' lack of focus in acting on advertisements.

Figure 48: Average Display Ad CPMs by Vertical, 3Q'08

units as indicated



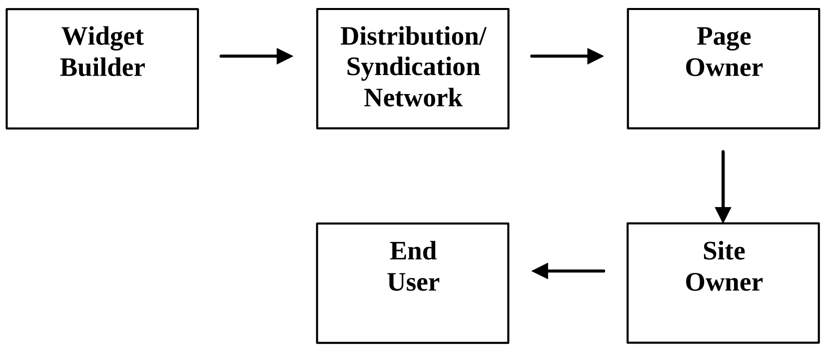
Source: PubMatic AdPrice Index Quarterly Report

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Complex Value Chain

Complicating the aforementioned problem of low CPMs is the complex value chain related to widget building and distribution. Widgets typically involve multiple branches, including a widget builder, page owner (think social networking page or blog), site owner (the social network itself), distribution/syndication network, and the end user. We think instituting an ad revenue sharing model amongst so many participants at a likely low monetization rate makes the ROI on widgets relatively unattractive when compared to other advertising forms.

Figure 49: Widget Value Chain Analysis



Source: J.P. Morgan estimates

The Nature of Widgets

We believe widgets have three characteristics that make them difficult to effectively monetize: 1) limited scale, 2) limited usefulness, and 3) a short life cycle. Although as a whole widgets are widely used by the general population, widgets have a very long tail, and, with only a few exceptions, each unique widget is likely lacking the scale necessary to be useful to advertisers. Aggregation through an ad network could be a possible solution to this problem, but the short life cycle of widgets would make this difficult. As widget popularity seems to be measured in weeks and months rather than years, aggregating a block of widgets for marketers and gathering performance data could prove to be a challenging task.

How to Monetize Them?

In our opinion, a non-ad based revenue model may be most successful given these challenges. For advertisers, (as David Cohen noted) the opportunity to place a branded widget for frequent interaction on personal computer or website is comparable to having a billboard on private property. As such, we think it is likely that advertisers would be willing to pay widget developers to build the gadgets for free distribution. Page owners would likely be willing to host the gadgets for free on their site, as they would have access to the gadget capabilities without having to pay development costs. In some instances, users may be willing to pay a subscription fee for the gadget if it had greater complexity or utility than the norm. In this way, we see the existence and growth of widgets persisting, but the likelihood of ad-based widget networks as unlikely.

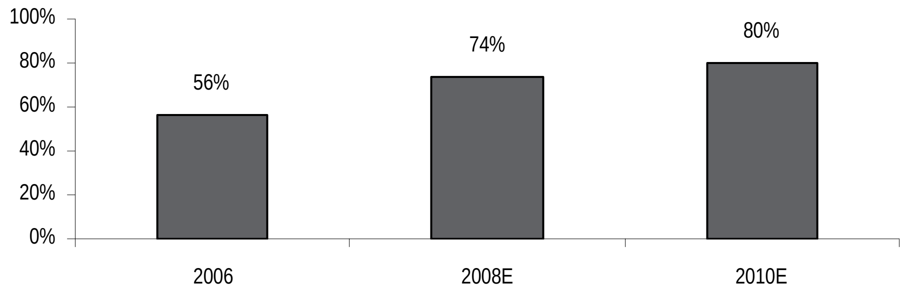
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Online Photo Market Outlook

Digital Camera Penetration Continues to Grow

Digital camera penetration in the US continues to grow, although at a slower rate, as we estimate that 74% of American households now own a digital camera. This is up from PMA's estimate of 56% in 2006. We expect digital cameras to continue to increase penetration, though at a less incremental rate, and we are currently forecasting 80% penetration by 2010.

Figure 50: Increasing Digital Camera Penetration



Source: PMA Marketing Research and J.P. Morgan estimates

In addition to increasing digital camera penetration, we believe there are several key consumer trends that will drive growth in the online photo markets:

(1) Consumers are purchasing higher-quality digital cameras;

(2) Consumers are uploading and sharing more photographs on the web;

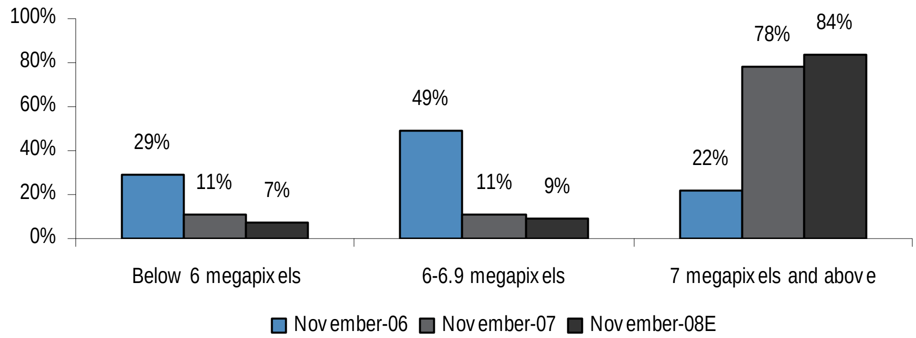
(3) Consumers are shifting away from home printing solutions and seeking more efficient online photo sites to develop their prints; and

(4) Consumers are buying more personalized products, including greeting cards, photo books, and calendars.

Resolutions Continue to Climb

In 2007, more than 75% of all digital cameras sold in the U.S. had resolutions of greater than seven megapixels, compared to about 25% in 2006. We estimate that by 2010, 90% of cameras sold will have 7MP or greater. As camera quality improves further, we believe home printing solutions will continue to become less attractive to consumers, and commercial processes capable of presenting the quality of the digital image will continue to grow in popularity. Additionally, as digital camera penetration grows, the devices will more frequently be in the hands of people who are less technologically savvy than the earlier adopters. We believe these users will be attracted to commercial printing solutions such as online photo providers because of their ease of use.

Figure 51: Resolution of Digital Cameras Sold in the U.S. Market



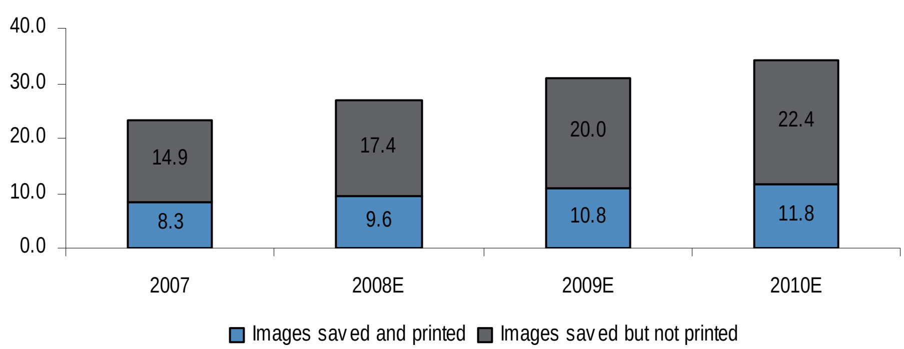
Source: NPD Group, J.P. Morgan estimates.

People Are Using Online Photo Services for Storing and Sharing Photos

As broadband penetration continues to increase and online photo sharing becomes more prevalent, we expect the percentage of consumers uploading their photos to the Internet to increase. Additionally, we believe consumers will find online photo storage an attractive backup option for their photographs as the quality of digital cameras (and therefore photo quality and size) continues to increase.

In addition to the increasing digital camera penetration amongst U.S. consumers, growth of the online photo market is being driven by non-digital camera owners as well. Social networking has become an increasing source for digital printing, as more and more people are not only uploading their photos, but they are also sharing them with friends and family. Furthermore, many social networking and blog sites have added photo capabilities to allow users to share entire websites as photo books. Online photo sites such as Shutterfly have also adapted to the social networking trend by enabling users to create personalized web sites that allow for collaboration with other members. We believe the volume of received images is only going to grow, as it is getting easier for consumers to share their photos. Moreover, we expect that as more photos are shared and received through the Internet, the number of photos ordered online will grow respectively.

Figure 3: Digital Images Saved



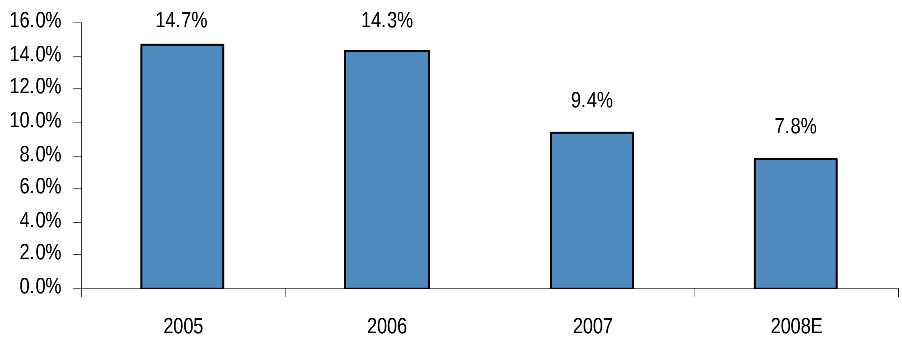
Source: PMA Marketing Research

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

We Expect Online Ordering to Drive Photo Print Growth

As digital camera penetration increases, we believe online services, whether providing in-store pick-up or mail order delivery, will prove to be the most convenient medium for people to store, enhance, print, and share their photographs. PMA Marketing Research estimates that retailers and online firms will account for 69% of all digital prints made in 2008 compared to 65% in 2007. Likewise, we think a mix shift will continue from household photo-quality printers to the use of online photo services.

Figure 52: Percent of Photo-Quality Printers Purchased with Digital Cameras



Source: PMA Digital Imaging Survey; J.P. Morgan Estimates

The pricing of digital prints at online photo sites has come down over the past few years, as discounts and promotional deals are prevalent in attempt gain competitive advantage. In addition, many online photo sites are focusing less on traditional print products, and instead are turning to personalized photo products and services to drive revenue growth. As the pricing of traditional 4x6 prints remains attractive, we believe an increasing number of people will turn to online photo services to fulfill their photo printing needs.

Table 46: Pricing of 4x6 Prints at Online Photo Sites

	Jan-04	Jan-05	Jan-06	Jan-07	Jan-08	Current
Shutterfly	39c	29c	19c	19c	19c	15c
Kodak Gallery	29c	25c	15c	15c	15c	15c
SnapFish	25c	19c	12c	12c	9c	9c

Source: Company reports

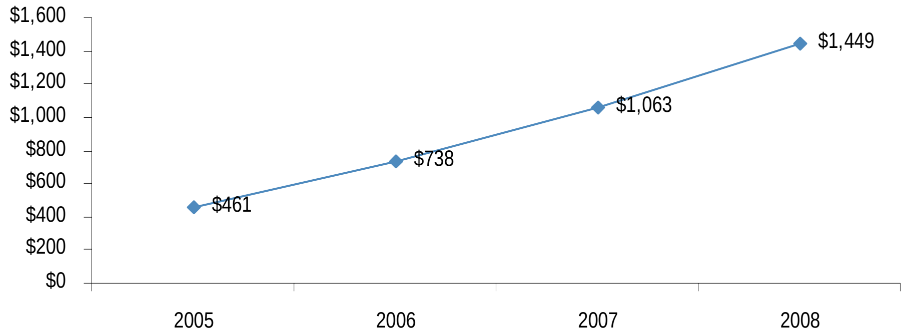
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Personalized Photo Products on the Rise

We expect the personalized products category (greeting cards, photo books, etc.) to be the primary area of growth for online photo providers during the next couple of years. PMA Marketing Research estimates that spending on custom photo merchandise is expected to reach nearly $1.5B in 2008, compared to $1.0B in 2007, and $7.0M in 2006. We think online photo sites will focus on expanding their custom photo product lines, as the competitive nature of the online photo industry is shifting beyond traditional 4x6 prints.

Figure 53: Custom Photo Products Ordered at Retail and Online

$ in millions



Source: PMA Marketing Research

We think the rise of custom photo products will increase the value of the online photo market and drive profitability of online photo sites. In addition to adding value to standard photo prints, we believe personalized photo products such as photo books will yield higher revenues as they:

- Drive AOV (average order value) growth;
- Increase customer engagement and retention; and
- Drive repeat purchasing.

As the economic environment continues to weaken, we express some concern over the online photo market, as it is highly driven by consumer discretionary spending. However, we believe the affordable nature of photo products and services as compared to other gift options may help drive sales in 2009.

2009 Cloud Computing Outlook

Why “Cloud”?

The name serves as a metaphor for the Internet, with processing and computing functions occurring in the Internet “cloud” rather than on a specific server. Although the term, technically, has a more narrow definition, the more common use, which we will adopt here, is for “cloud computing” to refer, essentially, to a computer that isn’t on your own desk or in your own server room.

- **More than a fad**. Cloud computing was on track to be the buzzword of 2008 until it was displaced by the credit crunch. But beneath the buzz, we think there is a compelling technology.

- **Cloud applications aim to replace software.** The abilities to collaborate more easily and to access documents from a browser window anywhere are two key benefits.

- **Cloud storage, processing aim to replace hardware.** Companies like Amazon, Google and Microsoft have massive economies of scale, and it’s a lot cheaper for them to buy servers and hard drives than it is for almost anyone else. Amazon has already added storage and processor time to the list of products it sells, and both Google and Microsoft began to offer cloud services in 2008.

One Name, Two Concepts. At Least.

As with many Internet trends (2.0 is a recent example), cloud computing has broadened in meaning somewhat as diverse companies and tools have jumped on the “cloud” bandwagon. At its core, though, the idea is actually quite simple: the benefits of using applications, storage and processing capacity online can often outweigh the costs, especially as Internet connections speed up and offer near-instantaneous response.

Cloud computing, as defined by companies, has now expanded to include two key concepts. We will touch upon each of these in more detail below:

- **Cloud applications and Software as a Service.** Google Docs is a frequently cited example; essentially, these are apps that replace software you might have otherwise used on your own computer, such as a word processor or spreadsheet. At a somewhat higher level of complexity, companies such as Salesforce.com, which offer on-demand SaaS (software as a service) solutions, now describe their platforms as operating in the cloud.

- **Cloud services.** Amazon has been the notable leader here, though others, including Google and Microsoft, also have offerings; services include storage and processing time, and allow smaller companies to lower costs by taking advantage of the big guns’ superior processing power and purchasing power.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Applications

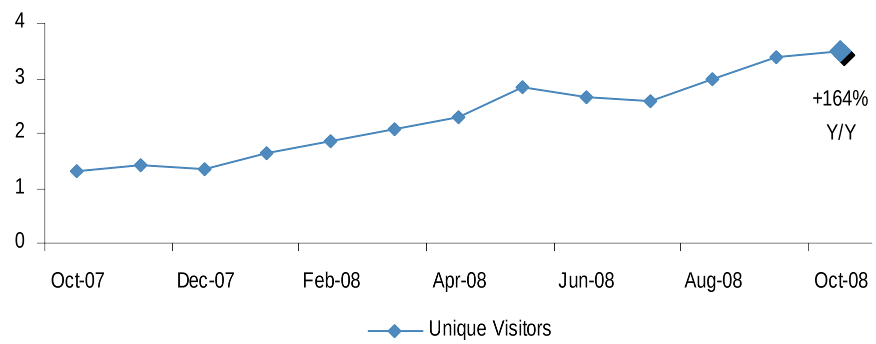
For simple, consumer-facing applications, cloud applications already have a foothold in replacing the more traditional software-on-your-computer model. The most successful is perhaps not what some would first think of as a cloud application: email.

Nevertheless, email sites are accessed by upwards of 70% of the nearly one billion users comScore estimates are using the Internet in a given month. And both Yahoo! and Google's email services work using Ajax, which makes them behave with a user interface and responsiveness similar to what one would expect from a desktop application.

Beyond email, companies ranging in size from startups to Google have made available a variety of applications that are more typically associated with the desktop, including word processing, spreadsheets, presentations and photo editing. Although the reach of these applications is significantly smaller than that of webmail, their growth over the past year has been quite rapid.

Figure 54: Traffic to Google Docs up 164% Y/Y in October

Unique Visitors in Millions



Source: compete.com

We think continued growth on the consumer and small business side is quite likely, for several reasons:

- **Portability.** The file can be available wherever the user can open a browser window. Additionally, as the application is designed to work in a browser, the user is not constrained to computers with the right software installed.

- **Collaboration.** Multiple people can work on the same document and see each others' changes in real time.

- **Convenience.** The web application model frees the user from needing to ensure that software is up-to-date.

- **Price point.** Many of Google's tools, e.g., are available for free, or for an annual fee of $50/user account for businesses. While we don't expect these tools to make much headway at a large corporation such as J.P. Morgan, a

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

smaller business may find the price compelling, compared to a Microsoft Office price point of over $100 retail.

- **For the software company, easier to avoid piracy.** The provider can ration access to the application, and there is less of a danger that multiple copies could be made from a single source.

At the same time, the model brings with it a variety of drawbacks, some more significant than others:

- **Data security.** Some clients, especially enterprise clients, may not want to put valuable information online in a way that enables the whole world to possibly access it.

- **Lack of features.** While online applications continue to make strides, they generally remain far short of the capabilities offered by a full-featured application such as Microsoft Excel. We believe that, for many users, a tool that offers only a fraction of Excel's capabilities is likely to be sufficient, and the lack of bells and whistles may not be a significant drawback.

- **Reliance on Internet connection.** Lose your link to the network, and you lose your documents – a tradeoff some may not be willing to risk. Some providers let users edit documents offline – but doing so temporarily removes some of the advantages described above.

Table 47: Google Apps Features

Feature	Details
Price	$50 / user account / year
Messaging application features	
Gmail and Google Calendar	Included
Gmail storage	25 GB / account
Gmail: ads	Can be disabled
Email Security	Provided by Postini
Email Archiving	Provided by Postini
Resource Scheduling in Google Calendar	Included
Gmail, Google Calendar, Google Talk	99.9% Uptime Service Level Agreement
SSL Enforcement for secure HTTPS access	Included
Collaboration Application features	
Google Docs, Google Sites	Included
Google Sites storage	10 GB, plus 500 MB / user for shared storage
Google Video	Private video sharing
Google Docs, Google Sites Uptime	99.9% Uptime Service Level Agreement
Support	
Email support	Included
Phone support	For critical issues
Integration	
Single sign-on API	Included
User provisioning API	Included
Email migration tools and API	Included
Email routing and email gateway support	Included

Source: http://www.google.com/apps/intl/en/business/details.html

Software as a Service

Software as a Service, or SaaS, is frequently delivered over the web in a way that can be said to rely on the cloud; Salesforce.com has recently described its CRM product as taking advantage of cloud computing. Such offerings are also occasionally called on-demand applications.

These tools tend to be more sophisticated (and expensive) than the small business and consumer-targeted offerings described above. Nevertheless, they can take advantage of many of the features noted above, including data portability and, for the vendor, easier updating.

Cloud Services

The web services space has seen Amazon take a leading role, with key products that offer storage (Amazon Simple Storage Service, or S3) and processing (Amazon Elastic Compute Cloud, or EC2), both introduced in 2006. More recently, other large players have joined the fray; Google rolled out its App Engine in April 2008, while Microsoft announced the availability of its Azure suite of web services in October 2008.

Although the details and implementation can vary, these web services tend to operate around a similar general concept; the service offers its users an ability to add scale, either in terms of storage or processing, that would be difficult to ramp independently.

The intended users are, for the most part, smaller companies such as startups that may not have the capital or know-how to build up server capacity immediately, as well as small and medium-sized companies which may experience occasional spikes in usage and find it more economical to rent the processing capacity to deal with such spikes, rather than purchase equipment ahead of time that can handle peak loads, but would also sit idle for the majority of the time.

For storage, the pricing generally includes a per-GB cost for transferring data in or out, as well as storage costs per GB per month; by way of example, Amazon charges US users on a sliding scale, starting at $0.15 per GB per month, see below:

Table 48: Costs of Amazon S3 for US users

Storage		Data Transfer: In		Data Transfer: Out	
Volume/mo	Price	Volume/mo	Price	Volume/mo	Price
First 50 TB	$0.15/GB	All	$0.10/GB	First 50 TB	$0.17/GB
Next 50 TB	$0.14/GB			Next 40 TB	$0.13/GB
Next 400 TB	$0.13/GB			Next 100 TB	$0.11/GB
Over 500 TB	$0.12/GB			Over 150 TB	$0.10/GB

Source: http://aws.amazon.com/s3/#pricing

Similarly, services that offer processing time are priced on a sliding scale depending on usage. (Google's App Engine is the exception, for now – the service is free, up to certain usage limits.)

Advantages of Cloud Services Model:

- **Scalability.** Rather than trying to project the growth of expected computing needs, an enterprise can pay for exactly the level of computing resources it requires. Additionally, if a company's needs spike unexpectedly, the cloud services model can absorb the spike, vs. needing to wait for resources to be bought and installed.

- **Pricing.** The large companies that offer these services tend to benefit from immense economies of scale, allowing them to price the services at levels that can be lower than what a smaller company would be able to achieve if buying its own hardware.

- **Focus.** Few companies, especially smaller ones, have a core competency in managing hardware and servers. By outsourcing these functions to a service provider, a company can focus on its core business.

Disadvantages:

- **Less configurable.** The processing and storage resources that are bought in a cloud model may not offer the option of being configured in precisely the way a user would prefer.

- **Data security.** As with cloud applications, some businesses may not be comfortable having key data stored on someone else's computer.

Outlook

We think the cloud computing model offers compelling solutions, both on the applications and on the services side, and expect fairly rapid growth in usage in both arenas in the coming months and years.

At the same time, we believe the profit opportunity for any of the larger players, especially on the services side, may be somewhat limited. With several large-cap companies competing, <u>we see services converging to essentially a commodity business</u>; we think that, in the medium term, providers like Amazon and Microsoft are likely to eat away a portion of each other's profitability on web services.

Additionally, it remains to be seen whether these types of cloud services will prove attractive to medium- and larger-sized companies, which have generally bought much of their own hardware.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

2009 Virtual Online Worlds Primer

Key Takeaways

- **’08 growth somewhat tepid**. Unique users at several virtual worlds were lower Y/Y in ’08, suggesting that their appeal may have been more limited than even we had expected.
- **We continue to believe sites aimed at children present the more compelling opportunity**. Virtual worlds present parents an opportunity to let their kids and teens play online and interact in a closed environment that is perceived as safe, especially when sites are operated by companies with trusted brands.
- **We think sites aimed at adults have yet to prove mainstream appeal**. Adults have much more freedom than children to choose other avenues of social interaction. As such, we think that, in their current form, virtual worlds aimed at adults are unproven in their ability to achieve meaningful mainstream penetration over the long term.

Two Audiences, Two Differing Growth Curves

With investments by major media companies, virtual worlds have been making news for several years. The biggest splash came when Disney purchased Club Penguin in July ’07 for as much as $700M. Over the course of much of the last few years, we have seen steady flow of news stories, both positive and negative, regarding virtual world sites.

We think that, although virtual worlds have yet to reach the status of mature companies, they are not, taken as an aggregate, positioned for further rapid growth. (This is not to say that some sites will not continue to experience spikes in usage).

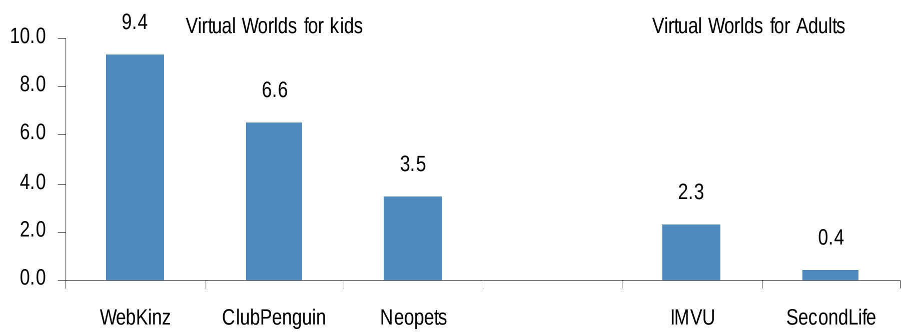
We think the market is ultimately one that should be seen as consisting of two parts – virtual worlds for children/teens and ones for adults– with diverging longer-term growth prospects.

We think virtual worlds for kids/teens are a product with strong promise, and one that could continue to achieve mainstream status in coming years. To the contrary, we think virtual worlds aimed at adults face greater challenges in the U.S. We think it is telling that virtual worlds have proven successful among kids, who have limited social options, and in places such as Finland, where external factors such as climate may limit users’ offline social options.

As such, we think the ability of virtual worlds (as distinct from video games, which target a different, more male demographic) to achieve mainstream penetration has not yet been proven.

Figure 55: In the US, Virtual Worlds for Kids Have a Much Bigger Audience

Average monthly US unique users in millions, Jan-Oct '08



Source: comScore Networks, J.P. Morgan estimates

Some Terms, Defined

- **Social network**: a site that allows users to form connections with others. Sites that are considered social networks will generally consist of profiles intended to represent the user more or less faithfully. Examples: MySpace, Facebook.

- **MMORPG**: (stands for Massively Multiplayer Online Role Playing Game) a game that creates an opportunity for users to interact with each other and with an immersive game environment. Prominent examples: World of Warcraft, EverQuest.

- **Virtual world**: these sites straddle a middle ground between social networks and MMORPGs, offering social functions in an immersive world. Some examples of virtual worlds include Second Life, Gaia Online, ClubPenguin and Neopets.

A virtual world creates an immersive environment for users to interact with each other, but the emphasis is not chiefly on gameplay, as in a MMORPG. Rather, the focus is on interaction with other users in a social way, and often on personalizing a user's VW presence, called an avatar, or personalizing the avatar's surroundings and possessions.

How Do They Make Money?

Most virtual worlds operate on one, or a combination, of three models: advertising, subscription revenue and the sale of virtual goods – whether virtual currency to be used inside the world, or improvements to a user's avatar. As the worlds mature, especially in those aimed at adults, advertising may play a larger role, although we think the exact look and feel of VW ads will likely change before we see a significant influx of revenue from external advertisers.

Challenges to an advertising-supported virtual world model:

- **Kids and pre-teens a key market**. Although some children's sites have used sponsorships and ads as a revenue stream, we believe parents who oversee their kids' browsing may be leery of strongly commercial sites, especially for younger kids. One similar model is TV's Disney Channel, which does not carry advertising. Additionally, we believe in the future we may see regulation in the space, similar to rules in Europe banning fast food companies from advertising on channels watched by kids and teens, or during hours they are more likely to be watching.

- **Hard to control environment**. The free nature of many virtual worlds means many sites have adult content that mainstream advertisers may not be comfortable appearing next to.

- **Issues of scale**. Some companies have set up a presence on virtual worlds, esp. Second Life, that must be continuously overseen by an employee whose avatar interacts with visitors. The investment of time may not pay off if traffic is too low, and such a presence does not scale well.

- **High site engagement**. If users are highly immersed in an online environment, their lower response to call-to-action advertisements is unlikely to generate attractive CPMs.

Virtual Worlds for Kids and Teens

Audience Is Growing

eMarketer estimates that nearly 4 out of 5 US teens will be online in 2008 and projects a 25% 2007-2011 CAGR in the number of kids aged 3-17 visiting virtual world sites.

We believe there is considerable cause for optimism in terms of kids' adoption of these sites, for several reasons.

Captive Audience

One key reason, and a differentiating factor between kids' worlds and ones for adults, is that kids' entertainment options are severely constrained compared to those of adults. The successful kids' sites are those that can give children a degree of freedom and interactivity, while assuring parents that their kids are in a safe environment.

Major Media Brands Are Investing

Two major media companies, Walt Disney and Viacom, have made significant investments in the Virtual World space, exemplified most significantly by Disney's nine-figure purchase of Club Penguin in 2007.

Table 49: Major Media Companies' Forays into VW space

Company	Date	Event
The Walt Disney Co.	June '03	Launched Toontown Online
	July '07	Acquired ClubPenguin for $700M ($350M + $350M earnout)
Viacom	June '05	Acquired NeoPets for $160M
	Jan. '07	Launched Nicktropolis

Source: Company releases

In the area of trust, we think the big media companies have an advantage, with established brands that parents are already familiar with. At the same time, any site aimed at kids is going to be subject to the whims of a fickle audience. As such, we think media companies are likely to remain open to acquiring sites that generate significant viral traffic.

Table 50: Summary of Virtual Worlds Aimed at Kids and Teens

Site	Owner	Target Audience	Business Model	Geographic Base	Jan-Sep '08 avg. monthly UU	Y/Y User Growth
BarbieGirls	Mattel	Young Girls	Toy Sales, Subscriptions	US, WW	3.3M	26%
ClubPenguin	Disney	Kids	Subscriptions	US, WW	10.8M	23%
CyWorld	SK Telecom	Teens, 20's	Virtual Goods	Chiefly: Korea	13.7M	-1%
Gaia Online	Private	Pre-teens and teens	Virtual Goods, ads	US, WW	3.3M	97%
Habbo Hotel	Sulake (Finland)	Teens	Ads and Virtual Currency	Europe, WW	6.3M	52%*
Millsberry	General Mills	Kids	Product Promotion	US	1.9M	N/A%
NeoPets	Viacom	Kids	Premium Memb., Ads, Virtual Items	WW	6.1M	-16%
Webkinz	GANZ	Kids	Toy Sales	US	8.4M	90%

Source: Company sites, comScore Networks, J.P. Morgan Estimates

User statistics are based on worldwide usage as tracked by ComScore; *Y/Y growth rate for Habbo is for July-Sep '08.

Virtual Worlds for Adults

Whereas virtual world sites aimed at children are starting to gain traction, the marketplace of sites aimed at adults remains in a much earlier phase of development. E.g., Second Life, sometimes touted as representative of the mainstreaming of virtual worlds, had 0.2% penetration of US Internet users in 10/08, according to comScore data, a level that could easily grow by a factor of ten while remaining solidly in the niche category. In fact, rather than demonstrating growth, the number was lower than a year ago. As such, we think it's likely that developers have not yet hit on a virtual world model with broad appeal to adults.

Table 51: Summary of Virtual Worlds Aimed at Adults

Site	Business Model	Geographic Base	Aug-Oct '07 avg. monthly UU	Y/Y User Growth
ActiveWorlds	Subscriptions, Hosting	US, WW	0.1M	181%
Google Lively	Ads	75%+ Outside US	0.6M	N/A%
IMVU	Premium Accounts, Ads	US, WW	4.8M	22%
Kaneva	Ads, Virtual Currency	Largely US	0.5M	-41%
Second Life	Subscriptions, Virtual Goods and Virtual Currency, Ads	75% Outside US	1.6M	-45%

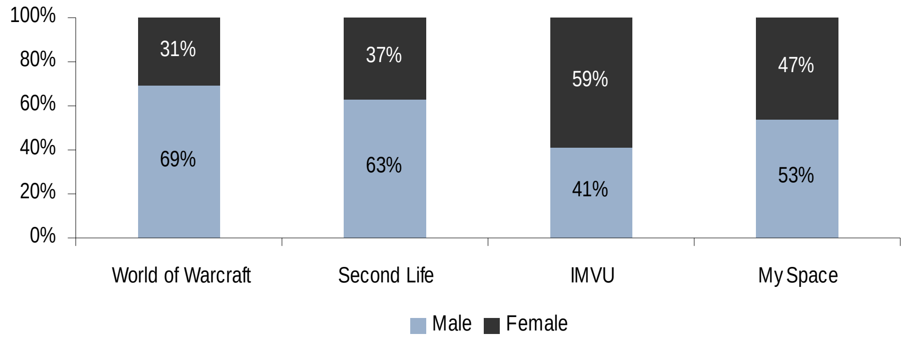
Source: Company sites, comScore Networks, J.P. Morgan Estimates

User statistics are based on worldwide usage as tracked by comScore.

Virtual Worlds Attract Usage across Gender Lines

Virtual worlds' interactivity and social aspect differentiates them from MMORPGs such as World of Warcraft, both in terms of usage and in terms of the demographics they attract. And while Second Life seems to attract more male users, a site like IMVU, with its focus on the social aspect, actually has a higher percentage of users who are female, according to comScore metrics.

Figure 56: While Warcraft Attracts More Men, a Site Like IMVU Tilts Female



Source: comScore Networks, J.P. Morgan estimates

comScore data for October 2008, Worldwide user base. Warcraft, Second Life and IMVU based on application users.

A Blurry Line: Virtual World or Messaging Client?

To some extent, IMVU, one of the more successful virtual world applications at growing usage in '08, could be called a (very) feature-rich messaging client; likewise, Google's short-lived Lively, introduced in July, was built on top of Google's GTalk engine. Lively attracted over a million worldwide unique users in its debut month, though had faded to less than half that in the following months and was shuttered in November.

Challenges

Second Life, in particular, has generated a significant amount of publicity over the past year, both positive and negative. The site has been very aggressive in signing up corporate sponsors, with companies such as IBM, Cisco, Toyota, Mazda and dozens of others setting up a presence in the world.

The site has also generated negative attention due to gambling (banned after an FBI investigation) and adult content. Likewise, IMVU has seen controversy due to user-created content of an adult nature. While we do not believe these issues present an existential threat, we think they are unlikely to go away, as world designers must navigate a narrow path between a total free-for-all and a site where usage regulations become too restrictive, significantly affecting the site experience and user growth.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Internet for Social Good

We feel it is important to recognize the increased usage of Internet sites and communications by the non-profit sector. More and more non-profits are adopting the Internet as a means of achieving social good works, taking advantage of the same extensive reach and low overhead embraced by the private sector. In this section, we have highlighted three of these websites devoted to social good works.

DonorsChoose.org

DonorsChoose.org is a not-for-profit web site focused on providing students educational resources that public schools often lack. The site was created by teachers at a Bronx public high school in the spring of 2000 who sought to address the scarcity of materials in public school classrooms. Teachers first submit project proposals for materials needed for their students to learn. Individuals can then browse through the selection of project proposals and choose one they wish to fund, either partially or in full. Proposals range from “Where Did All the Pencils Go?” ($60), to “Dictionaries for At-Home Use” ($259), to “Geological Field Trip” ($2,000). Users of the site can browse by cost, location, resources, subject, and grade level (ranging from PreK to Adult Education).

Within a week of selecting and funding a project proposal, DonorsChoose.org forwards the donor an “e-thank-you” from the teacher, which includes the date the individual can expect his/her feedback package. The nonprofit site then purchases the student materials and ships the items directly to the school, along with a disposable camera and guidelines for preparing feedback packages. The teacher photographs the students participating in the project and writes an impact letter to the donor, which is added to the feedback package along with thank you letters written by the students. Packages are sent to donors who completed a project or made a partial contribution of $100 or more.

Wikipedia.org

Wikipedia is a multilingual, web-based, free content encyclopedia. The content is written collaboratively by volunteers worldwide and can be edited by anyone. The site was created in 2001 and has grown substantially since, attracting approximately 684M users per year as of 2008. Articles are written in over 250 languages by more than 75,000 active contributors. Most of the articles can be edited by anyone with Internet access, and visitors do not require special qualifications to contribute, since their primary role is to cover existing knowledge. Anyone is welcome to add information, cross-references or citations, as long as they do so within Wikipedia’s editing policies and to an appropriate standard.

CharityBuzz.com

CharityBuzz.com is an online auction site designed for nonprofit organizations worldwide, including those founded by celebrities such as Bette Midler, Andre Agassi, and Rosie O’Donnell. Services are “all inclusive” and span the entire lifecycle of the auction, including overall account production, catalog creation and design, credit card authorization, and payment collection. CharityBuzz charges a percentage of revenue raised deducted from the amount they remit to the charity after the auction is closed. In addition, by using CharityBuzz, charities vastly increase the number of bidders they would typically have exposure to, thus increasing the amount of money raised for their cause.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

International Sector Outlooks

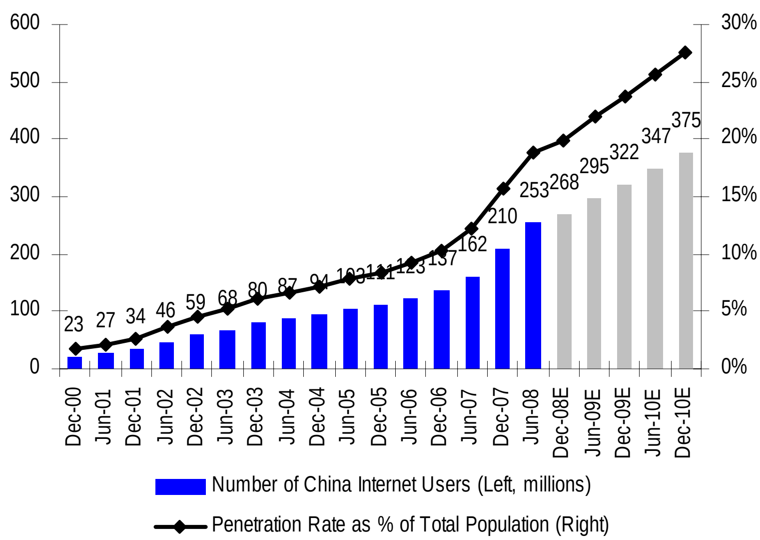
China Internet Market Overview

Number of Internet Users Continues Strong Uptrend

China's Internet population grew at a rapid pace in 2007, increasing 53% Y/Y to 210M, according to China Internet Network Information Center (CNNIC). In 1H08, the number of Internet users climbed a further 20% to reach 253M as per CNNIC, giving China the world's largest Internet user base. This strong growth in recent years has been driven by factors such as robust GDP growth, lower priced computers, more affordable telecom connection fees, government support to Internet usage and low-cost entertainment aspects. Further, growth in the rural population exceeded that in the overall population, growing at almost 128% in 2007, as lower-income groups also continue to adopt the Internet.

Despite this rapid growth, China's Internet penetration rate of ~20% of the population is still well below that of developed markets like the US, Japan and Korea (over 70%). We expect Internet users to grow by around 20% Y/Y in 2009 to reach ~320M, or the penetration rate to reach ~24% of the population by the end of 2009.

Figure 57: China Internet Users and Penetration Rate

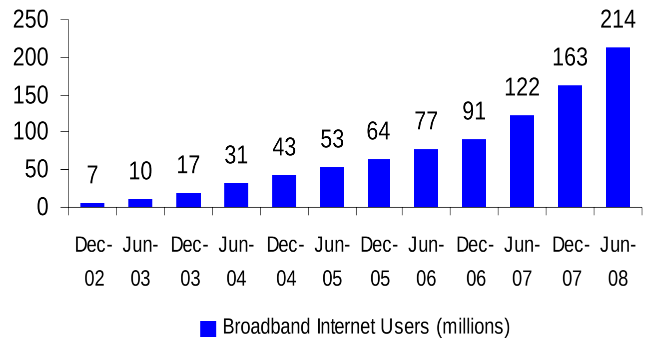


Source: CNNIC (China Internet Network Information Center), J.P. Morgan estimates.

Broadband and Mobile Continue Rapid Growth

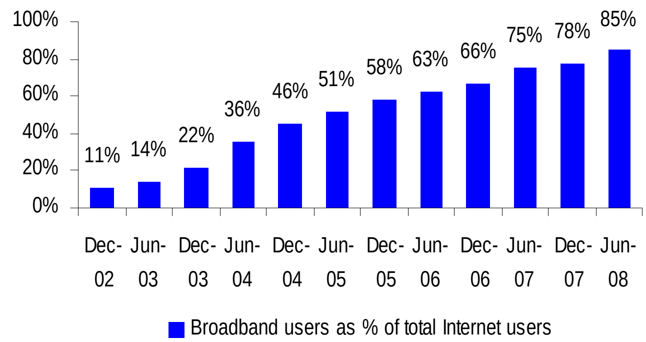
The number of users with broadband Internet access grew 80% Y/Y to 163M (78% of total users) by the end of 2007, and to 214M (85% of total users) by June 2008, as per CNNIC.

Figure 58: Broadband Internet Users in China



Source: CNNIC.

Figure 59: Broadband Internet Users as % of Total Internet Users



Source: CNNIC.

Further, the number of broadband subscribers reached 66.5M by the end of 2007, up 28% Y/Y.

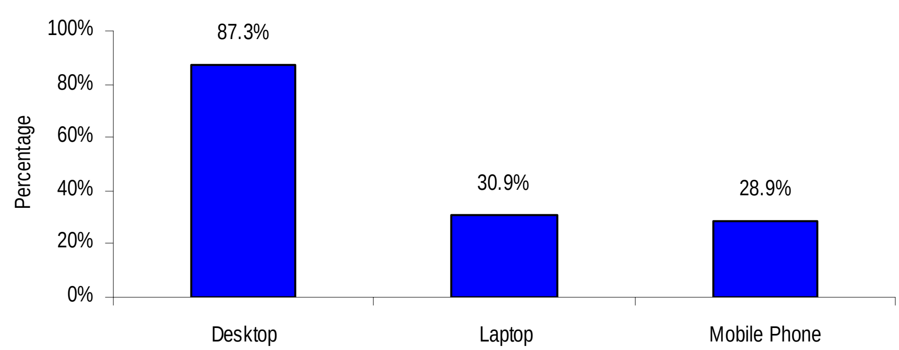
Table 52: Trends in Broadband Subscriber Penetration

	2003	2004	2005	2006	2007
Broadband subscribers (MM)	10.4	23.9	37.5	51.9	66.5
Population Penetration (%)	0.8%	1.8%	2.9%	4.0%	5.1%
Households Penetration (%)	2.7%	6.2%	9.1%	12.5%	15.9%

Source: CNNIC, Ministry of Information Industry (MII), J.P. Morgan estimates.

Since China has yet to roll out 3G mobile technology, mobile Internet access is slow. Despite this impediment, the number of mobile Internet users increased by 65% Y/Y to 73.1M by Jun-08, as per CNNIC. The number of mobile Internet users was 29% of all Internet users and 12% of all mobile users. This compares to South Korea, where ~51% of mobile users use their phones to browse the Internet. We expect mobile Internet usage to increase significantly once 3G technology becomes available to consumers.

Figure 60: Methods of Accessing by Device



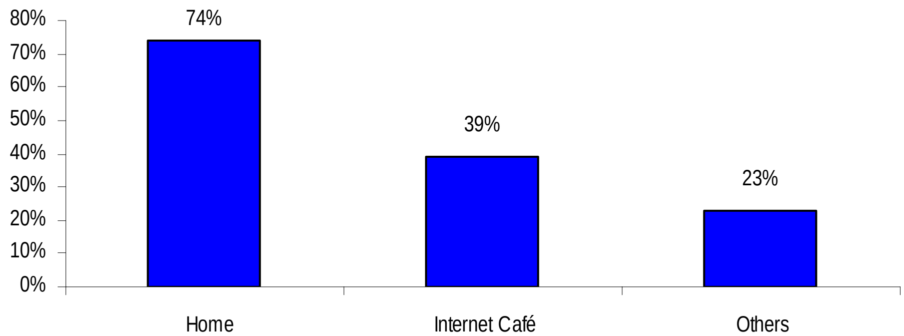
Source: CNNIC (Jun-08).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Home Has Become a Preferred Place to Access the Internet

Given the increase in Internet accessible computers, broadband penetration, and per capita wealth, the home has become the preferred place for most users to access the Internet, with over two-thirds of all Internet users accessing the Internet from home. Access from an Internet café lost share to the home, but still grew almost 61% in 2007.

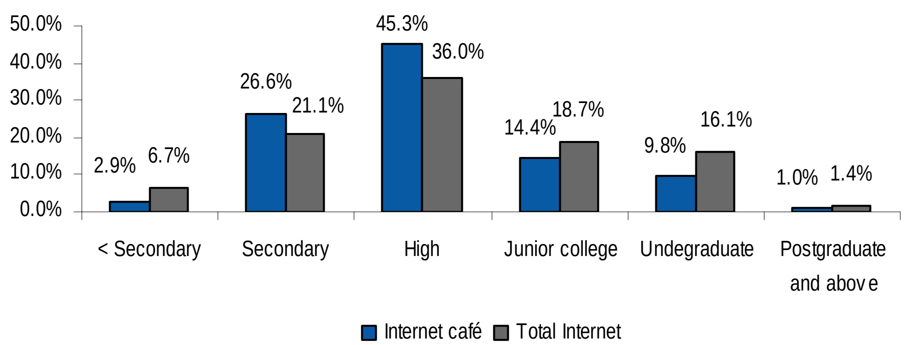
Figure 61: Main Access Locations



Source: CNNIC (Jun-08).

However, given the relatively lower cost to access the Internet from an Internet café, about Rmb51.6 per month ($7.46), as per CNNIC, more young people are drawn to Internet cafes. While Internet access at home is more expensive for those who pay for it, about Rmb74.9 per month ($10.83), we expect Internet access from home to continue to grow at a fast rate as a wealthier population continues to buy more computers and can more readily afford home access.

Figure 62: Young Secondary and High School Students More Likely to Use Internet Cafes

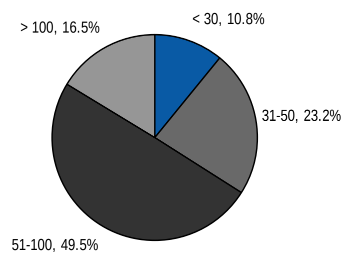


Source: CNNIC (2007).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 63: Home Internet Access Charges

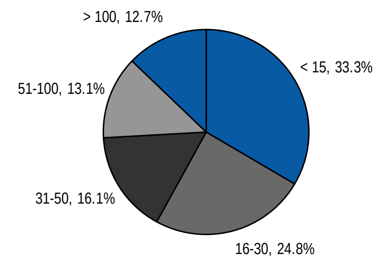
Rmb



Source: CNNIC (2007). Average: 74.9 Rmb / Month

Figure 64: Internet Cafe Access Charges

Rmb



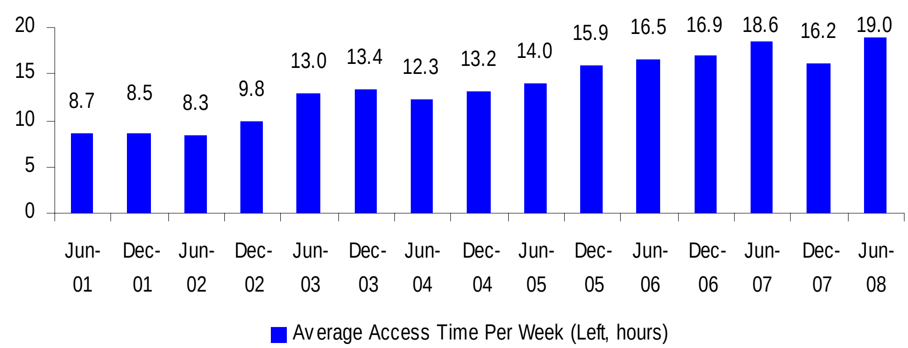
Source: CNNIC (2007). Average: 51.6 Rmb / Month

Users Spending More Time Online

China's Internet users are continuing to spend more time online. CNNIC's Jun-08 survey showed users spent an average of 19 hours per week online. This was up from 16.2 hours per week six months earlier. We note that Internet usage has almost doubled compared to the 8.7 hours per week spent online in June 2001.

Figure 65: Average Time Spent Online

Hours/week

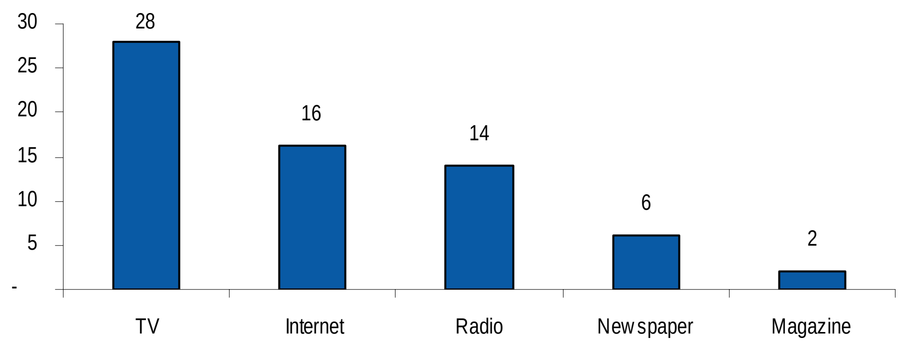


Source: CNNIC (Jun-08).

Notably, as per some surveys, Internet use has surpassed radio and print media as a method of obtaining information and is second only to TV in terms of weekly consumption.

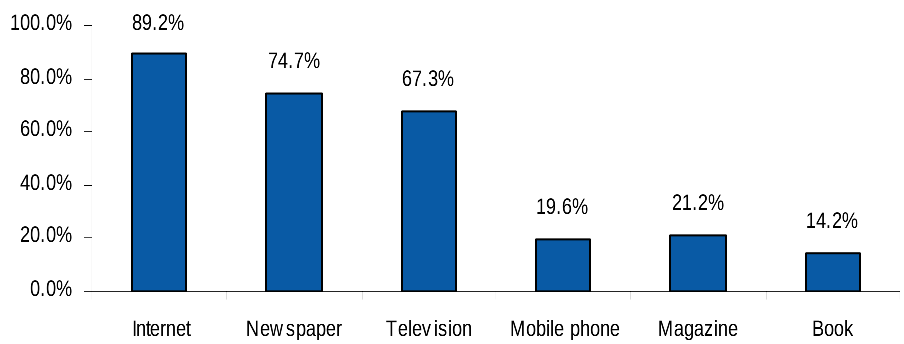
Figure 66: Time Spent on Different Media

Hours/week



Source: CMMS, CNNIC.

Figure 67: Top Information Source for High-Impact Users – the Internet



Source: CNNIC (2007). Note: Defined as those aged 25-40, with junior college education or higher and an annual income of Rmb2,000 or more.

Media and Instant Messaging Are Among the Most Popular Internet Uses

According to the Dec-07 CNNIC survey, online music is the most popular use of the Internet, with 86.6% of Internet users accessing online music. Online video is also popular, with 76.9% usage, while online news use was 73.6%.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

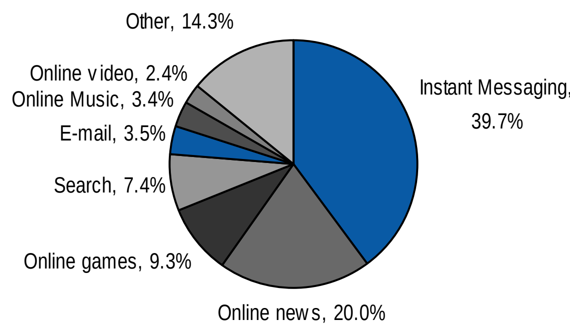
Table 53: Internet Usage by Category

Use	% who use	(Millions)
Search engine	72.4%	152.04
E-mail	56.5%	118.65
Instant message	81.4%	170.94
E-government	25.4%	53.34
Online news	73.6%	154.56
Update blog/personal spaces	23.5%	49.35
Internet games	59.3%	124.53
Online music	86.6%	181.86
Online video	76.9%	161.49
Online shopping	22.1%	46.41
Online payment	15.8%	33.18
Online banking	19.2%	40.32
Online job search	10.4%	21.84
Online education	16.6%	34.86
Online brokerage	18.2%	38.22

Source: CNNIC (2007).

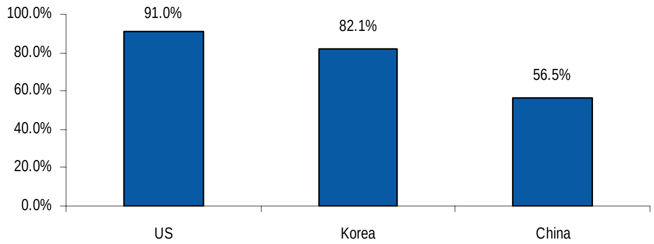
Instant messaging (IM) use was cited by 81.4% of all respondents, second only to online music. However, IM was the first stop for 39.7% of all Internet users, almost 20% more than the second most frequent first stop, online news at 20.0%. Online music came in at a distant sixth place, or 3.4%. It is also interesting to note that IM was more widely used in China than e-mail, as per the survey, which has likely benefited companies like Tencent, which owns the popular QQ brand.

Figure 68: First Stop When Using the Internet



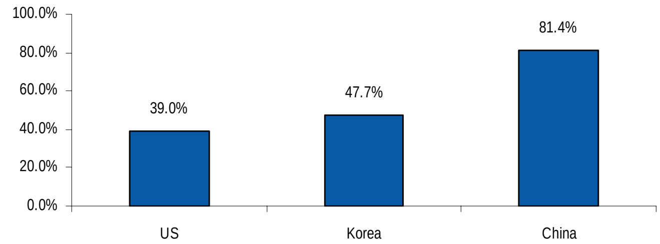
Source: CNNIC (2007).

Figure 69: Email Use - China Behind Korea and US



Source: CNNIC (2007), Pew Internet Study (Aug '06), NDIA Survey on Computer and Internet Use (Dec '06)

Figure 70: IM Use - Significantly Higher in China



Source: CNNIC (2007), Pew Internet Study (Aug '06), NDIA Survey on Computer and Internet Use (Dec '06)

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Online Advertising

We Maintain Our Positive View on 2009 and Longer-Term Online Ad Market Growth

While there are debates over how China's economy will shape up over the next 2-3 years, we believe strongly that Internet usage will continue to grow despite more challenging economic conditions. Lower computer prices, declining connection fees, higher influence of online media, and government support should continue to drive Internet growth in China.

Further, whether China's 2009 GDP growth rate turns out to be over 9% or a lower 5-6% (in a "hard landing" scenario), GDP growth should add further upside to a base case of 18% online brand media growth, in our view. Indeed, with better measurements and lower price, online ads will likely be a preferred medium in difficult times. Also, the online ad market still only accounts for a very small portion of China's overall ad market (still less than 10%).

We forecast the online ad market to witness 28% Y/Y growth in 2009 to reach Rmb14.3B (US$2.1B), and 37% Y/Y growth in 2010 to reach Rmb19.6B (US$2.9B).

Search Ad to Grow Faster than Brand Ad
We expect search advertising to see stronger growth in 2009 than brand advertising. From a top-down perspective, search ad is still ~40% of the total online ad market in China. This compares with 67% in the US. As such, we still see room to grow.

From a bottom-up perspective, we expect: (1) higher adoption of pay-for-performance advertising during challenging macro environment, (2) search usage to increase with the growing eCommerce market, and (3) use of search ads as a brand advertising tool.

Table 54: China Online Advertising Market Forecast

	2004	2005	2006	2007	2008E	2009E	2010E
Brand Advertising (RMB M)	1,700	2,329	3,377	4,559	6,428	7,585	10,013
Search Advertising (RMB M)	584	846	1,442	2,851	4,663	6,614	9,438
Other Online Format (RMB M)	70	91	109	122	135	148	163
Total Online ad market (RMB M):	2,354	3,266	4,928	7,533	11,226	14,347	19,614
Total Online ad market (US$M)	284	402	621	999	1,627	2,092	2,860
Growth Rate (Rmb, %)	*99%*	*39%*	*51%*	*53%*	49%	28%	37%
Total China ad market (Rmb M)	78,778	90,704	105,712	116,422	155,074	178,336	203,303
Growth Rate (Rmb, %)	*12%*	*15%*	*17%*	*10%*	11.0%	15.0%	14%
Ad market as % of GDP	0.49%	0.50%	0.50%	0.47%	0.49%	0.49%	0.50%
Online ad as % of Total ad market	3.0%	3.6%	4.7%	6.5%	8.0%	9.3%	11.0%

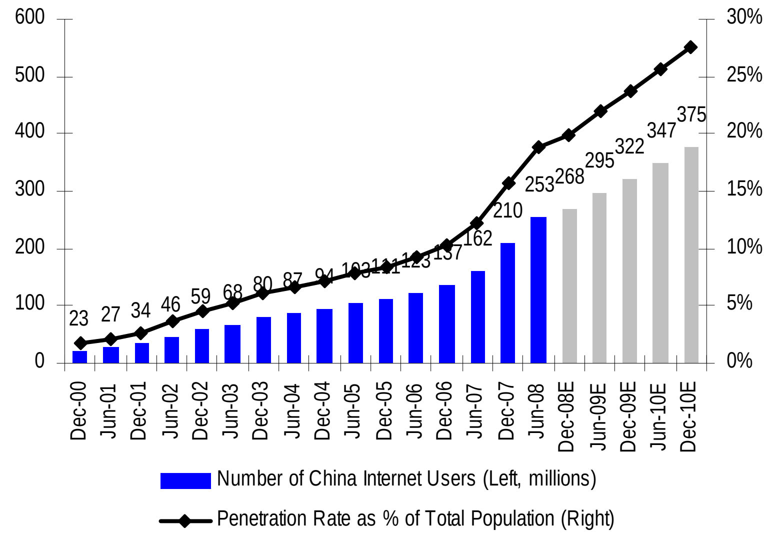
Source: iResearch, CNNIC, J.P. Morgan estimates. Note: Growth rates are in Rmb terms.

Online Advertising: Top-Down Perspective

Internet Usage Growth – Same Old Story, But Is That What Is Driving the Online Ad Spending Growth Expected in 2009?
We expect China's Internet user base to grow around 20% Y/Y in 2009 to 24% penetration, from its current penetration rate of 20%. As mentioned earlier, this is driven by lower-priced computers, more affordable telecom connection fees, government support of Internet usage, low-cost entertainment aspects, etc. As of

June 2008, the number of Internet users in China was 253 million (or 20% of the population). By the end of 2009, we expect the Internet population to reach ~320 million (or 24% of the population).

Figure 71: China Internet Users and Penetration Rate



Source: CNNIC, J.P. Morgan estimates.

We believe if the number of Internet users grows 20% Y/Y (or roughly equal to the increase in media consumption), a minimum of ~18% Y/Y growth in online brand ad spending should be achievable, given: (1) higher number of hours spent online per user, (2) Internet can reach a broader audience in smaller cities in China, (3) more measurable and lower cost compared with traditional media like TV, (4) general inflation in advertising rates, and (5) GDP growth should also drive overall ad spending up.

GDP Growth Likely Between 6.0-9.5%: Added to 20% Internet User Growth = Potential 26-29% Growth

According to J.P. Morgan chief China Economist Frank Gong, Chinese officials are forecasting that China's economic growth may slow to "8%" oya, from nearly 12% oya in 2007, while many in the market have been pricing in a “hard landing” scenario in which China's GDP growth could dip into 6-8% oya territory.

While the few percentage points difference in the top and bottom ranges of GDP significantly changes the investment sentiments, from a fundamental revenue perspective, we believe online ad industry could potentially grow roughly 26% (20% of penetration growth + 6%GDP growth) to 29% (20% of penetration growth + 9%GDP growth).

Indeed, J.P. Morgan forecasts domestic consumption to pick up at a faster pace in 2009 vs. 2008. This should be positive for domestic ad spending.

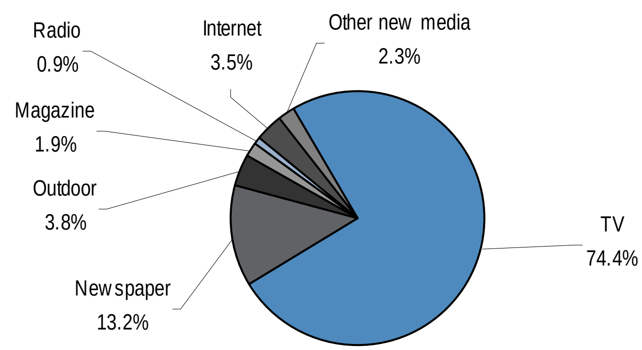
US Advertising Spending = 2% of GDP vs. China’s 0.5%

Although ad spend as a percent of GDP in China is still below the US level, as such we still believe advertising in China can grow at least in line with GDP. Online ads should grow even faster; therefore a projection for flat growth is quite bearish, in our view.

Online Brand Advertising Only Accounts for 3.5% of Overall Advertising, as per CTR Market Research

According to the latest CTR Research (leading cross-media research company in China), online brand advertising accounts for 3.5% of overall advertising. We believe if advertisers were to cut overall advertising, TV would be the first medium to be cut as rates are higher and results are less measurable vs. Internet. This compares to around 8% in the US and more than 10% in the UK.

Figure 72: China Advertising Spending Breakdown by Medium



Source: CTR Market Research, Feb 2008

We believe advertisers may likely reduce the budget on some types of traditional media, such as TV/newspapers, and turn more to Internet advertising. The CPM (cost per thousand) based price for Internet is around Rmb15-20, vs. Rmb50-100 for TV. Therefore, from a cost and reach basis (Internet can reach the whole nation, vs. local TV), the Internet still appears to be at an advantage vs. TV stations.

In addition, performance for Internet advertising is more measurable. Therefore, during times of budget tightening, advertisers will likely use the Internet as a more measurable media.

Online Advertising: Bottom-Up Perspective

Many investors also expected concerns over trends in a few significant sectors for online advertising: automobiles, real estate and financial services.

Automobiles Advertising

Our auto analyst, Frank Li, currently expects auto sales revenue to be roughly flat to slightly down in China in 2009 (with units flat and average selling price down ~5%).

Driver 1: Increased Online Allocation

Currently ~10% of automobiles advertising budget is allocated online in China, according to CTR Market Research. We believe that, with Internet population growing, more measurable results, and lower rates vs. TV, automobile companies will continue to increase budget allocation online.

In addition, we believe more money will be directed to drive product sales (through advertising particular models, driving traffic for test drives) rather than general branding exercise. In our opinion, a product-specific campaign would be more effective over the Internet as Chinese consumers tend to do a lot of their own research before their first car purchase.

Driver 2: Auto makers Still Have Room to Increase Ad Budget During Difficult Times
Auto industry overall spends ~ 6% of its top-line revenue on advertising. However, with (1) passenger car ASP still around 35% higher than the global average, and (2) net margins for China-based autos makers higher than global peers as well, we believe there is still room to increase the overall automobile advertising budget.

In addition, we believe longer-term growth prospects for auto sales in China are higher compared to other developed countries. As such, we would expect leading auto companies to further invest during difficult times, in order to gain market share for the long run.

Driver 3: Geographic expansion in autos sales
As we believe lower-tier cities shall be seeing faster autos sales in the next few years, we believe advertisers would also be well served by investing more on the Internet for nationwide customer reach (rather than magazine and newspaper, which has limited geographic coverage).

Real Estate Advertising
A Geographic Diversification Story Beyond Beijing
Online real estate advertisers for Sina and Sohu are still concentrated around the Beijing area. Currently, more than 70% of Sina's real estate ads are from the Beijing area. We expect that adoption of online real estate ads will drive Sina's ad sales. In particular, Sina formed a new joint venture with eHouse to push real estate online ad sales. eHouse has offices in more than 30 cities across China, and should be able to help Sina drive ad revenue outside of Beijing.

Even in the City of Beijing, Online Ad Growth Is Likely Despite Market Slowdown
From our checks with other private real estate portals in Beijing, those sites are still seeing acceleration in online ad spending. We believe (1) online is an effective medium, and (2) the only way for real estate companies to relieve themselves of current inventories is to cut price and increase promotions.

Financial Services Advertising
Investment funds have increased their overall ad budgets in late '07 and early '08. While they currently have pulled back on their overall budgets, they still have increased online allocation, so we believe companies like Sina still see growth in the segment.

We think new drivers for the next few quarters could be insurance companies, personal banking, and wealth management advertisements.

Branded Advertising

We Forecast Ad Spending to Still See ~18% Growth in 2009

The branded advertising (online display ad) segment is expected to grow ~41% Y/Y in 2008 to reach Rmb6.4B, as per our estimates (or in US$ terms, 54% Y/Y growth to reach ~US$932M). Growth during the year received a significant boost from the Beijing Olympics as advertisers attempted to capitalize on the historic event to promote their brands to Chinese consumers.

For 2009, we lowered our forecast of branded ad segment growth to ~18% (from 22% growth). We believe the growth rate is achievable given the continuing increase in Internet usage, higher cost effectiveness, and more measurable results for advertisers. Further, our China economics team expects consumer spending growth to accelerate next year compared to 2008, which should also support the growth of branded advertising.

Table 55: China Branded Ad Segment Forecast

	2004	2005	2006	2007	2008E	2009E	2010E
Branded Advertising (RMB M)	1,700	2,329	3,377	4,559	6,428	7,585	10,013
Branded Advertising (US$ M)	205	287	426	605	932	1,106	1,460
Growth rate (Rmb, %)	*72%*	*37%*	*45%*	*35%*	*41%*	*18%*	*32%*
Branded ad as % of total ad market	2.2%	2.6%	3.2%	3.9%	4.6%	4.9%	5.6%

Source: J.P. Morgan estimates.

Leading Portals Should Gain Market Share with Advertisers' Flight to Safety

Among different properties in Internet media, we believe leading portals will likely gain market share next year from smaller vertical sites, social networks sites, or video sites. We expect second-tier sites, with less financial backing and traffic, will likely offer a lower CPM rate to advertisers in order to drive revenue growth.

However, leading brand advertisers will likely turn to leading portals, with (1) advertisers making concentrated ad spending to maintain strong brand image on leading sites, (2) leading portal's strong media influence, (3) proven historical performance, and (4) leading portals will also likely offer SNS, video content to attract users, and will likely offer advertisers new advertising packages.

After years of slow market share decline to new Internet properties, we estimate that leading portals will see market share gain in next few years.

Table 56: Online Brand Ad Market Share Trend for Leading Portals

Year	2002	2003	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2012E
Market share of key portal players* (%)	68%	67%	67%	64%	62%	64%	66%	69%	68%	66%	65%

Source: Company reports, Bloomberg estimates, J.P. Morgan estimates.
* Includes: Sina, Sohu, NetEase, Tencent (Bloomberg estimates for Tencent).

Good CCTV 2009 Prime Time Auction Results Set Positive Tone for 2009 Ad Market

Every year at 8:18am on Nov. 18, CCTV (China Central Television) holds an advertising auction for the next year's (2009) prime time ad resources on CCTV channels. This important event auctions off ~15% of the country's total TV ad spending and sets the tone for ad growth in the coming year.

CCTV reported prime time ad revenue of Rmb9.26B, up 15.4% Y/Y: This is at the high end of industry expectations of 10-15%. We see the following implications: (1) while advertisers are generally cautiously optimistic about the 2009 outlook, the auction results suggest consensus (hundreds of advertisers participated) is more optimistic than cautious; (2) with the CCTV auction setting a positive tone, the online brand ad rate is highly likely to achieve >20% growth; (3) published rates for leading portals and media are likely to increase next year.

We continue to expect the online branded ad segment to benefit from decent 2009 overall ad market growth, as well as increased online ad allocation.

We look at absolute dollar amount of ad sold at the auction (as prime time resources are essentially the same every year – although this year has slightly more inventory – and always gets completely auctioned off). The table below shows the auction results growth rate vs. online brand ad growth rate (in Rmb terms).

Table 57: CCTV Auction Results vs. Online Brand Ad Growth

Year	CCTV Prime time Auction Revenue (Rmb billion)	*YoY Growth*	Online Brand Ad Growth	Number of times (X): [Online Brand Ad Growth / CCTV Auction Growth Ratio]
2003	3.31	*26%*	102%	3.9
2004	4.41	*33%*	72%	2.2
2005	5.25	*19%*	37%	2.0
2006	5.87	*12%*	45%	3.8
2007	6.80	*16%*	35%	2.2
2008E	8.03	*18%*	41%	2.3
2009E	9.26	*15%*	18%*	1.2

Source: CCTV, ZenithOptimedia. Note: J. P. Morgan current estimates.

Growth to Continue in the Longer Term after a Strong 2008

We expect branded ad spending to continue to grow in the longer term, given the following assumptions:

(1) Robust longer-term domestic consumer growth and high industry competition should continue despite current macro downturn.

(2) Continued Internet usage growth even after the Olympics.

(3) While a portion of Olympics-related ad spend in 2008 would have come from international companies targeting international visitors (buying ads in China during Olympics to show their presence there) and will not come back post-Olympics, we believe these international companies would not use Chinese Internet portals significantly to advertise in the first place.

(4) Some industries, such as fast moving consumer goods (FMCG), may increase their percentage of online spending after the Olympics – due to good ROI from

online advertising – while "non-Olympics sensitive" sectors such as online games and real estate should continue to spend on online advertising.

(5) The 2010 World Expo in Shanghai is another highly anticipated international event, and should provide advertisers another opportunity to associate their brands with a high-profile event that demonstrates the success of China.

Macroeconomic Impact on Ad Spends of Certain Volatile Sectors

Investors still seem concerned about China's economic outlook. In particular, recent data point to a slowdown in automobile sales, as well as significantly lower real estate sales volume. While the strong macro headwind against online advertisement is not good for the headlines, we believe online advertising is still likely to be healthy during the slowdown period.

Auto and Real Estate Sectors

As per our estimates, automobiles and real estate account for 25% and 15%, respectively, of Sina and Sohu's online ad revenue. As such, we have done some more detailed analysis on automobiles and real estate sectors. We note that:

(1) Online real estate and automobile ads still account for a small percentage of total advertising revenue for each of these two sectors. From our discussions with ad agencies and advertisers, we believe advertisers in auto and real estate segments would likely increase allocation to a more measurable and low-cost media, namely the Internet, while budgets in TV, newspaper and other traditional media would likely be cut.

Even if we assume overall real estate ads decelerate in both 08 and 09, we believe there is still room for online ad budget allocation to grow

Table 58: Real Estate Segment Advertising Spend– Bear Case Assumptions for 2009

	2005	2006	2007	2008E	2009E
Overall real estate segment ad revenue (Rmb B)	18.9	21.0	21.8	20.7	18.6
Growth rate (%)		*11%*	*4%*	*-5%*	*-10%*
Newspaper	11.6	12.4	12.8	11.9	10.5
% of total real estate budget	*61%*	*59%*	*59%*	*57%*	*56%*
Growth rate (%)		*7%*	*3%*	*-7%*	*-12%*
Outdoor	3.6	4.2	4.2	3.9	3.4
% of total real estate budget	*19%*	*20%*	*19%*	*19%*	*18%*
Growth rate (%)		*16%*	*1%*	*-7%*	*-12%*
Online	0.0	0.4	0.7	1.1	1.4
% of total real estate budget	*0%*	*2%*	*3%*	*5%*	*7%*
Growth rate (%)			*70%*	*55%*	*26%*
Others: TV, magazine, and others	3.7	4.0	4.1	3.8	3.4
% of total real estate budget	*20%*	*19%*	*19%*	*18%*	*18%*
Growth rate (%)		*8%*	*2%*	*-7%*	*-12%*

Source: CTR, J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

For autos, online ad allocation has historically been higher than other segments. We expect the trend to continue

Table 59: Automobile Segment Advertising Spend – Bear Case Assumptions for 2009

	2005	2006	2007	2008E	2009E
Overall automobile ad revenue (Rmb B)	11.0	14.0	18.1	21.7	19.6
Growth rate (%)		27%	29%	20.0%	-10.0%
Newspaper	4.7	5.4	6.2	7.4	6.5
% of total automobile budget	*42.4%*	*38.8%*	*34.2%*	*34.2%*	*33.1%*
Growth rate (%)		16.0%	14.0%	20.0%	-13.0%
Magazine		0.7	0.9	1.1	0.9
% of total automobile budget		*4.9%*	*5.0%*	*5.0%*	*4.8%*
Growth rate (%)		19.0%	31.0%	20.0%	-13.0%
Radio		0.4	0.6	0.7	0.6
% of total automobile budget		*2.8%*	*3.4%*	*3.4%*	*3.3%*
Growth rate (%)		53.0%	59.0%	20.0%	-13.0%
Internet		1.1	1.7	2.0	2.4
% of total automobile budget		*7.7%*	*9.2%*	*9.2%*	*12.2%*
Growth rate (%)			53.7%	20.0%	19.7%
TV	5.5	6.4	8.7	10.5	9.1
% of total automobile budget	*50.1%*	*45.8%*	*48.3%*	*48.3%*	*46.6%*
Growth rate (%)		16.0%	36.3%	20.0%	-13.0%

Source: CTR, Sina Auto channel news, J.P. Morgan estimates.

(2) Even assuming a bear case for ad budgets to decline, we think leading portals could possibly see 28% Y/Y growth in 2009. With a low % of budget being allocated to the Internet now, we believe our minimum case of ~18% Y/Y 2009 ad growth is still achievable.

(3) For the Real Estate Sector, We Still See Room for Growth in Southern China

From a market perspective, real estate sales (as well as ad dollar spend) are very dispersed over the whole. For example, Beijing only accounts for ~5% of property sales in China, and a similar ad spending for the city as well. We note that both Sina and Sohu have the majority of their revenue coming from Beijing or areas surrounding Beijing. With Sina's eHouse JV and Sohu's continued expansion into Southern China, we believe at least 90% of the real estate advertising market remains untapped.

Table 60: Real Estate Advertisement Breakdown by City

(In RMB, B)	2007	% of overall real estate advertisement
Guangzhou	1.3	5.9%
Shanghai	1.1	4.9%
Chongqing	1.1	4.9%
Beijing	0.9	4.3%
Chengdu	0.9	4.2%
shengyang	0.6	2.7%
Wuhan	0.5	2.3%
Tianjin	0.5	2.2%
Changsha	0.4	1.9%
Fuzhou	0.4	1.8%
Total		35.3%

Source: CTR, J.P. Morgan estimates.

Sector Likely to See Margin Expansion in 2009

During 2006 and 2007, the branded ad sector has seen margins decline, mainly due to (1) competition for exclusive content, and (2) increasing video content offerings (broadcasted videos and user-generated contents) have led to higher bandwidth costs.

We expect these to lead to margin upside for the sector in 2009 and 2010:

(1) After the 2008 Olympics, portals will likely reduce high editorial costs. For Sohu in particular, the upfront fee for the Olympics sponsorship amortization will be finished by 4Q08, and this should lead to higher margins. Sina's Euro exclusive 2008 soccer broadcast was concluded in 2Q08, which will also reduce Sina's costs going forward.

In 2009, we don't expect any big sports events to be held, and as such portals are not likely to become involved in a price war for exclusive contents.

(2) Increasing monetization of video contents – advertisers are more receptive to video-based advertising and are now likely willing to pay a higher fee for video ads.

User Segmentation – Already Happening, But Leading Portals Should Continue to See High Growth

Over the past year, there has been an increase in the popularity of web2.0 sites such as SNS sites like 51.com, Xiaonei, mop.com, and video sites such as Tudou, Youku.

While these sites have driven eyeballs and ad dollars away from traditional portals, we still expect leading portals to hold dominant user market share and to gain revenue market share, given (1) Sina and Sohu are the leading news sites in China – other new sites do not have a similar level of media influence; (2) portals are also aggressively expanding horizontally to offer SNS, such as blogs and videos.

What Are the Portals Doing to Prepare for a Potential Downturn?

(1) More Focus on CPM vs. the Time-Based Model
In its 4Q08 – 1Q09 rate card, Sina offers more of its sought-after resources in the CPM (cost per thousand) business model. We believe that in more cost-conscious times, more advertisers will adapt to the CPM model vs. the traditional CPT (cost per time) model.

In addition, the CPM model would likely drive more of customers' spending to content pages and away from the sought-after resources.

(2) Cost Control
Leading companies are reviewing different aspects of their businesses to optimize the number of employees in each department. For example, Sina currently has no plans to take fresh college graduates next year.

(3) Video Ads - A Key Driver in 2009
With the success of video content and video format advertising during the Olympics, we believe advertisers will increase video ad spending in both price and volume in 2009. Sina has been building up its video contents to capture the growth in video ads.

(4) Tighter Credit to Reduce Account Receivables Risk

In general, all portals have a tighter credit control policy regarding smaller or riskier advertisers. For example, large companies such as China Mobile can maintain prior credit terms. For smaller companies with shorter credit histories, portals like Sina would likely require prepayment.

Regulatory Risk Remains Lower than Other Online Sectors

We believe the regulatory risk remains lower for the portal online ad business compared to other segments in China, such as WVAS, online music or online games. Online advertising is the most established online business in China (since the late 90s), and regulations and boundaries are well understood by industry players. We believe the leading portals have strict internal compliance departments and automated content scans to ensure contents are in compliance with government standards. While Web 2.0 content such as music, video, and blogs has come to the government's attention, we believe if there is further regulatory tightening for Web 2.0 content, leading portals should be less impacted than pure Web 2.0 companies. Leading portals are the most trusted by the government among Internet companies and have the best compliance procedures; further, the financial impact would be less significant because still only a small portion of their revenues is from Web 2.0 content.

Online search

Still in Early High-Growth Stage

The online search advertising market in China is expected to grow ~64% Y/Y in 2008, as per our estimates, to reach Rmb 4.7B (US$676M). Within this, the PPC search segment is expected to grow ~74% Y/Y to reach Rmb 4.3B (or in US$ terms, grow ~90% Y/Y to reach ~US$623M). We believe online search advertising is still in an early high-growth stage in China, driven by: (1) rising Internet penetration, (2) significant growth in websites and pages, (3) higher search usage (due to greater mass of web content), and (4) large number of SMEs (with small ad budgets) turning to search advertising (due to the higher ROI).

For 2009, we expect the search advertising market in China to witness ~42% Y/Y growth to reach Rmb 6.6B (~US$ 9.6B), with the PPC segment growing at ~45% Y/Y to reach Rmb 6.2B (~US$ 0.91B). We continue to expect Baidu to remain the dominant player in China in the near to medium term (Baidu continues to maintain a market share of ~65% as of 3Q08), and remain a key beneficiary of the industry growth.

Table 61: China Search Market Forecast

	2004	2005	2006	2007	2008E	2009E	2010E
Avg. Internet users (Mn)	87	103	124	174	239	295	348
Number of search (Bn)	47	62	82	123	161	209	254
Coverage	12%	14%	17%	21%	24%	26%	29%
Click through rate	20.0%	21.0%	22.5%	24.3%	25.5%	25.5%	26.2%
Price per click (Rmb)	0.25	0.29	0.34	0.40	0.44	0.45	0.47
PPC Market (Rmb M)	280	506	1,062	2,472	4,299	6,234	9,039
PPC Market (US$ M)	34	62	134	328	623	909	1318
Growth rate (Rmb, %)	*94%*	*80%*	*110%*	*133%*	*74%*	*45%*	*45%*
Total Search Market (Rmb M)	584	846	1,442	2,851	4,663	6,614	9,438
Total Search Market (US$ M)	71	103	182	378	676	964	1,376
Growth rate (Rmb, %)	*304%*	*45%*	*70%*	*98%*	*64%*	*42%*	*43%*
Search ad as % of total ad market	0.7%	0.9%	1.4%	2.4%	3.3%	4.3%	5.3%

Source: CNNIC, J.P. Morgan estimates. Note: Excluding distributor discount.

Impact of Macro Concerns Should Be Relatively Less

Since the beginning of 2008, we have heard news about credit tightening in respect to SMEs in China. In particular, China GDP growth has moderated from double-digit growth for the past few years to 9% in 3Q08.

While we expect the economic headwinds are negative for growth, this should not significantly affect search market growth, as (1) SMEs are likely to turn to online search providers for low-cost effective marketing, particularly during tough economic times, (2) existing customers are still a small portion of China SME base of 40 million (vs. market leader Baidu's active customers of 194K), and (3) large-brand advertisers continue to increase spending on search.

Further, growth in search advertising should also be supported by: (1) still-low Internet penetration, (2) diverse advertiser base, and (3) higher ROI.

Also, most advertisers and agencies we met with believe ad spending on search is low compared with international standards. Greater customer education and better tools (API) should encourage advertisers to spend more on search.

Search Usage vs. Advertiser Readiness vs. Monetization

To better understand the growth potential of China's Internet search market, we think it would be useful to look at the search space from three different perspectives: (1) search users, (2) advertisers, and (3) search monetization/market size. We view search usages and advertiser readiness as the two main drivers for the monetization of the online search market.

Figure 73: Search Monetization Driven by Both Search Usage and Advertising Readiness

Source: J.P. Morgan

Search Market Outlook: Usage

Like the US, online search in China offers users with personalized information. As users become more experienced, they look for information on the Internet beyond the major portals. Entertainment-related content, such as pictures and music, have always been popular in China. Going forward, we believe the non-entertainment related searches such as eCommerce and e-Government will continue to gain popularity.

Growing Usage in China

The latest statistics from CNNIC show that the number of users in China has reached 253M as of June 2008. We expect usage in China to continue to grow, driven by such factors as:

- **Entertainment tool.** Digital entertainment, such as MP3, movies, etc., can be downloaded from the web virtually free of cost or at a very low cost. Online games—LAN-based (local area network), MMORPG (massively multiplayer online role playing games), or casual board and chess games—are also low-cost alternatives to offline entertainment. Internet in general is a low-cost form of entertainment—Internet café access costs about Rmb2-3 per hour vs. Rmb40 for a movie.

- **Communication tool.** Migrant workers (about 10% of total population, or 140 million people in China, are floating population) as well as relocated white-collar workers visit Internet cafés after work to use instant messenger and email, or to play games or watch movies. Despite the government constantly monitoring these services, blogs and bulletin board services have also increased in popularity in China—they serve as channels for the Chinese to express their personal views and communicate with others.

- **Information source.** Most traditional media is still tightly controlled by the government. The Internet offers an alternative information source that users seem to find more friendly and entertaining to use. Major portals have also been increasing their content over the past few years to make more information available to users. Other government initiatives such as electronic tax filing, customer clearing, and government agency websites also boost Internet usage. Apart from growth in the number of users, the time spent online per week as well as the number of days online per week is on the rise.

Surge in Websites and Webpages in China
China is no exception to the information boom. As of December 2006, there were around 4.4 billion webpages, up from 650 million in December 2004 (CNNIC, excludes 217 million overlapped pages).

The number of websites located in China is also rapidly growing. According to CNNIC, the number reached 1.9 million by July 2008, up from 669k by end-2004. The amount of information per page (in terms of number of bytes) is also in the rise.

Users Turning to Search in China
With information on the Internet ever expanding, it is natural that users turn to search engines to organize the high volume of information. As a result, the number of searches in China is expected to increase more than fourfold from 2003 to 2008. According to the 2008 CNNIC report, more than 69% of Internet users use search engines

Search Market Outlook: Advertisers' Readiness

Online advertising accounts for only ~5% of the total ad spending in China, while search revenue is even smaller, at ~4% of the total ad market. As in the US, we believe the paid search ad is particularly well suited for small and medium enterprises (SME) in generating sales leads. Yet, as with the low Internet adoption rate in China, paid search is still a new advertising concept for these advertisers. Hence, continuous education and marketing are required to drive market growth.

1. Large Available SME Market for Search Advertising, but Low Internet Usage
According to the National Development and Reform Commission, Department of Small and Medium-Sized Enterprises figures, as of F'05, there were 43 million SMEs in China. These SMEs are mainly 39 million individual businesses (small businesses registered with some government departments). Statistics from the State Administration for Industry & Commerce (SAIC) suggest that the number of SMEs in China is roughly 24 million. Despite the discrepancies, we believe the overall number of SMEs is large.

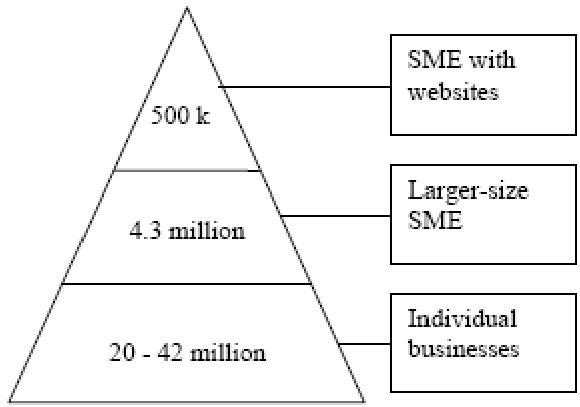
According to the SAIC, as of F'05, there were 4.3 million larger-size SMEs (registered directly with the SAIC). The total number of websites in China is 843,000 (as of December 2006). We estimate 60% of the websites are corporate (excluding personal sites, bulletin boards, and inactive sites). Therefore, the number of corporate websites in China is roughly 506,000.

We do not think the market is saturated
Based on Baidu's 3Q08 active marketing customers of 194,000, the company's penetration among larger SMEs is less than 5%. Hence, we believe the market is far from reaching a saturation point.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

50% of corporate websites get less than 50 page views per day
According to the CNNIC survey, about 50% of all corporate websites in China have less than 50 page views per day. With a low hit rate, we believe corporations would use the search engine market (both search engine optimization and paid search) to increase traffic to their sites and as a result generate new business leads.

Figure 74: Number of SMEs by Different Segments



Source: SAIC, J.P. Morgan estimates.

2. E-Commerce Should Be Another Growth Driver
We expect C2C eCommerce to see better adoption in the next few years, driven by factors such as: (1) better acceptance for "mail order" (China's catalogue sales are non-existent, and most transactions are done face to face) through increased marketing, better varieties, and increased adoption of home TV shopping networks; (2) improved trust and safety features by eCommerce sites; and (3) more regulated online payment infrastructure. In the US, eCommerce companies are leading users for paid search advertising. We believe a similar trend will emerge in China too, as paid search is an effective method for targeting prospective buyers who already have items in mind. Currently, leading online search advertisers in China include Alibaba, Taobao, Dangdang, Joyo, Ctrip, and eLong. We expect paid search to benefit from eCommerce growth in the future.

3. Local Search: Another Promising Area
Similar to the US, we believe there is a large commercial potential for local search in China. Particularly, there are a large number of households/individual businesses eager to promote their local businesses. In addition, IP address assignment is quite well organized in China. We expect IP-based marketing to be more popular going forward as online advertisers become more sophisticated.

4. IT Outsourcing Companies Are the Main Educators for Search Usage
The two types of companies that help drive paid search usage of SMEs are ad agencies and IT outsourcing companies. While ad agencies mainly focus on companies that already have websites, IT outsourcing companies target SMEs that are less sophisticated in IT infrastructure.

IT outsourcing companies such as Sino-I (250.HK), and Hichina (net.cn), provide one-stop services for SMEs—domain name registration, web hosting, website design, and promotions (mainly through search engine optimization, paid search, directory listing). We believe the IT outsourcing companies will be key players in the future to drive Internet adoption growth and search usage for SMEs.

China Enterprise (ce.net) (fully-owned by Sino-I) is one of the first official agents for Google in China. It has approximately 220,000 customers. The company is a dedicated educator for IT services in China with each of its 77 offices conducting regular meetings for entrepreneurs and SMEs. We believe this kind of education will help expand the number of advertisers for online search services.

5. Ad Agencies Would Have to Drive Search Market Growth

Paid search marketing campaigns are usually more involved than display ads. Advertisers need to decide on what keywords to use, the number of keywords, bidding strategy and bidding period. In addition, more sophisticated advertisers also pay attention to competitors' strategy, lead quality and ROI. A well-run search campaign is arguably more difficult than banner ads where advertisers simply design the banners and place them on as many relevant websites as possible.

Furthermore, budgets for search campaigns are more difficult to manage as spending is based on the number of clicks, which non-experienced advertisers do not have control over. The ad spending amount essentially has no limit. Hence, advertisers are generally quite cautious about the initial spending and only allocate a small daily budget for trial, or even worse, may simply give up on paid search campaigns. We believe education by agents and distributors can eventually help advertisers overcome these barriers, and advertisers will thus increase their budgets on search campaigns.

Search Market Outlook: Monetization

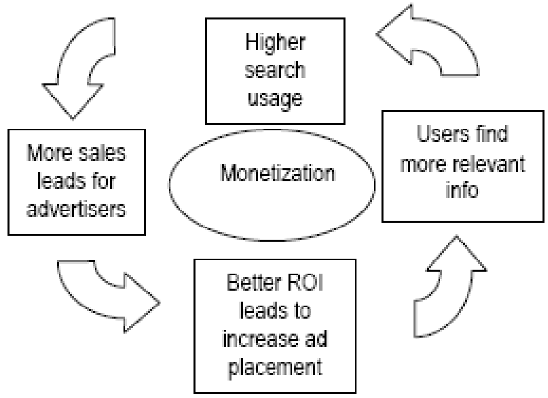
We expect monetization of the paid search market to grow quickly, driven by both higher search usage by users and better adoption by advertisers. The coverage ratio is low compared with the US, and we expect it to increase and drive monetization of the market.

Self-Fueling Cycle to Expand Monetization

We view the market as a self-fueling cycle driven by users and advertisers growth. Higher search usage leads to a higher number of sales leads for advertisers. With more high quality leads coming from paid search, advertisers would place more keywords in more search engines. As users find more relevant product information by advertisers, they will conduct more searches, thus leading to higher usage. This cycle should continue, and lead to market size expansion.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Figure 75: Monetization Increase Driven by Self-Fueling Cycle



Source: J.P. Morgan.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Online Gaming

Growth Outlook Remains Robust

The online gaming sector continued to see strong growth in 2008, with ~37% Y/Y growth to reach Rmb13.9B (~US$1.8B), as per our estimates. The MMORPG segment (~84% of total gaming market) grew ~37% Y/Y to reach ~US$1.5B, as per our estimates, with the success of the free-to-play model continuing as a key factor. The casual game segment, meanwhile, grew ~43% Y/Y to reach ~US$293M, as per our estimates.

For 2009, we forecast ~29% Y/Y growth in the MMORPG segment and ~35% Y/Y growth in casual games. We expect companies with strong operating and marketing capabilities and healthy game pipelines to continue to benefit from the market's growth.

Table 62: China MMORPG Market Forecast

	2005	2006	2007	2008E	2009E	2010E	2011E
MMORPG gamers (million)	18.9	24.6	34.4	44.7	55.9	66.0	75.9
Game users penetration	17.0%	17.9%	19.7%	22.3%	25.3%	27.6%	29.4%
Average ARPU per month (RMB)	21.7	20.5	20.7	21.7	22.4	22.8	23.3
Market size (RMB million)	4,918	6,043	8,544	11,663	15,016	18,073	21,200
MMORPG Market size (US$M)	592	728	1,124	1,535	1,976	2,378	2,789
Growth Rate:	*35%*	*23%*	*54%*	*37%*	*29%*	*20%*	*17%*

Source: iResearch, J.P. Morgan estimates.

Table 63: China Casual Game Market Forecast

	2005	2006	2007	2008E	2009E	2010E	2011E
Casual game players (million)	24.4	32.6	42.4	50.9	59.0	66.1	71.4
Casual players penetration	22.0%	23.8%	24.2%	25.4%	26.7%	27.7%	27.6%
Assumed Ratio of paying users	22%	23%	25%	27%	29%	30%	31%
APRU per month (Rmb)	11.0	11.6	12.2	13.5	14.5	15.6	16.7
Market size (RMB million)	708	1,044	1,563	2,227	2,996	3,714	4,435
Casual Market size (US$M)	85	132	206	293	394	489	584
Growth Rate:	*82%*	*54%*	*56%*	*43%*	*35%*	*24%*	*19%*

Source: iResearch, J.P. Morgan estimates.

Key Industry Drivers

We expect continued robust growth of online gaming in China to be driven by:

(1) Continued strong Internet user growth in China (2008E-2010E CAGR of 18%).

(2) Upside in gamer penetration, which is still less than half of Korea's penetration (also below HK and Taiwan), with additional gamers coming particularly from lower-tier cities.

(3) Increasing broadband penetration, with 214M broadband Internet users as of Jun-08, or 85% of total Internet users; CAGR of ~100% over the last 5 years.

(4) Efforts of game companies – better quality, innovative games and more effective promotions to continue to attract players; also, success of the free-to-play (item-based sales) model (contributing ~63% of industry revenues in 2007, up from ~52% in 2006, as per IDC estimates).

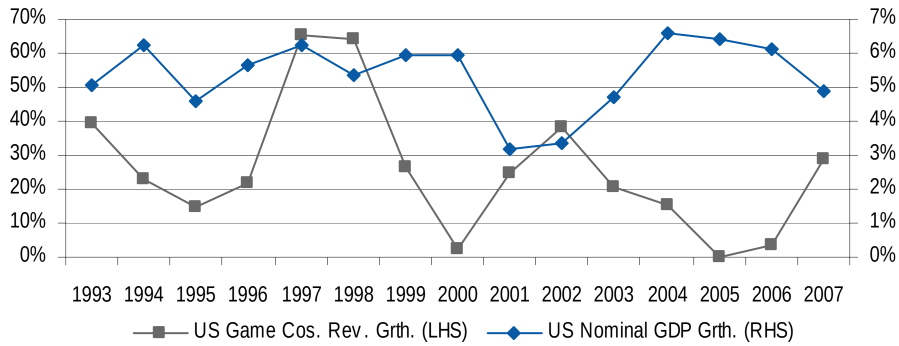
(5) Limited leisure alternatives – teenagers in first-tier China cities spending more on entertainment like Internet/games, with the trend being replicated in smaller cities.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Game Software Industry Typically Not Correlated with Macroeconomic Growth, Thus Should Be Less Vulnerable in an Economic Slowdown

Historically, the game software industry has not been significantly correlated with macroeconomic growth. For instance, in developed markets such as the US, the videogame software industry has historically exhibited cyclicality driven by game hardware launches (consoles, handheld devices). These in turn result from technological advances by the hardware manufacturers – in terms of faster processing devices with superior graphics and game play capabilities – typically every 4-5 years, which creates the need for newer software and also drives consumer demand. As a result, the game software industry is relatively less vulnerable in an economic slowdown, compared to other industries and software segments.

Figure 76: US Game Software Leading Companies' Revenue Growth vs US GDP (Nominal) Growth



Source: DataStream. Note: Correlation coefficient: -0.19 (weak correlation). (1) Leading US game software companies' revenue growth based on total revenue of Electronic Arts, Activision, THQ and Take Two. (2) Prior game platform cycles were 1995-2000 and 2000-2005; current console cycle started in 2005 (Xbox 360 launch).

In addition to the above, in recent times, other aspects contributing to potentially greater resilience of the gaming sector have been: (1) the increasing acceptance of gaming among a wider demographic (e.g., games being seen as a family entertainment avenue, including women and children); (2) increasing penetration of the Internet and more broadband connections driving online gaming; (3) emergence of innovative business models such as free-to-play online games and in-game advertising making gaming more affordable for consumers; and (4) greater variety of games (e.g., casual games such as music and dancing games) to appeal to diverse tastes.

Good Understanding of Gamers' Needs Will Be Key for Companies' Success

Competition within the online gaming industry increased in 2007, with more free games, more competitors, and further public listings (significant capital raised via IPOs in 2H07). With the continuing popularity of the free-to-play model, we believe game companies can continue to generate revenue growth as long as gamers believe it is really "worth it." Thus, we expect game companies that take care to maintain a good understanding of what gamers will pay for (or strong marketing capabilities), and then respond accordingly, will see greater success going forward. Hence, in our view, companies like Shanda (leading free-to-play game operator with strong operating and marketing capabilities) are more likely to capitalize on the robust industry growth.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Online Gaming Primer

What Are Online Games?

Broadly speaking, we can separate online games into two segments: (1) casual games, and (2) serious games / MMORPG. Causal games are easy to play and only require brief tutorials. Some examples are puzzles, board games and some old arcade games. Demographics for casual games are diverse: they cut across age groups (from young child to senior citizens) and are equally split across genders. Very often, these games are free.

What Is a MMORPG Online Game?

These are more complex games with a large number of scenes, multiple players and characters. Serious game players are also more committed to the games than casual players. They usually comprise young adults or teens who spend more than 10 hours per week on online games.

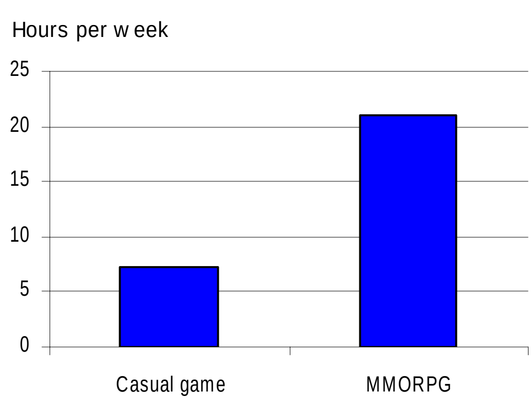
The most popular games that account for most of China's online game revenues (~84% of total online gaming market, as per our estimates) are Massively Multiplayer Online Role Playing Games (MMORPG). These games are not simply about shooting and killing or finding treasures and saving the princess, as in some other games. MMORPG are community-based, and players can interact with other players, form coalitions with acquaintances to fight battles, make villages more livable and even have virtual marriages.

MMORPG games are very dynamic; game developers and operators always extend the map, create new weapons and run special virtual events. Typically, operators have a new release every month and a major upgrade once a year—and users can download them free of cost.

What Is a Casual Game?

Casual games are online games that are typically less evolving compared with MMORPG games. Players typically only spend less than 30 minutes per game session. The contents and depth is much simpler, and requires fewer skills or less training to play the games.

Figure 77: Time Spent on Games per Week



Source: IDC (2007).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Casual games can be broadly classified into 1) board and chess games, and 2) advanced casual games. Board and chess games, as the name suggests, are board games, chess, different types of card games, and other traditional games put online. These are viewed more as commodity products, and difficult to differentiate from competitors. As such, monetization is typically lower.

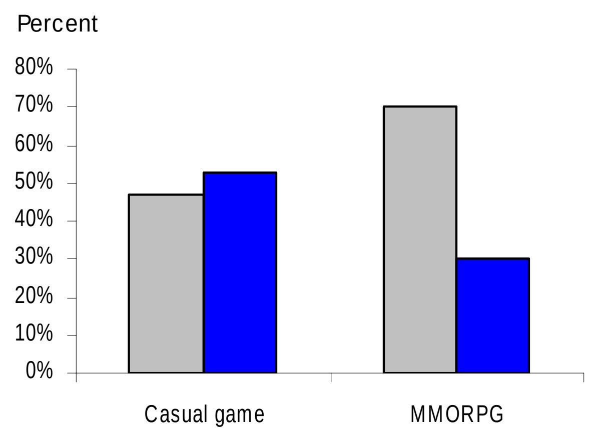
Advanced casual games are online games that have more depth and content compared with board and chess games. However, they are not as involving as MMORPG. Gamers spend less than an hour per game session. Successful advanced casual games are typically more innovative, and bring in new ideas to the market space. The popular advanced casual games include: BNB, O2Jam, Freestyle, China.com's Yulgang games, and can also be regarded as casual MMORPG games. Successful casual games generate more revenue compared to board and chess games.

The revenue model for casual games is in-game item sales. Typical game items are: avatars (virtual clothing, accessories, and decorative products), tools (i.e., virtual golf clubs to play golf), weapons, special features (i.e., ability to see competitors' card in card games), and membership (priority access to game servers, and "members only" games).

Casual and MMORPG Are Complementary Rather than Competing Products
We believe casual games and MMOPRG satisfy needs of players at different times. For example, if a player has 15 minutes to kill, they likely would turn to casual games, but if a player has a few hours everyday, playing a simple casual game is likely to become too boring. Therefore, this same player could play both types of games at different times, depending on his or her availability and needs.

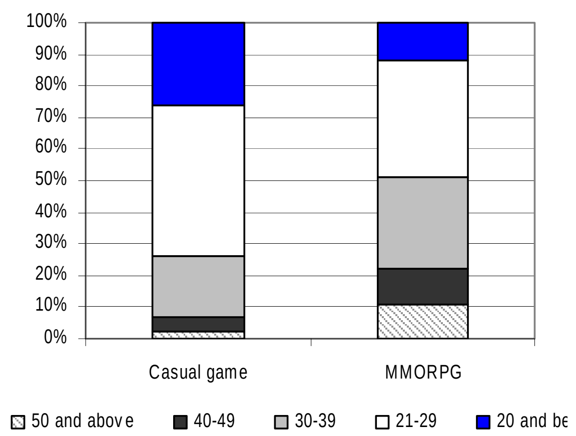
We believe new innovative advanced casual games attract non-game players to online games and further expand the gamer base. We observe this from the demographics differences between casual games and MMORPG games. These additional players could perhaps become MMORPG gamers down the road, if they find online gaming interesting.

Figure 78: Gender Comparison Between Casual and MMORPG



Source: IDC (2007). Note: Grey – Male players, Blue – Female players.

Figure 79: Age Comparison Between Casual and MMORPG



Source: IDC (2007).

Do Gamers Have Time to Play Both Advanced Casual and MMORPG?

In China, the market trend is to develop advanced casual games that are more complex and involving, and as such these casual games consume more time compared with before. Investors are concerned that this would reduce spending on MMORPG games. We believe this may be true, but the effects on MMORPG should be minimal, in our opinion. First, it is not uncommon for users to play multiple games, so users can play both MMORPG and casual games during the same day. Second, an expanded casual game user base should also bring new users to MMORPG.

Online Games—A Sticky Business

In online games, players build a strong community with other game players. They communicate through instant messengers in the game. Once players have been playing for a certain period, they start building their seniority and respect within the gaming community, as well as their stock of accumulated weapons. As such, fair play becomes very important. Hacking not only demoralizes players but also seems to cause "community unrest" and to threaten the "social order" in the game space. Game operators hire game masters or 'GMs' who patrol the game space to check unfair practices, and remove those users who violate the rules. Leaving the game means severing ties with the community, as well as giving up weapons and armors accumulated over time. As such, players have proved to be quite loyal to the games.

A well-run game is therefore very sticky, and the operators' goal is to make their game stickier. To further increase user loyalty, game operators organize special events in the virtual space, as well as organize offline promotions and parties. One good example is Lineage in Korea, which was launched in Korea about six years ago and remains one of the top games in the country.

Any Piracy Issues of Online Games?

Online games are designed to get around the piracy issue. There are two sets of software – server software and client software. Server software is installed inside game companies' servers. The game server is designed to protect against hackers trying to copy or alter the server software. Client software is distributed free of charge and can be downloaded from a game operator's sites at any time. Since client software is free, unlike game consoles where game software is charged for a fee, there is no reason to make pirated copies. As such, piracy problems are very limited.

What are pirated servers?
This refers to the situation where the main server software is stolen from game companies or the server software is being reverse-engineered. In this situation, “criminals” put stolen / pirated server codes on home-run servers and charge users a lower fee than authentic servers to play the game on their servers. These are referred to as “pirated” servers.

Games that are operated widely across the globe are more prone to being pirated. This is because game developers need to distribute a source code to outside game local operators, and as such, there is a higher chance of the source code being leaked out. For example, Mir2, Mu, and Lineage are well known for having pirated servers in China.

NetEase, which develops its games in-house, has not seen any pirated server issues. Also, new games have more security features to protect the server software from being pirated. For example, we have not noted any pirated servers for World of Warcraft.

What are hacking tools / software?
Hacking in online games typically refers to special (purchased or self-written) programs that run on players’ PCs. With these special hacking tools, game players can, for example, get infinite lives, nuke all the adjacent players, or take tools from others. Hacking demoralizes other players and results in their leaving the game.

To tackle the issue, online game operators can: (1) amend the actual game software, (2) hire more game masters to patrol the virtual community, and (3) bar hacking players from playing the game. The first option is the most effective way to deal with the problem. However, as many online game operators only purchase games from other developers and do not have access to the source code, there could be a time delay in addressing a particular hacking issue. In fact, this is a fairly frequent issue raised by operators in China, and has led to the decline of some early online games.

Economy of Games
We believe the required number of concurrent users is low for a MMORPG game to break even. Excluding development costs or licensing fees, a game can achieve an operational breakeven at 4,000-5,000 average concurrent users.

With relatively low breakeven user numbers, we believe the number of MMORPG game titles will continue grow. However, many of these will likely be small-scale games that we expect will target niche audiences, much like different types of movies: action-adventure, science-fiction, martial arts, war, mystery, medieval, etc.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 64: Estimated Gross Income of a MMORPG under Various Concurrent Users

	Case 1	Case 2	Case 3
Average concurrent users	1,000	4,000	10,000
Active paying users	11,000	44,000	110,000
ARPU per users (RMB):	9	9	9
Revenue after distributor's discount	79,200	316,800	792,000
Number of servers	3	4	9
Monthly server amortization & bandwidth cost	16,375	21,833	49,125
Game masters and other labor cost	48,000	64,000	144,000
Marketing and promotion	55,440	110,880	158,400
Other operating expenses	47,520	95,040	158,400
Gross Net Income	(88,135)	25,047	282,075

Source: J.P. Morgan estimates. Note: Excluding development cost, amortization of licensing fee or revenue sharing with game developer.

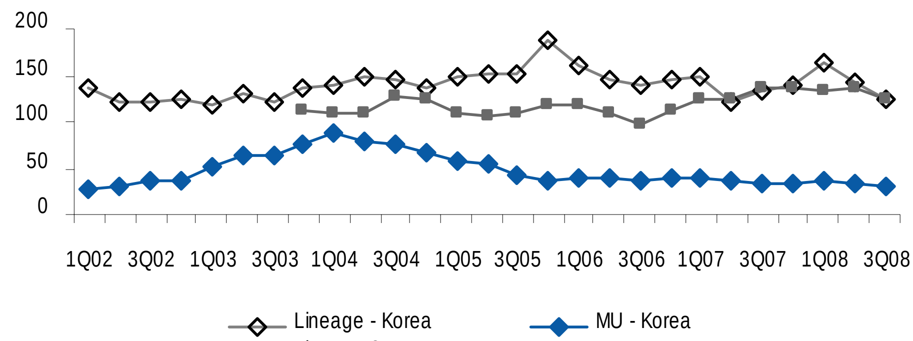
How Fast Would a Game Decline From Its Peak?

As a rule of thumb, typical popular MMOPRG games reach their peak in around three years. The rate of decline from the peak varies depending on various factors. Some games decline at a faster rate compared with others. For example, we noted Mu, operated by 9Webzen, experienced a step function (around 50% drop each step) type of sharp fall, mainly due to hacking and cheating tools, while Mir 2 declined 30% Q/Q in 3Q05, mainly due to pirated servers.

We believe the rate of decline from the peak varies, depending mainly on these factors: 1) hacking or pirated server issues, 2) ongoing promotion and user activities, 3) availability of upgrade packs.

Some of the Korea games have still maintained a high level of usage for over 6 years.

Figure 80: PCU (Peak Concurrent Users) Trend for Long-Running Korean Online Games



Source: Company reports.

Comparison of Leading Games and Game Companies

Table 65: Leading MMORPG Companies by Revenue Market Share

	2006	2007	1H08
Shanda	22%	24%	21%
NetEase	31%	22%	18%
Giant Interactive	7%	18%	16%
The9	17%	15%	14%
Sohu	1%	4%	10%
Perfect World	2%	7%	9%
NetDragon	2%	4%	5%
Kingsoft	3%	4%	3%
Others	15%	3%	3%

Source: Company reports, J.P. Morgan estimates for companies covered by J.P. Morgan, and IDC for all others.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 66: Leading MMORPGs by PCU (Peak Concurrent Users)

(PCU in '000s)	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Fantasy WWJ (NetEase)	1,236	1,313	1,223	1,335	1,503	1,472	1,443	1,520	1,666	2,082
Sequential growth	*18.5%*	*6.2%*	*-6.9%*	*9.2%*	*12.5%*	*-2.1%*	*-1.9%*	*5.3%*	*9.6%*	*25.0%*
ZT Online (Giant)	120	320	558	755	874	1,073	888	983	1,530	2,100
Sequential growth		*166.7%*	*74.4%*	*35.3%*	*15.8%*	*22.7%*	*-17.2%*	*10.7%*	*55.6%*	*37.3%*
WoW (The9)	610	630	595	680	680	665	809	990	999	1,030
Sequential growth	*15.1%*	*3.3%*	*-5.6%*	*14.3%*	*0.0%*	*-2.2%*	*21.7%*	*22.4%*	*0.9%*	*3.1%*
TLBB (Sohu)						400	400	400	600	700
Sequential growth							*0.0%*	*0.0%*	*50.0%*	*16.7%*
WWJ2 (NetEase)	581	562	593	603	480	505	305	387	386	544
Sequential growth	*4.8%*	*-3.3%*	*5.5%*	*1.7%*	*-20.4%*	*5.3%*	*-39.7%*	*26.9%*	*-0.4%*	*41.1%*
Eudemons Online (NetDragon)	26	50	128	325	438	496	527	574	479	505
Sequential growth		*92.3%*	*156.0%*	*153.9%*	*34.8%*	*13.2%*	*6.3%*	*8.9%*	*-16.6%*	*5.4%*

Source: Company reports. Note: Individual game data not reported by Shanda and Perfect World.

Table 67: Leaders in MMOG Active Paying Accounts (Free-to-Play Model)

(In '000s)	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Shanda	2,470	2,230	2,140	2,290	2,340	2,720	3,080	3,470	4,110	4,240
Sequential growth		*-9.7%*	*-4.0%*	*7.0%*	*2.2%*	*16.2%*	*13.2%*	*12.7%*	*18.4%*	*3.2%*
Giant Interactive	143	602	698	787	986	1,248	1,318	1,405	1,447	1,760
Sequential growth		*321.0%*	*15.9%*	*12.8%*	*25.3%*	*26.6%*	*5.6%*	*6.6%*	*3.0%*	*21.6%*
Sohu						209	690	1,096	1,387	1,684
Sequential growth							*230.1%*	*58.8%*	*26.6%*	*21.4%*
Perfect World			26	602	695	1,040	1,390	1,565	1,701	1,530
Sequential growth				*2215%*	*15.4%*	*49.6%*	*33.7%*	*12.6%*	*8.7%*	*-10.1%*
The9					4	194	183	255	210	165
Sequential growth						*4995%*	*-5.3%*	*39.2%*	*-17.8%*	*-21.6%*

Source: Company reports, J.P. Morgan estimates. Note: Perfect World: based on item-based games; Sohu: based on TLBB; The9: based on SUN, GE and JJW.

Table 68: Leaders in MMOG Quarterly ARPU per Active Paying Account (Free-to-play Model)

(In Rmb)	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Giant Interactive	84	117	220	220	320	295	305	309	325	286
Sequential growth		*39.3%*	*88.0%*	*0.0%*	*45.5%*	*-7.8%*	*3.5%*	*1.1%*	*5.3%*	*-12.1%*
Perfect World			12	76	95	98	136	141	151	188
Sequential growth				*544.9%*	*25.2%*	*2.8%*	*38.8%*	*3.7%*	*7.1%*	*24.5%*
Sohu						171	118	147	199	179
Sequential growth							*-30.8%*	*24.6%*	*35.4%*	*-10.1%*
Shanda	91	137	155	165	177	174	179	173	156	164
Sequential growth		*49.7%*	*13.4%*	*6.8%*	*7.1%*	*-1.9%*	*3.1%*	*-3.2%*	*-10.0%*	*5.2%*
The9					88	85	175	155	217	228
Sequential growth						*-3.4%*	*105.4%*	*-11.2%*	*39.4%*	*5.2%*

Source: Company reports, J.P. Morgan estimates. Note: Perfect World: based on item-based games; Sohu: based on TLBB; The9: based on SUN, GE and JJW.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

eCommerce

eCommerce Is Still in the Early Stage of Growth in China
eCommerce usage comprising only 33% of the total Internet penetration. This is at a lower level compared with other countries.

We believe the key issues facing the low percentage of online shopping include:

- Internet users have low trust in online merchants
- Chinese consumers historically have not used mail order (essentially, it has not existed before).
- Many Chinese consumers still prefer cash transactions, touching the products that they plan to buy.

Table 69: Online Shoppers as a % of Internet Population

	Online shoppers as a % of Internet population
Global	86%
China	33%
US	94%
UK	97%
Japan	97%
South Korea	99%

Source: China: China IntelliConsulting. Others: Nielsen (2008).

Outlook in China Online Shopping Is Brighter Entering 2009

We observe a few trends to drive eCommerce growth in 2008 that should benefit the industry in the longer term.

More branded online stores to gain user awareness. Besides long-time players like Dang Dang, Joyo, and 360buy, new branded B2C stores such as Vancl and YesPPG have become heavily involved in offline marketing. This helps to raise awareness of eCommerce among Internet and non-Internet users.

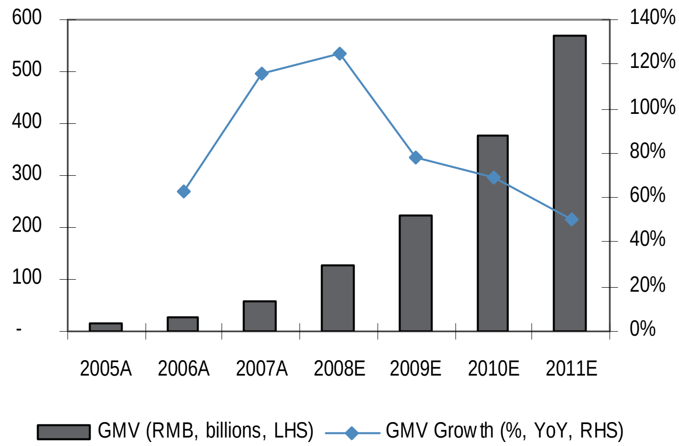
Baidu entrance to eCommerce space. The largest portal in China by traffic, Baidu has entered eCommerce with the launch of Youa. We believe Baidu can leverage its large search user base to try to its benefit as it enters eCommerce.

Taobao setting high trust and safety standards. With trust and safety the top priority among Internet shoppers, Taobao has significantly improved its safety standards in 2008, by implementing such things as a seven-day money back guarantee and a 30-day warranty on electronics products (more details below). With the industry leader continuing to set higher safety standards for online shoppers, the eCommerce industry seems very likely to see healthy long-term growth.

Market share by Gross Merchandise Volume
iResearch projects 2007 - 2011 CAGR growth of 78%, to reach Rmb569 billion in 2011.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

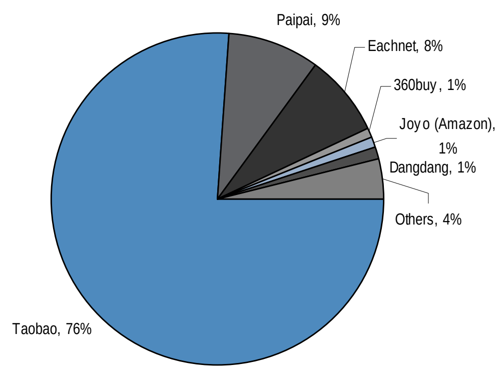
Figure 81: GMV of Online Shopping in China



Source: IResearch (2008).

Taobao has been the leader in the China eCommerce market. According to 2Q08's iResearch report, Taobao's market share in China is 76%.

Figure 82: Online Shopping Market Share by GMV



Source: IResearch (2Q08).

Taobao.com Leader in Online Shopping Space

Taobao is the leading C2C eCommerce service provider in China. Its third-party marketplace model has drawn more than 1.3 million merchants to list their products on Taobao.com.

Taobao was founded in May 2003, and its related payment system Alipay began service in October 2003. In June 2004 the company launched its instant messaging service platform. By June 2005, Taobao surpassed EBay as the leading C2C service provider in China.

Currently, 80% of its transactions are done through Alipay. By August 2008, Taobao reached breakeven through pay-for-performance advertising by Taobao sellers on the Taobao site as well as on Alimama (ad network with 400,000 affiliates).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 70: Taobao Historical Statistics

	Registered Users (M)	GMV (RMB, B)	No. of merchants (M)	No. of transaction (M)
2005	14	8	0.3	26
2006	31	16.9	0.6	92
2007	53	43.3	1.0	244
1H08	72	41.3	1.3	249

Source: Taobao.com

Alipay
A few quick points on Alipay:

1. According to Alipay, it has more than 100MM registered accounts. Transaction value was Rmb60B in FY07, and Alipay expects this to double in FY08.

2. Who uses Alipay? According to Alipay: 50% Taobao users for payment, 30% Peer-2-Peer payment, and 20% non-Taobao e-commerce companies.

3. China online payment landscape (as per company estimates): Alipay: 45% of market share, UnionPay ~20%, and Tenpay: ~ 10%.

4. Alipay plans to roll out internationally to facilitate cross-border transactions.

Baidu: Youa.com – Launched on Oct. 28, 2008

Baidu launched its “closed-beta" C2C service with 10k customers. The new name for C2C service is “Youa” (means “we’ve got it” in Chinese). Over the past six months, Baidu has been promoting Youa service through road shows around the country, and through off-line and on-line marketing.

Baidu: Could Be Taking Similar Market Share as Paipai in the Next 1 - 2 Years
While initial user feedback and momentum seem to be good, we are not yet modeling in benefits from Baidu’s Youa service. However, we note that we maintain cautious optimism on the longer-term success of Youa, given:

1. Baidu does not seem to have a large team dedicated to eCommerce. This makes us cautious on the longer-term success of the business. In particular, Taobao’s strong eCommerce ecosystem of (1) trusted Alipay payment system, (2) logistics partners, and (3) eCommerce technology / API would require lots of effort for Baidu to duplicate.

2. Taobao and Baidu are both likely to offer performance-based advertising to merchants. This would improve buyers’ and sellers’ stickiness to Baidu, and would help Baidu to gain market share.

3. Baidu’s high traffic volume would likely drive buyers to the site as well.

Leading B2C players in China

Dangdang, Joyo Amazon, and 360buy are the three leading online merchants in China. We have summarized some facts about these companies below.

Table 71: Leading B2C players in China

	Joyo Amazon	DangDang	360buy
Products	Focusing mainly on books, audio/video products, consumer electronics products, household products, and gifts. More than 450k items.	Provides nearly a million commodities online to all online shoppers worldwide, including 27 selected commodity types such as books, AV products, home decor, cosmetics, digital products, accessories, luggage and bags, dresses, and mother and baby products.	360buy is the largest professional 3C online auction platform in the B2C market in China
Revenue (2008 estimated)	US$152 million	US$182 million	US$215 million
Payment system	Joyo Amazon actively developed partners. Joyo announced its support for the payment system of Alipay in June 2008.	Dangdang cooperates with Yeepay to carry out offline e-payment through the telephone. Company also partners with various banks for online payment.	The mobile point-of-sale (POS) payment system using a card, which was launched first by 360buy in 2007.
Logistics	Joyo Amazon has delivery service in the 25 main cities in China in 2008. Aside from the self-building delivery service company Century Joyo, Joyo Amazon also engages a large number of third-party logistics service companies. Joyo Amazon has large logistics centers in Beijing, Suzhou, and Guangzhou.	Dangdang allies with more than 100 private express delivery companies in 66 cities nationwide to implement "logistics on bicycle" and provide a fast four-hour delivery service to Beijing users. The warehouses of Dangdang logistics are scattered in Beijing, East China, and South China.	Distribution range of home appliance products expanded to 329 cities nationwide. Currently, 360buy adopts two logistics and distribution systems: (1) self-build logistics systems in Beijing, Shanghai, Guangzhou, and Chengdu; (2) cooperation with third-party manufacturers for the big commodities and express delivery service companies for the small commodities.
History	Founded in May 2000, and was acquired by Amazon in 2004.	Founded in 1999.	Founded in 2004.

Source: IDC. J.P. Morgan.

Trust and Safety Issue

Addressing the Trust and safety issue, we believe Taobao has the leading consumer protection plan in place:

Table 72: Taobao's Consumer Protection Plan

	Launch Date	Plan	Details
Phase 1	Mar 07	Seller guarantee	Participating sellers guarantee the quality of products. Consumers will be refunded the money if not satisfied with product.
Phase 2	Apr 2008	7-day money back guarantee	Consumer can return goods within 7 days of purchase of products from participating sellers.
	Apr 2008	Compensation for fake goods (e.g., cosmetics)	Within 14 days of purchase of a fake product from a participating seller, consumer will be refunded an amount equal to three times the value of the goods.
Phase 3	Sep 2008	30-day warranty for digital products and electrical home appliances	Participating sellers provide 30-day warranty for digital products and electrical home appliances
	End of 2008	Assurance of authenticity of antiques and jewelry	Participating sellers assure the authenticity of antique and jewelry products
	2009	Certified checks provided for food products	Food products that have been certified as “Quality Safe” (QS)” by the government

Source: Taobao.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Russia Sector Outlook

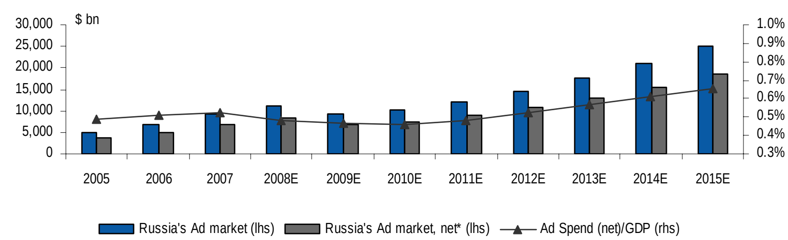
This section is taken from "Russian Media: Ad market forecasts cut," originally published November 13, 2008.

The Russian Advertising Market

Russian ad market assumptions cut on weaker GDP forecast. Consistent with J.P. Morgan's reduction of its Russian GDP growth forecasts to 2.5% in 2009 and 5.0% in 2010 (changed over the last three months from our earlier estimate of 6.0% for 2009 and 7.0% for 2010), we cut our forecasts for Russia's ad market by 19% for 2009 and 24% for 2010. We now forecast Russian ad market growth of 22% to RUB205 bn in 2008 and 5% to RUB215 bn in 2009 vs. our previous expectations of 28% and 23% respective growth rates. In dollar terms, the ad market cuts look even more pronounced because of an assumed new RUB/$ FX rate (see Table 73). We also assume a lower ad market/GDP ratio to reflect the expected reduction in ad prices. We estimate that ad spending as a percentage of GDP will decline to 0.48% in 2008 (vs. our previous estimate of 0.55%) and to 0.46% (vs. 0.58%) in 2009.

Internet '09E growth estimate cut to 33% from 53%. We cut our Internet market forecasts by 5% for '08, 18% for '09 and 23% for '10. We forecast 33% growth in 2009 and 30% in 2010 vs. our previous expectations of 53% and 39% respectively. We leave our Internet market breakdown between search and display unchanged. However, we do not rule out that advertisers may start shifting toward performance-based advertising forms (or from display to search), which would result in a higher share of search vs. our current estimates (51.8% in 2009E and 54.7% in 2010E). We note that advertising remains de facto the only on-line revenue source for Russian internet companies, while online commerce remains undeveloped due to lack of reliable online payment systems.

Figure 83: Russian Advertising Market Growth



* To calculate net advertising market size, gross market size is adjusted for VAT (18%) and companies' online revenue overlap, which we estimate at 13%

Source: AKAR (Association of Communications Agencies of Russia); Economic Development and Trade Ministry; Zenith Optimedia; Video International; J.P. Morgan estimates.

Table 73: Russian Advertising Market Forecast Changes

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Nominal GDP ($ bn) – OLD	1,290	1,672	1,893	2,109	2,329	2,550	2,831	3,138	3,459
Nominal GDP ($ bn) – NEW	1,290	1,704	1,475	1,640	1,841	2,062	2,303	2,552	2,812
GDP deflator, % average – OLD	14%	12%	9%	8%	8%	7%	7%	6%	6%
GDP deflator, % average – NEW	14%	20%	7%	8%	8%	7%	7%	6%	6%
Real GDP growth, % – OLD	8.0	8.0	7.0	6.0	6.0	6.0	6.0	6.0	6.0
Real GDP growth, % – NEW	8.1	7.2	2.5	5.0	6.0	5.8	5.5	5.0	4.6
FX – OLD (RUB/$1)	25.6	23.6	24.2	24.9	25.7	26.6	27.0	27.3	27.6
FX – NEW (RUB/$1)	25.6	24.9	31.4	32.0	32.6	33.0	33.1	33.2	33.1
Total advertising market, net (RUB bn) - OLD	168.6	215.4	264.8	319.0	379.0	444,5	517.9	596.2	682.7
Total advertising market, net (RUB bn) – NEW	168.6	204.9	215.1	241.7	287.5	355.8	433.2	517.8	610.5
y/y change (%) - OLD	26%	28%	23%	20%	19%	17%	17%	15%	15%
y/y change (%) – NEW	26%	22%	5%	12%	19%	24%	22%	20%	18%
Total advertising market, net ($ bn) – OLD	6.7	9.1	10.9	12.8	14.7	16.7	19.2	21.8	24.7
Total advertising market, net ($ bn) – NEW	7.5	9.2	7.6	8.4	9.8	12.0	14.5	17.4	20.5
y/y change (%) - OLD	35%	35%	20%	17%	15%	13%	15%	14%	13%
y/y change (%) – NEW	35%	22%	-17%	10%	17%	22%	21%	19%	18%
Advertising spending (net)/GDP (%) - OLD	0.52%	0.55%	0.58%	0.61%	0.63%	0.66%	0.68%	0.70%	0.71%
Advertising spending (net)/GDP (%) – NEW	0.52%	0.48%	0.46%	0.46%	0.48%	0.52%	0.57%	0.61%	0.66%
y/y change (pp) - OLD	0.01	0.02	0.03	0.03	0.03	0.02	0.02	0.02	0.02
y/y change (pp) - NEW	0.01%	-0.04%	-0.02%	0.00%	0.02%	0.04%	0.04%	0.04%	0.04%

* To calculate net advertising market size, gross market size is adjusted for VAT (18%) and companies' online revenue overlap, which we estimate at 13%. Source: AKAR; Economic Development and Trade Ministry; Zenith Optimedia; Video International; J.P. Morgan estimates.

Outlook is deteriorating. In a 3Q08 trading update, Rambler said that a reduction in advertising campaign commitments over the last few weeks was behind a 3% q/q revenue decline. The company now guides for 2008 sales at the lower end of its previous guidance. In particular, over the last few weeks, advertising bookings were up to 50% lower than planned. Rambler has removed its 2009 guidance due to lack of visibility for market growth rates next year, but believes advertising will shift to cheaper Internet, which should support online ad revenues. We believe the shift will take place, but it is unlikely to compensate for the negative macro impact on online revenues. We view the results as further evidence of deterioration across discretionary items such as advertising. Given the high sensitivity of ad revenue to macro/GDP factors and the lack of clarity on 2009 growth rates, we believe Russian mass media stocks, including Rambler, are not likely to recover in the medium term.

We expect a higher market share for TV, Internet. We have raised our '09 TV ad market share forecast from 50% to 51.5% of the total ad market to reflect the decline (already seen in 2008) of print, outdoor and radio ads as a percentage of the total market, as well as the current shortage of TV ad space – a situation that should protect the TV ad market. We have raised our '09E Internet market share estimate slightly (from 7.1% to 7.2%) as we expect support for online advertising from growing broadband penetration and the redistribution of advertising budgets in favor of the cheaper Internet. For all other ad types (print, outdoor and radio), we cut our market share estimates to reflect 1H08 statistics and our expectations of higher market shares for TV and Internet.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 74: Estimate Changes – Ad Market Breakdown by Types

	2008E	2009E	2010E	2011E	2012E
TV – OLD	48.9%	49.6%	50.1%	50.1%	50.1%
TV – NEW	49.9%	51.5%	52.8%	53.3%	53.8%
Diff., pp	1.0pp	1.9pp	2.7pp	3.2pp	3.7pp
Print – OLD	22.2%	20.7%	19.4%	18.3%	17.6%
Print – NEW	20.9%	19.4%	18.3%	17.3%	16.6%
Diff., pp	-1.3pp	-1.3pp	-1.1pp	-1.0pp	-1.0pp
Outdoor - OLD	17.2%	17.1%	17.0%	16.9%	16.8%
Outdoor - NEW	16.6%	15.1%	14.6%	14.1%	13.6%
Diff., pp	-0.6pp	-2.0pp	-2.4pp	-2.8pp	-3.2pp
Radio – OLD	6.1%	5.6%	5.3%	5.0%	4.7%
Radio - NEW	5.9%	4.9%	4.4%	4.1%	3.8%
Diff., pp	-0.2pp	-0.7pp	-0.9pp	-0.9pp	-0.9pp
Internet – OLD	5.7%	7.1%	8.2%	9.2%	10.2%
Internet - NEW	5.7%	7.2%	8.3%	9.3%	10.2%
Diff., pp	0.0pp	0.1pp	0.1pp	0.1pp	0.0pp

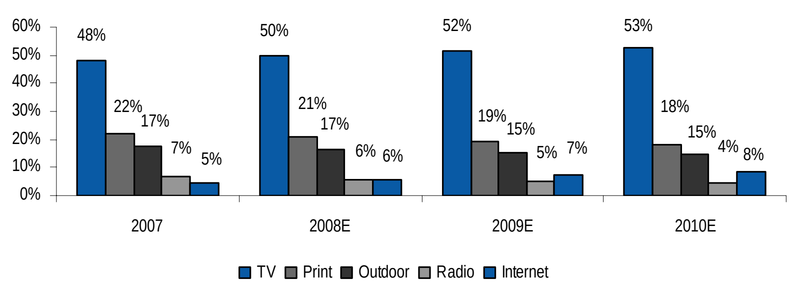
Source: Video International; AKAR; Zenith Optimedia; J.P. Morgan estimates.

Table 75: Ad Market by Types (RUB bn)

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
TV	112,500	138,664	150,267	173,113	207,807	259,647	319,012	384,866	457,912
y/y growth, %	31.0%	23.3%	8.4%	15.2%	20.0%	24.9%	22.9%	20.6%	19.0%
Internet	10,816	15,839	21,008	27,213	36,259	49,227	65,800	85,682	107,647
y/y growth, %	89.5%	46.4%	32.6%	29.5%	33.2%	35.8%	33.7%	30.2%	25.6%
Print	51,900	58,097	56,625	60,022	67,476	80,147	94,040	108,204	122,608
y/y growth, %	16.4%	11.9%	-2.5%	6.0%	12.4%	18.8%	17.3%	15.1%	13.3%
Outdoor	40,400	46,090	44,019	47,823	54,920	65,569	76,882	88,395	100,080
y/y growth, %	22.1%	14.1%	-4.5%	8.6%	14.8%	19.4%	17.3%	15.0%	13.2%
Radio	15,700	16,444	14,349	14,484	16,054	18,425	20,666	22,598	24,160
y/y growth, %	25.6%	4.7%	-12.7%	0.9%	10.8%	14.8%	12.2%	9.3%	6.9%

Source: Video International; AKAR: Zenith Optimedia; J.P. Morgan estimates.

Figure 84: Russian Advertising Market Breakdown



Source: Video International; AKAR; Zenith Optimedia; J.P. Morgan estimates.

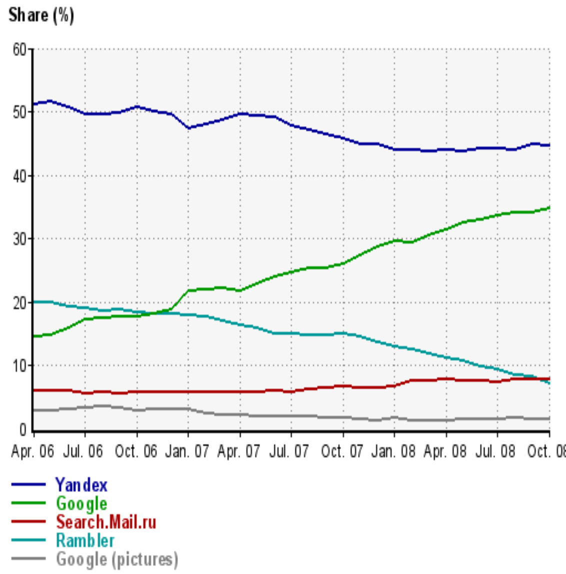
Table 76: Russian Advertising Market Breakdown

	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
TV	48.1%	49.9%	51.5%	52.8%	53.3%	53.8%	54.3%	54.8%	55.3%
Print	22.2%	20.9%	19.4%	18.3%	17.3%	16.6%	16.0%	15.4%	14.8%
Outdoor	17.3%	16.6%	15.1%	14.6%	14.1%	13.6%	13.1%	12.6%	12.1%
Radio	6.7%	5.9%	4.9%	4.4%	4.1%	3.8%	3.5%	3.2%	2.9%
Internet	4.6%	5.7%	7.2%	8.3%	9.3%	10.2%	11.2%	12.2%	13.0%

Source: Video International; AKAR; Zenith Optimedia; J.P. Morgan estimates.

Google market share forecast raised slightly. We have also changed our Internet market breakdown between providers in favor of Google: we expect its market share will grow to 7% in 2012 vs. our previous estimate of 3.2%. At the same time, we reduce our ‘12E Rambler market share assumption from the previous 17% to 14%. Our new estimates are based on recent Internet audience statistics (see Figure 1 below) that show a continuation of audience growth for Google and a decline for Rambler. Our new assumptions also reflect the Russian regulator’s refusal to approve the acquisition of ad agency Begun by Google. We believe this will push Google to move more aggressively to create its own Russian language ad agency. While this could take some time, we estimate it could potentially lead to a higher market share (in money terms) in the longer term.

Figure 85: Internet Audience Growth (market share)



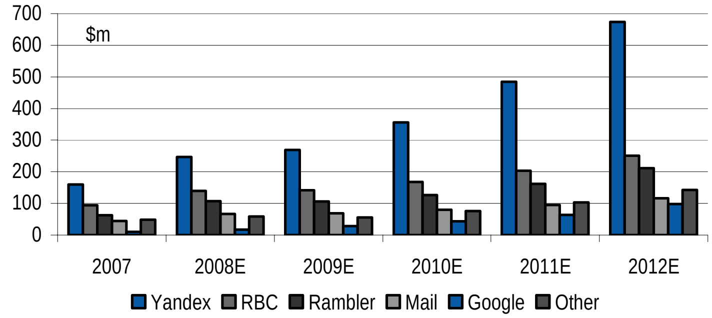
Source: Liveinternet.ru

Table 77: Internet Market Breakdown

Revenue breakdown, $ mn	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Yandex	160	247	269	356	484	674	929	1,252	1,630
RBC	94	139	141	168	204	251	304	361	410
Rambler	63	108	106	126	162	211	278	360	444
Mail	45	67	69	80	95	117	140	164	184
Google	10	17	28	44	64	98	150	200	272
Other	49	59	56	76	103	143	184	247	312
Internet market, gross	423	636	669	851	1,113	1,493	1,986	2,584	3,253
Market share, %									
Yandex	38%	39%	40%	42%	44%	45%	47%	48%	50%
RBC	22%	22%	21%	20%	18%	17%	15%	14%	13%
Rambler	15%	17%	16%	15%	15%	14%	14%	14%	14%
Mail	11%	11%	10%	9%	9%	8%	7%	6%	6%
Google	2%	3%	4%	5%	6%	7%	8%	8%	8%
Other	12%	9%	8%	9%	9%	10%	9%	10%	10%

Source: Video International; AKAR; Zenith Optimedia; J.P. Morgan estimates.

Figure 86: Russian Internet Market Breakdown by Key Providers



Source: Source: AKAR; CNews; Rambler; RBC; Zenith Optimedia; J.P. Morgan estimates.

Figure 87: Russian Internet Market – 2008E

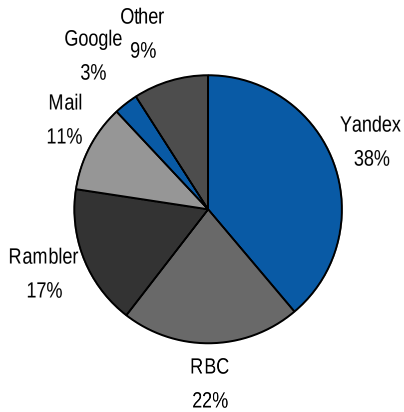
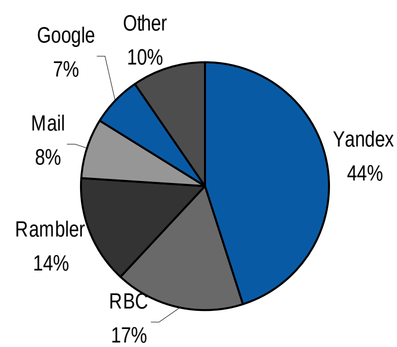


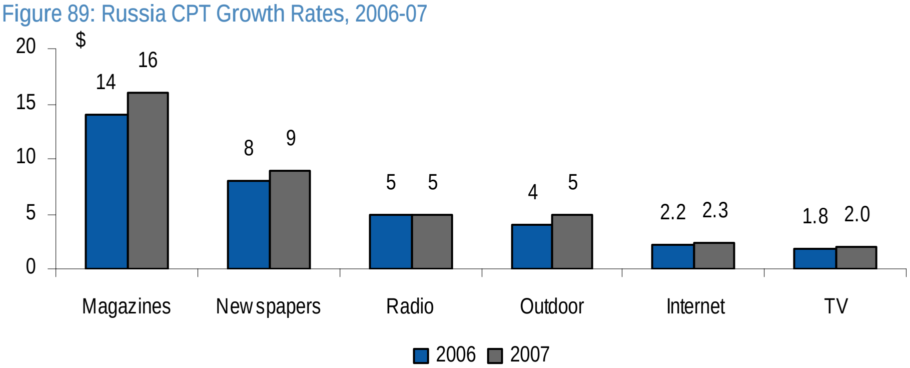
Figure 88: Russian Internet Market – 2012E



Source: AKAR; CNews; Rambler; RBC; Zenith Optimedia; J.P. Morgan estimates.

TV and Internet offer relatively low advertising costs. Because television offers the largest audience and greatest reach, it remains the cheapest advertising medium in Russia on a CPT basis (*cost per thousand*, a commonly used measure to calculate the relative cost of an advertising campaign). Internet is the second-cheapest medium. Based on various cost efficiency estimates (which can differ significantly), in 2007, CPT stood at $2.0 for TV, $2.3 for Internet and more than $5 for the remainder of the market.

Figure 89: Russia CPT Growth Rates, 2006-07



Source: CTC Media; Rambler; RBC; Zenith Optimedia; Initiative Future Worldwide.

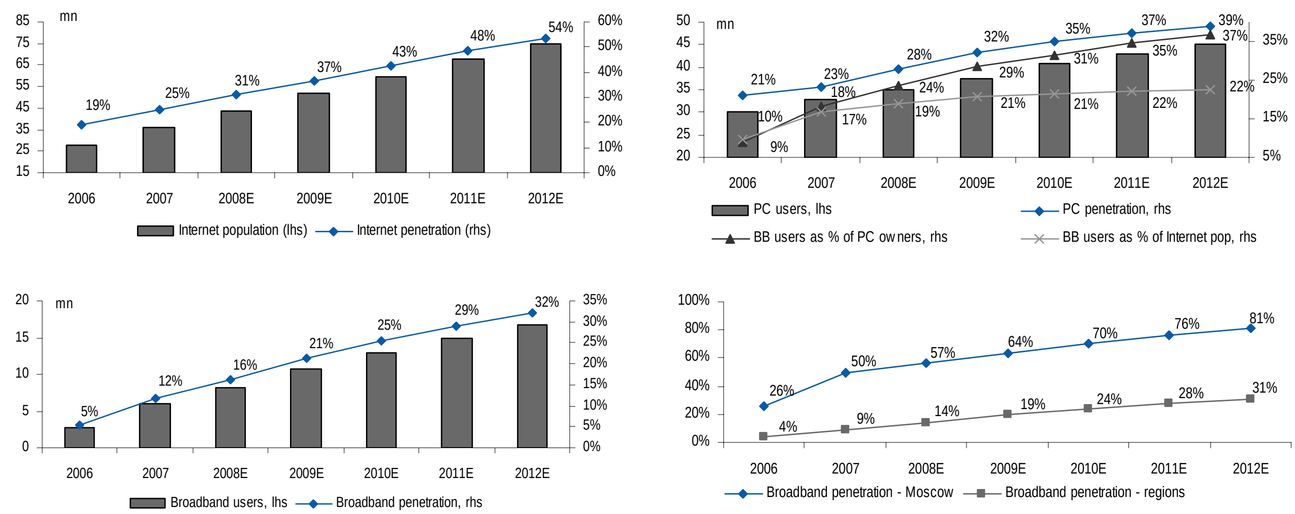
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Russian Internet appears undeveloped based on per capita comparisons. If we compare per capita advertising spending on TV and Internet ($31.0 and $2.8 respectively in Russia in 2007), Russia lags behind all developed countries, but leads among developing economies ($67-196 per capita TV and $7-87 per capita Internet spending in developed countries) We should note that the relatively high per capita spending for TV (compared to other developing countries) at $31.0 does not mean poor growth potential for TV. Television is currently the only true nationwide advertising medium in Russia. Notably, most TV advertising revenues in Russia are still derived from consumer staple sectors such as food and household products, with consumer discretionary sectors such as finance, insurance and retail strongly underrepresented. TV advertising remains brand/image advertising by nature. As the economy matures and disposable incomes rise, consumer discretionary sectors should increase their advertising budgets and explore new marketing channels, including TV and Internet, in our view.

For the Internet, broadband infrastructure is developing rapidly, which should make high-quality service more readily available and affordable – in the nation's regions in particular – supporting consumer spending on the medium.

Internet ads still not a substitute for TV. Despite its relatively low CPT, Internet advertising does not yet serve as a substitute for television due to the relatively small audience size. The Communications Ministry estimates the number of Internet users reached 29.4 mn in 2007; meanwhile, the TV audience was close to the total population size of 142 mn. We believe the recent surge in TV advertising prices – which resulted in TV advertising money being redistributed between channels, rather than moving online – supports our view that Internet advertising is still not a substitute for TV.

Figure 90: Russian Internet Penetration and Broadband Market Snapshots



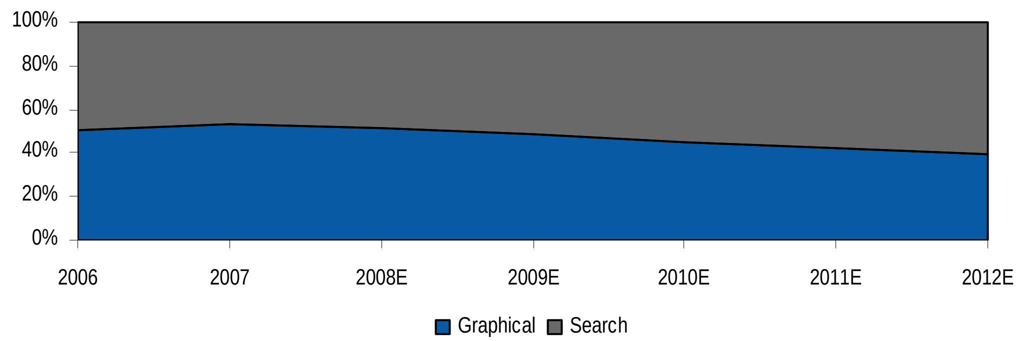
Note: Internet population includes Russia only and does not include users outside Russia or potential users.
Source: Economic Development and Trade Ministry; J.P. Morgan estimates.

Search advertising looks set to overtake graphical in mid-term. In Russia, graphical advertising remains the preferred technique. We estimate that graphical advertising accounted for 54% of the market in 2007, vs. 35% in the US and 45%

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

globally. The reason is that most Russian online advertising from traditional business is image advertising, while consumer staple and discretionary sectors prefer either TV or no advertising at all. As the economy matures and disposable incomes rise, we expect consumer discretionary sectors to increase their advertising budgets and explore new marketing channels, including the Internet. We forecast search advertising will overtake graphical in 2009 (see table below).

Figure 91: Russian Internet Market Breakdown by Advertising Type



Source: AKAR; CNews; Rambler; RBC; Zenith Optimedia; J.P. Morgan estimates.

Table 78: Internet Market Estimate Changes (RUB mn)

	2008E - Old	2008E - New	Change, %	2009E - Old	2009E - New	Change, %	2010E – Old	2010E – New	Change, %
Search	8,143	7,745	-5%	13,208	10,882	-18%	19,405	14,886	-23%
Display	8,509	8,094	-5%	12,291	10,126	-18%	16,070	12,327	-23%
Internet market, total	16,652	15,839	-5%	25,499	21,008	-18%	35,475	27,213	-23%

Source: Video International; AKAR; Zenith Optimedia; J.P. Morgan estimates.

Search Internet

Yandex likely to lead in paid search. We estimate Yandex's share of the paid search market at 67% in 2007. We forecast stable market shares for Yandex and Rambler and a higher share for Google going forward.

Table 79: Search Internet

Revenue breakdown, $ mn	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
Yandex	131	208	232	312	431	608	848	1,156	1,521
Rambler (Begun)	25	56	56	67	90	121	167	228	293
Google	10	17	28	44	64	98	150	200	272
Other	30	30	30	42	57	77	93	128	164
Total Search Internet Market	196	311	346	465	642	903	1,258	1,712	2,250
Market share, %									
Yandex	67%	67%	67%	67%	67%	67%	67%	68%	68%
Rambler	13%	18%	16%	14%	14%	13%	13%	13%	13%
Google	5%	5%	8%	9%	10%	11%	12%	12%	12%
Other	15%	10%	9%	9%	9%	8%	7%	8%	7%

Source: Company data; AKAR; Zenith Optimedia; J.P. Morgan estimates.

Growth of queries and revenue per click should drive paid search advertising. We believe that growth in search Internet advertising will come from an increase in the number of queries, a result of Internet audience growth, as well as higher monetization rates. More specifically, we forecast monetization rates will grow to 7.1% by 2012 vs. 5.6% in 2007, which is well below developed market levels. Monetization growth should come from growth of all components, including revenue per click, coverage and click-through rates, all of which remain below global levels. We expect an increase in Russia's RPS (revenue per 1,000 searches) from $14 in 2007 to $24 in 2012, driven by advertiser demand for keywords, as well as continued increases in sponsored-link relevancy. We forecast revenue per click in Russia to grow from $0.25 in 2007 to $0.34 by 2012, and click-through rates to rise from 15.5% in '07 to 18% by '12.

In the mid-term, we forecast RPS and revenue per click will remain under pressure in 2009-10 due to the expected impact of the deteriorating macro-environment on the online advertising market.

Table 80: Russian Internet Market Assumptions – Search

	2007	2008E	2009E	2010E	2011E	2012E
Average queries (per week, per Internet user)	7.5	7.7	7.7	8.1	8.6	9.7
Number of queries (per user, per year)	392	399	405	421	445	504
RPS (revenue per 1,000 searches, $)	14.0	17.8	16.8	18.5	21.3	24.0
Coverage (% of web pages with advertisement placed)	36%	37%	38%	38%	39%	39%
Clickthrough rate (number of clicks on ad divided by number of times ad was delivered)	15.5%	16.0%	16.5%	17.0%	17.5%	18.0%
Revenue per click ($)	0.25	0.30	0.27	0.29	0.31	0.34
Monetization rate	5.6%	5.9%	6.2%	6.5%	6.8%	7.1%

Source: AKAR; CNews; Rambler; RBC; ZenithOptimedia; J.P. Morgan estimates.

Graphical Internet

RBC leads in graphical advertising. We estimate RBC's share of the graphical advertising market at 41% in 2007. We expect it to grow to 43% in 2008 and 44% in 2009, given the company's intensive acquisition pipeline and its diversification into new online services. However, we forecast market share will slowly decline beyond 2009, since we do not assume any further acquisitions. We forecast Mail.ru will maintain a stable market share in 2009-10, with a decline thereafter. We expect a stable market share for Yandex and Rambler going forward.

Table 81: Graphical Internet

Revenue breakdown, $ mn	2007	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
RBC	94	139	141	167	201	248	302	358	408
Mail.ru	45	67	69	80	95	117	140	164	184
Rambler	38	52	50	59	72	90	111	132	152
Yandex	29	39	37	44	53	66	81	96	108
Total Market	227	325	323	386	471	590	727	872	1,003
Market share, %									
RBC	41%	43%	44%	43%	43%	42%	41%	41%	41%
Mail.ru	20%	21%	21%	21%	20%	20%	19%	19%	18%
Rambler	17%	16%	15%	15%	15%	15%	15%	15%	15%
Yandex	13%	12%	11%	11%	11%	11%	11%	11%	11%

Source: Company data; AKAR; Zenith Optimedia; J.P. Morgan estimates.

Prices and audience expansion should drive graphical advertising. We estimate RPM will rise from $1.0 in 2007 to $1.1 in 2012. We believe the number of pages viewed per user, per day in Russia will grow from 15 in 2007 to 17 in 2012. While our longer-term forecasts assume RPM and CPT expansion, we forecast their reduction in 2009-10 due to the impact of macro-conditions on the online advertising market.

Table 82: Russian Internet Market Assumptions – Graphical Advertising

	2007	2008E	2009E	2010E	2011E	2012E
Pages viewed/user/day	15	16	16	16	16	17
Total pages viewed, bn	197	264	304	341	390	456
Change, y/y	146.8%	34.0%	15.2%	12.2%	14.6%	16.7%
Impressions (ads delivered) per page viewed	0.43	0.43	0.43	0.43	0.43	0.43
Total impressions, bn	86	115	132	148	170	198
CPT, cost per thousand pages viewed	$2.3	$2.4	$2.0	$2.2	$2.3	$2.4
RPM, revenue per thousand pages viewed	$1.0	$1.0	$0.9	$0.9	$1.0	$1.1

Source: AKAR; CNews; Rambler; RBC; ZenithOptimedia; J.P. Morgan estimates.

Other Internet Market Issues

Russia rejects Google/Begun deal. Based on information contained on the Antimonopoly Service's website, a press release from Rambler and comments made by Google to Bloomberg, Google's bid for Begun (a Russian language online advertising agency) was rejected on October 24, 2008. In July, Rambler announced plans to sell Begun to Google, saying it hoped to complete the deal in September. The potential deal included a partnership between Google and Begun. We estimate that if concluded, the deal could potentially have increased Google's market share (in money terms) in Russia from the current 2-3% (JPMe) to at least 10-12%. In earlier comments, Rambler's CEO said the combined market share of Google and Rambler could have reached 40% long term. We believe the reason for the bid's rejection was government support for domestic companies Yandex and Rambler, which could have lost market share if Google acquired Begun. We view the news as neutral for Rambler and positive for Begun and note the government's increasing involvement in Russia's Internet space.

Alisher Usmanov acquires control of Mail.ru. Russian business daily *Vedomosti* reported on September 24, 2008 that Alisher Usmanov increased his stake in Mail.ru from 35% to 50% in July, paying $300 mn. This implies a $2 bn valuation for the total company and a 2007 price/EBITDA ratio of 55x. The deal has not been officially confirmed by the company. According to *Vedomosti*, Mr. Usmanov is also negotiating to increase his stake in Yandex from the current 10% to a controlling level, so far without success. Mail.ru had been planning to conduct an IPO in 3Q08, but postponed the move due to a change in shareholder structure: Tiger Global Management sold 14.55% of Mail.ru (out of its total holding of 27.95%) to DST. Tiger was the IPO's initiator, but apparently decided to fix a profit pre-IPO.

Yandex reportedly postpones IPO. According to *Vedomosti* (October 6, 2008), Yandex decided to postpone its IPO (previously planned for 3Q08) because of market conditions. The company may decide to place its shares in May 2009 if the market stabilizes, the report said. We view the move as reasonable if the company targets a total capitalization of $2-3 bn. We do not rule out a further postponement of the IPO if financial markets are still weak in 2009.

RBC owners reportedly seeking a strategic buyer. Reuters reported (October 1, 2008) that key shareholders in RBC (the three founders, who own 51% of the company) are seeking a strategic investor to help maintain a rapid pace of growth. A source reportedly familiar with the company's plans told Reuters that RBC wants to maintain 40-50% annual growth rates. Plans to find a strategic investor may in fact relate to the company's debt situation and worsening cash situation in our view. According to RBC, as of mid-2008, its cash position was $232 mn and debt reached $158 mn (plus $60 mn in commercial paper placed in 2H08). The company faces a tough debt payment schedule in our view, including a $45 mn loan payment in November '08, $60 mn in bond redemptions in March '09, $43 mn in June '09 and $60 mn in July '09. In addition, the company has warned about expected writedowns related to its investments in stocks. The company has not disclosed the size of any potential writedowns as yet, but we are concerned that these losses might have hurt its cash position, which could potentially lead to difficulties in repaying short-term debt. In addition, according to the company, some of its key shareholders' equity is pledged. No precise details are available yet, but this could also potentially add to difficulties in meeting the debt payment schedule.

Internet audience survey shows Yandex.ru in the lead. The most recent survey (September'08) conducted by TNS Gallup Media on Russia's Internet audience revealed that Yandex.ru was the most popular web source, with a total monthly audience of 16.1 mn users (vs. 15.9 mn for Mail.ru). Based on the survey, the popularity of social networks such as Odnoklassniki.ru and online news sites (*Kommersant*, for example) grew at a faster pace than other web sources. We note the survey does not cover website audience for Google, RBC and others.

Table 83: Russia's Top-15 Internet Websites

Rating	Unique users*, mn	May-08	Sept-08	% change
1	Yandex (search engine)	14.7	16.1	10%
2	Mail.ru (mail service)	14.9	15.9	7%
3	Odnoklassniki.ru (classmates)	10.7	12.2	14%
4	Vkontakte.ru (classmates)	NA	10.4	NA
5	Rambler (search engine)	9.6	9.5	-1%
6	SUP Fabrik (incl. social network LiveJournal)	6.7	7.1	6%
7	Life.ru (tabloid)	4.6	5.2	13%
8	Agava (6 sites, hosting, dating, job, mail)	4.7	4.8	2%
9	Mamba (dating)	5.0	4.6	-8%
10	KP (tabloid)	3.8	3.9	3%
11	RuTube (video)	3.7	3.9	5%
12	Kommersant (newspaper)	2.8	3.4	21%
13	GURU (cars, mobile, games)	2.2	3.1	41%
14	Vesti.ru (news)	2.6	2.7	4%
15	Independent Media (Publishing House)	2.3	2.5	9%
	Total	25,056	23,500	18%

*Number of people who conduct a web search at least once a month. The sample includes Russian cities with more than 100,000 inhabitants, aged 15-54. The survey does not include RBC, Google and other Internet sources.
Source: TNS Gallup Media.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Korean Internet Outlook

Sector Summary

Although Internet stocks have corrected and valuations appear less demanding compared to early 2008, we are concerned that the online advertising market could shrink in FY09 due to an economic slowdown, and that the ruling party's initiatives on regulating the Internet industry could dampen sentiment.

Contracting Online Ad Market

Contrary to consensus' view that the online ad market would still grow backed by advertisers' heavy-weight online ads, we estimate that the online ad market will shrink by 4.6% in FY09, although the magnitude of the scale-down should be less than that of the total domestic ad market. We believe the biggest weakness will stem from display ads, which could result in an 12% drop in combined revenue of NHN and Daum. Both companies' search ad revenue will still grow due to the market share shift towards performance-based advertising, in our view, although the growth could slow significantly to 12% in FY09, from 61% in FY07.

Mounting Regulations

As portals have played an influential role in forming public opinion in events such as the presidential election and the US beef case, some portals have been criticized for sorting and posting news reports that favor certain interest groups. In addition to the political bias, certain portals' accountability for their users' defamatory posts has been actively discussed. As a result, regulators and political parties are in favor of stricter control on portals. We believe the implementation of regulations will dampen sentiment for the Internet sector, as it reflects the government's strong intent to apply stricter rules on portals and Internet users' activities.

Recommendation

We believe both NHN and Daum lack near-term catalysts amid a weak economy and regulatory risks. We think NHN will hold up better than Daum, since investors are likely to prefer the market leader, given advertisers on tighter budgets tend to lean towards the market leader to reap more benefits on their dollar spending. Although we believe the downside for NHN is limited at the current trading range, we think the stock is less likely to rebound in the near term, unless the market is convinced of an economic recovery. We believe Daum's share price will be largely volatile and could offer more downside as the company has relatively less earnings visibility and is more sensitive to the economy. We believe once visibility on NHN's global operations increases and Daum's traffic monetization improves, their stocks might start to appear attractive.

Investment Summary

We have a negative view on the Korean Internet industry. Although Internet shares have corrected 50% YTD and valuations look less demanding compared to earlier this year, we are concerned that the online advertising market could shrink in FY09 due to an economic slowdown, and that the ruling party's initiatives on regulating the Internet industry could dampen sentiment.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

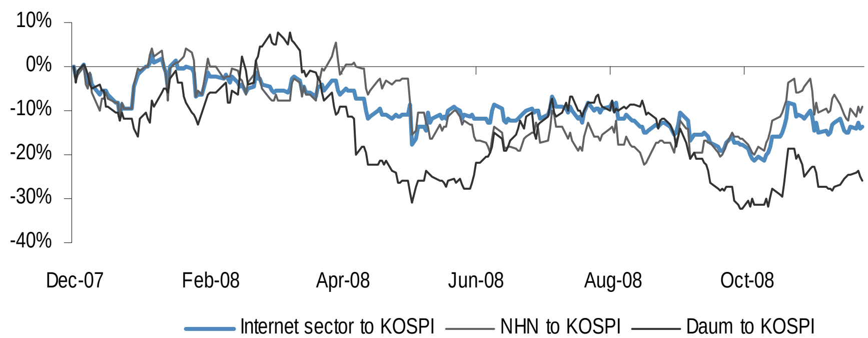
Our View on Share Prices

Despite Lower Trading Range, a Near-term Rebound Appears Less Likely

Korea's Internet sector has underperformed the KOSPI by 27.5% for the past year — NHN and Daum fell 56% and 65%, respectively. In particular, the shares fell sharply during August-September due to the emergence of regulatory risks. After such a sharp correction, NHN has been holding up better, outperforming the KOSPI by 12% since early October, while Daum has underperformed by 3%. We believe the weakness in Korea's Internet sector largely stems from concerns about regulatory uncertainties and an economic slowdown.

We expect these negatives to continue to dampen sentiment for the sector and its fundamentals for the next two to four quarters. Although current valuations are at historical lows, we believe the market is largely reluctant to offer premium on growth stocks and is more sensitive to near-term earnings. The trading range has significantly lowered to 14-16x FY08E EPS for NHN and 13-18x FY08E EPS for Daum, while the 12-month historical average trailing P/E range is 20-50x for NHN and 40-80x for Daum.

Figure 92: Korean Internet Sector Relative to KOSPI Performance



Source: Datastream

We believe both NHN and Daum lack near-term catalysts due to the weak economy and regulatory risks. We think NHN will hold up better than Daum, since investors will likely prefer the market leader, given that advertisers on tighter budgets tend to lean towards the market leader to reap more benefits from their dollar spending. We believe that although the downside for NHN should be limited at the current level, the stock is unlikely to rebound in the near term unless the market is convinced of an economic recovery. We believe Daum's share price will be largely volatile and could carry more downside risk as the company has relatively less earnings visibility and is more sensitive to the economy.

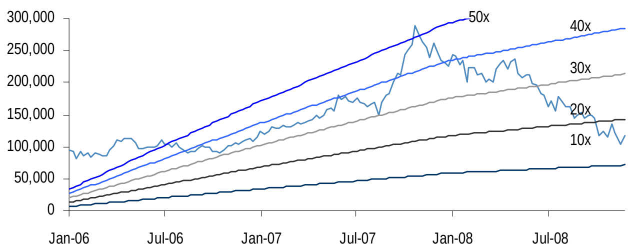
Our Price Targets Are Based on a 10-year DCF Valuation

We derive our price targets using DCF, because the companies consistently generate recurring free cash flows from operations and there is no major change in the capital structure. We use a 10-year DCF model with a 5.8% risk-free rate, 0% terminal growth rate and 12.7% WACC for NHN and 14.3% for Daum. Our 10-year DCF model yields fair values of W130,000 for NHN and W33,000 for Daum. For Daum, we applied a 20% discount to our DCF-based fair value estimate to derive our price target of W26,000, as Daum is a relatively small company in the market and its operations are more sensitive to the economy.

Valuations for Korean Internet companies remained at a 20-30% discount to their global peers until 1H07, but the gap almost disappeared in late 2007 and early 2008 when Korean Internet share prices rallied due to unprecedented earnings growth. During the recent market weakness, however, the gap with the global peers widened again to the 10-20% level, which we believe will continue until regulatory uncertainties disappear and the next round of growth story begins in Korea.

Figure 93: NHN-TTM Trailing P/E Bands

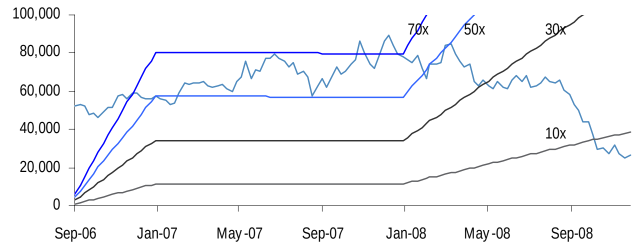
Won



Source: Company data, J.P. Morgan estimates.

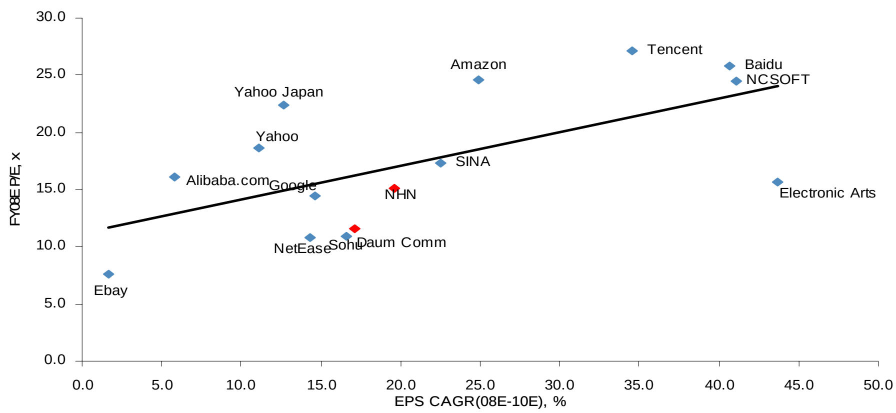
Figure 94: Daum-TTM Trailing P/E Bands

Won



Source: Company data, J.P. Morgan estimates.

Figure 95: Global Internet Companies' EPS CAGR vs. 08E P/E



Source: Company data, J.P. Morgan estimates. Note: Price as of 28 Nov. 2008.

Negative Share Price Drivers

We believe the online ad market will contract by 4.6% due to the economic downturn. Korea's domestic ad market has constituted about 1% of GDP, on average, for the past 15 years. Given the ad market has historically reacted more sharply to GDP growth and the ad market-to-GDP ratio tends to fall below 0.8% in a downturn, in FY09, the domestic ad market will contract 15% Y/Y, by our estimate. Contrary to the consensus view that the online ad market will continue to grow, backed by advertisers' heavy-weight online ads, we estimate that the online ad market will shrink by 3%, although the magnitude of the scale-down should be less than that of the total domestic ad market. We believe the biggest weakness will stem from display ads, which could result in a 12% drop in the combined revenue of NHN and Daum. We believe both the companies' search ad revenue will still grow due to the market share shift towards performance-based advertising, although the growth could slow significantly to 12% in FY09, from 61% in FY07. We believe NHN will weather the economic slowdown better as advertisers are likely to opt for the portal with the largest market share, where the possibility of ads hitting target customers is higher.

Stricter Regulations Likely to Dampen Sentiment

Koreans are among the heaviest users of Internet portals for participating in various discussion boards. Since portals have played an influential role in forming public opinion in events such as the presidential election and the US beef case, some portals have been criticized for sorting and posting news reports that favor certain interest groups. In addition to the political bias, certain portals' accountability for their users' defamatory posts has been actively discussed. As a result, regulators and political parties are in favor of stricter controls on portals. We believe the implementation of regulations will dampen sentiment on the Internet sector as it reflects the government's strong intent to apply stricter rules on portals and Internet users' activities. More importantly, rigid control could hurt user traffic and portals' revenues, in our view.

Recovery in 4Q Likely to Be Weak after Disappointing 3Q Results

NHN's revenue and operating profit in 3Q declined Q/Q for the first time in the past four years. The weak economy and change in online game rules led to the 4% and 13% Q/Q drop in the portal's revenue and operating profit, respectively. Daum's revenue and operating profit fell 1.3% Q/Q and 4.7% Q/Q, respectively, mainly due to its higher dependence on display ads, advertisers' preference for bigger portals, and management's quality initiatives. We expect a recovery in 4Q to be weak despite seasonality, as companies are likely to reduce their ad budgets further, and Y/Y growth of the e-commerce market is unlikely to be exciting.

Positive Share Price Drivers

Development of Rich Media Ads Should Increase the Unit Price of Banner Ads

Managements of NHN and Daum stated that their unit pricing for rich media banner ads—which use expansion ads, pop-up pictures or moving pictures—is about 20-200% more expensive than for a static ad, depending on the ad type. According to NHN, rich media ad revenue accounts for about 25% of its banner ads (versus 8~15% for Daum) and this continues to grow. Such ads are mainly adopted by large-scale advertisers, which can afford a higher unit price. However, portals continue to develop new types of rich media ads, and we expect more advertisers to accommodate these new formats. Hence, we believe rich media will be a key driver for the Internet advertising market over the next few years.

Diversification of Revenue Mix

We expect portals' revenue mix to continue to diversify as contributions from ecommerce and gaming businesses increase. For NHN, gaming accounted for 30% of sales as of 3Q08 versus 23% in FY06, while Daum's e-commerce revenue accounted for 14% of total revenue as of 1Q08 versus 9.5% in FY06. Although gaming and ecommerce revenues account for smaller shares of total revenue than online ads, we believe it is a meaningful development for them to have an additional strong growth driver, as in our opinion it creates a more balanced and diversified business model.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

U.S. Company Previews

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Amazon.com, Overweight, ($50.76)

We are upgrading Amazon.com to Overweight from Neutral. Although we believe a tough consumer environment may hamper spending in the near term, in the medium to longer term, we see Amazon continuing to take share within eCommerce even as eCommerce continues to outpace overall retail growth. Our 12-month price target for AMZN is $65.

- **Amazon is a net share gainer**. eCommerce is gaining share – and Amazon is gaining share within eCommerce. Through the first 9M'08, US retail sales rose 2%, US eCommerce grew 8%, and Amazon North America retail revenue was up 31% Y/Y. We expect these relative trends to continue through F'09, with eCommerce growing faster than retail and Amazon outgrowing eCommerce.
- **Amazon is diversifying its business**. The company has added more product lines (e.g., office products), continues to expand its geographic footprint, and is aggressively pursuing revenue streams not derived from physical sales from inventory: third-party sales, digital media sales and Web Services. We think Amazon is establishing itself as an unmatched online marketplace, and its higher-margin non-retail businesses could boost profitability in the medium to long term.
- **Low Cap-Ex model driving solid FCF generation**. Since 2Q'07, Amazon's TTM CapEx has been at or below 25% of operating cash flow, a trend we expect to continue. While we think operating margins are likely to stay in the 5% range in the medium term, we believe Amazon can continue to produce solid FCF growth, up 57% in F'09 and 42% in F'10.
- **2009 drivers**. In our view, the following factors will drive shares in 2009: (1) the impact of the economy on retail and eCommerce spending, both in the US and abroad, (2) Amazon's ability to take share within eCommerce, (3) the impact of brick-and-mortar retail bankruptcies, and (4) customer uptake of digital download and web services businesses.
- **Adjusting 4Q'08 estimates**. We are lowering our 4Q'08 revenue, EBITDA and EPS estimates, to $6.25B, $376M and $0.35 (from $6.65B, $407M and $0.40), as we expect the tough environment to result in slower revenue growth and add pricing pressure this quarter; we are also lowering our F'09 revenue, EBITDA and EPS forecasts due to our anticipation of a longer, deeper recession that we previously saw. Our F'08 – F'10 estimates are in the table below:

Table 84: Amazon.com Financial Snapshot

$ in millions, except per share data

AMZN	4Q'08E	F'08E	F'09E	F'10E	Y/Y F'08E	Y/Y F'09E	Y/Y F'10E
J.P. Morgan							
Revenue	6249.1	18711.1	21693.5	26165.1	63%	16%	21%
EBITDA	376.0	1398.0	1419.2	1734.3	28%	2%	22%
EPS	$0.35	$1.32	$1.20	$1.54	18%	-9%	28%
Consensus							
Revenue	6563.6	19037.2	21700.5	25492	66%	14%	17%
EBITDA	388.9	1280.7	1472	1847.2	18%	15%	25%
EPS	$0.43	$1.40	$1.57	$2.29	25%	12%	46%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

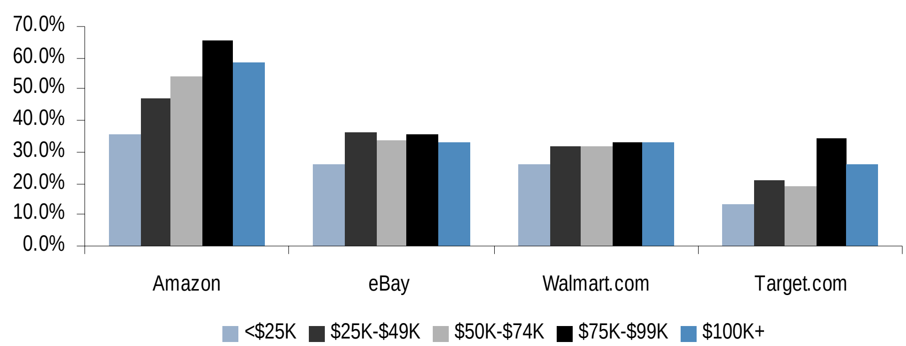
Takeaways from the J.P. Morgan Internet Team's 2008 Consumer Survey

Amazon Emerging as the Clear Leader in US eCommerce
In our November 2008 survey, we asked those who shop online which stores they expected to buy from this holiday season. Nearly 50% of online shoppers said they planned to shop at Amazon.com during the holiday season, and the expected reach for Amazon was 39% higher than that of its nearest competitor.

Additionally, Amazon continues to do extremely well in terms of reach among those who earn $100K or more, with 59% of shoppers in that income category saying they had shopped there. No other online retailer in our survey had a penetration higher than 33% with the over-$100K income bracket.

Figure 96: Amazon's Reach with Higher-Income Users Is Unparalleled, above 50%

% of online shoppers in each income group who made a holiday purchase from site in '07



Source: J.P. Morgan Internet Team 2008 Consumer Survey

Our Estimates and Outlook for 2009

Despite our long-term optimistic outlook for Amazon, we believe an unfavorable consumer spending environment is likely to depress revenue growth in the first half of the year. As such, we are reducing our F'09 revenue growth rate assumptions; we now expect North America revenue to grow 14% Y/Y (from 17% previously and 26% in F'08E), as we expect EGM revenue growth to slow to 20%, from 39% in F'08E. Internationally, we are now projecting 17% Y/Y growth, from 19% previously and 32% in F'08E. Our new revenue estimate is thus $22.0B, from $22.5B, implying a 15% Y/Y growth rate.

Due to the difficult pricing environment, we see gross margin in F'09 at 21.4%, down ~70 bps Y/Y. We do not think Amazon will be able to significantly rationalize any of its operating expense lines, and thus think much of the gross margin contraction will flow through to the operating margin line: we expect a ~61 bps operating margin decline Y/Y to 4.8%.

Our model now calls for EBITDA in F'09 of $1.43B, down from $1.56B previously and up 1% Y/Y. We are cutting our F'09 EPS estimate to $1.22, from $1.43.

Our Estimates and Outlook for 2010

We think a recovery in consumer spending is not likely until 2H'09 and believe that a rebound in F'10, as well as easier comps from the depressed levels of 1H'09 could set up accelerating revenue growth at Amazon in F'10. We are modeling 19% Y/Y revenue growth in F'10 to $26.2B; we think both North America and International revenue growth could be faster in F'10 than F'09.

Our model calls for EBITDA of $1.73B, slight Y/Y operating margin expansion to 5.0%, and EPS of $1.54.

We Are Introducing a Price Target of $65

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession; and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for Amazon of a ~38% F'09-F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 38x EV/EBIT multiple to our F'09 EBIT estimate (reflecting better forward visibility than the current valuation of 29x our F'09 estimate) and thus arrive at our December 2009 price target of $65.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 85: Key Valuation Assumptions

5 yr forward EBIT CAGR		38%
1x EBIT Growth		38
2009 EBIT	$	704
Implied Enterprise Value	$	26,416
+ Cash	$	2,602
- Debt	$	895
Market Value	$	28,123
Share count		436
2009 Price Target	$	65

Source: Company reports and J.P. Morgan estimates.

Our EV/EBIT valuation is based on the following projections for revenue and operating income growth

Table 86: Growth Profile

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	21,693.5	26,165.1	31,528.7	37,676.5	44,646.3	52,146.9
Y/Y change		*20.6%*	20%	19%	18%	17%
Less: Operating Expenses	20,989.3	25,239.8	30,299.1	35,905.7	42,146.1	48,684.3
As % of total revenues	*96.8%*	*96.5%*	*96.1%*	*95.3%*	*94.4%*	*93.4%*
Operating Income (Loss)	704.2	925.3	1,229.6	1,770.8	2,500.2	3,462.6
Operating margin	*3.2%*	*3.5%*	3.9%	4.7%	5.6%	6.6%

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

AMZN trades at a premium to its peers. Our updated F'09 assumptions yield a 2009 EV/EBITDA multiple of 14.5x our F'09 EBITDA estimate of $1.42B, versus the ecommerce group at 6.5x and its large-cap peers at 7.8x. Given the rapid revenue growth and superior industry position, we believe the stock has capacity to see further multiple expansion and thus rate AMZN Overweight.

Risks to Our Rating

AMZN could underperform if it encounters difficulties in its international expansion, including regulatory hurdles that make the business climate less hospitable and potentially less profitable than the markets where it currently operates. Amazon may have difficulty growing revenues while maintaining its current operating margins. Amazon could suffer if consumer spending continues weakening or remains depressed longer than we expect. Amazon faces competition from a variety of online and offline retailers, and improved offerings from these competitors could hamper Amazon's growth.

Table 87: Amazon Annual Income Statement

$ in millions

	FY 2007	FY 2008E	FY 2009E	FY 2010E
Net sales	14,835	18,711	21,694	26,165
Cost of sales	11,482	14,564	17,044	20,568
Gross profit	3,354	4,147	4,650	5,597
Gross Margins	22.6%	22.2%	21.4%	21.4%
Fulfillment	1,253	1,572	1,817	2,188
Marketing	336	447	513	613
Technology and content	715	859	984	1,151
General and administrative	200	234	271	322
Other operating expense (income)	9	(28)	16	16
Stock-based compensation (1)	185	282	345	383
Amortization of other intangibles	-	-	-	-
Restructuring-related and other	-	-	-	-
Total operating expenses	2,697	3,367	3,946	4,672
Total recurring operating expenses	2,512	3,130	3,601	4,289
		0	-	-
Operating Profit (Reported)	655	780	704	925
Operating Profit (Pro Forma)	840	1,017	1,049	1,308
Operating Margin (Reported)	4.4%	4.2%	3.2%	3.5%
Operating Margin (Pro Forma)	5.7%	5.4%	4.8%	5.0%
EBITDA	1,089	1,398	1,419	1,734
Income (loss) from continuing operations	840	1,017	1,049	1,308
Interest Income	91	87	80	80
Interest Expense	(78)	(75)	(47)	(57)
Other Income, net	(1)	21	-	-
Total non-operating expenses, net	12	33	33	23
Income (loss) before equity in losses of equity-method investees	852	1,050	1,082	1,331
Income (loss) before change in accounting principle (reported)	852	1,050	1,082	1,331
		-	-	-
Cumulative effect of change in accounting principle	-	-	-	-
GAAP Income before taxes	661	811	737	948
Tax Rate	*27.9%*	*28.4%*	*29.0%*	*29.0%*
Provision (benefit) for taxes	184	231	214	275
Pro Forma Net income (loss)	668	819	868	1,056
Remeasurement of 6.875% PEACS and other	(7)	(2)	-	-
Other gains (losses), net	-	(4)	-	-
Total Extraordinary Items	(7)	(11)	-	-
GAAP Net income (loss)	477	571	523	673
GAAP EPS	$1.12	$1.32	$1.20	$1.54
Shares Outstanding	424	432	437	439
% Of Revenue				
Fulfillment	8.4%	8.4%	8.4%	8.4%
Marketing	2.3%	2.4%	2.4%	2.3%
Technology and content	4.8%	4.6%	4.5%	4.4%
General and administrative	1.3%	1.3%	1.2%	1.2%
Y/Y Change				
Revenue	39%	26%	16%	21%
Fulfillment	37%	25%	16%	20%
Marketing	30%	33%	15%	19%
Technology and content	18%	20%	14%	17%
General and administrative	14%	17%	16%	19%
PF Operating Income	71%	21%	3%	25%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 88: Amazon Quarterly Income Statement

$ in millions

	FY 2007				FY 2008E				FY 2009E			
	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Net sales	3,015	2,886	3,262	5,673	4,135	4,063	4,264	6,249	4,597	4,499	4,920	7,678
Cost of sales	2,296	2,185	2,500	4,503	3,179	3,096	3,265	5,024	3,586	3,451	3,788	6,219
Gross profit	719	701	762	1,170	956	967	999	1,225	1,011	1,048	1,132	1,459
Gross Margins	23.8%	24.3%	23.4%	20.6%	23.1%	23.8%	23.4%	19.6%	22.0%	23.3%	23.0%	19.0%
Fulfillment	253	248	285	467	343	345	378	506	379	382	433	622
Marketing	71	63	72	131	101	98	104	144	110	108	118	177
Technology and content	167	176	181	190	203	218	226	212	225	247	266	246
General and administrative	49	49	47	54	51	61	60	62	60	63	64	84
Other operating expense (income)	-	3	3	3	6	(45)	7	4	4	4	4	4
Stock-based compensation (1)	34	46	51	54	54	73	70	85	82	84	87	92
Amortization of other intangibles	-	-	-	-	-	-	-	-	-	-	-	-
Restructuring-related and other												
Total operating expenses	574	585	639	899	758	750	845	1,014	861	889	972	1,225
Total recurring operating expenses	540	539	588	845	704	722	775	929	779	805	885	1,133
								0.0136				
Operating Profit (Reported)	145	116	123	271	198	217	154	211	151	159	160	234
Operating Profit (Pro Forma)	179	162	174	325	252	245	224	296	233	243	247	326
Operating Margin (Reported)	4.81%	4.0%	3.8%	4.78%	4.79%	5.3%	3.6%	3.38%	3.3%	3.5%	3.3%	3.0%
Operating Margin (Pro Forma)	5.94%	5.6%	5.3%	5.73%	6.09%	6.0%	5.3%	4.74%	5.1%	5.4%	5.0%	4.2%
EBITDA	241	225	235	388	317	405	300	376	318	333	342	426
Income (loss) from continuing operations	179	162	174	325	252	245	224	296	233	243	247	326
Interest Income	20	20	23	28	26	20	21	20	20	20	20	20
Interest Expense	(19)	(19)	(19)	(21)	(22)	(21)	(17)	(15)	(11)	(11)	(12)	(13)
Other Income, net	-	(1)	(1)	1	5	(8)	24					
Total non-operating expenses, net	1	-	3	8	9	(9)	28	5	9	9	8	7
Income (loss) before chg in accnting principle (reported)	180	162	177	333	261	236	252	301	242	252	255	333
Cumulative effect of change in accounting principle	-	-	-	-	-	-	-	-	-	-	-	-
GAAP Income before taxes	144	112	124	281	205	208	182	216	160	168	168	241
Tax Rate	*22.9%*	*29.6%*	*35.5%*	*26.3%*	*30.2%*	*22.1%*	*32.4%*	*29.5%*	*29.0%*	*29.0%*	*29.0%*	*29.0%*
Provision (benefit) for taxes	33	33	44	74	62	46	59	64	46	49	49	70
Pro Forma Net income (loss)	147	129	133	259	199	190	193	237	195	204	206	263
Remeasurement of 6.875% PEACS and other	(2)	(5)	(2)	2	(2)	-	-	-	-	-	-	-
Other gains (losses), net	-	-	-	-	-	(4)	-	-	-	-	-	-
Total Extraordinary Items	(2)	(5)	(2)	2	(2)	(4)	(5)	-	-	-	-	-
GAAP Net income (loss)	111	79	80	207	143	158	118	152	113	120	119	171
GAAP EPS	$0.26	$0.19	$0.19	$0.48	$0.34	$0.37	$0.27	$0.35	$0.26	$0.27	$0.27	$0.39
Shares Outstanding	420	423	425	427	426	430	436	436	436	437	437	437

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 88: Amazon Quarterly Income Statement (cont.)

% Of Revenue												
Fulfillment	8.4%	8.6%	8.7%	8.2%	8.3%	8.5%	8.9%	8.1%	8.3%	8.5%	8.8%	8.1%
Marketing	2.4%	2.2%	2.2%	2.3%	2.4%	2.4%	2.4%	2.3%	2.4%	2.4%	2.4%	2.3%
Technology and content	5.5%	6.1%	5.5%	3.3%	4.9%	5.4%	5.3%	3.4%	4.9%	5.5%	5.4%	3.2%
General and administrative	1.6%	1.7%	1.4%	1.0%	1.2%	1.5%	1.4%	1.0%	1.3%	1.4%	1.3%	1.1%
Q/Q Change												
Revenue	-24%	-4%	13%	74%	-27%	-2%	5%	47%	-26%	-2%	9%	56%
Fulfillment	-24%	-2%	15%	64%	-27%	1%	10%	34%	-25%	1%	13%	44%
Marketing	-21%	-11%	14%	82%	-23%	-3%	6%	38%	-23%	-2%	9%	50%
Technology and content	3%	5%	3%	5%	7%	7%	4%	-6%	6%	10%	7%	-8%
General and administrative	29%	0%	-4%	15%	-6%	20%	-2%	4%	-4%	5%	2%	32%
PF Operating Income	-21%	-9%	7%	87%	-22%	-3%	-9%	32%	-21%	5%	1%	32%
PF Net Income	15%	-12%	3%	95%	-23%	-5%	2%	23%	-18%	4%	1%	28%
Y/Y Change												
Revenue	32%	35%	41%	42%	37%	41%	31%	10%	11%	11%	15%	23%
Fulfillment	33%	36%	36%	41%	36%	39%	33%	8%	11%	11%	15%	23%
Marketing	31%	21%	14%	46%	42%	56%	44%	10%	9%	10%	14%	23%
Technology and content	21%	17%	16%	17%	22%	24%	25%	12%	11%	14%	18%	16%
General and administrative	9%	11%	-4%	42%	4%	24%	28%	16%	17%	3%	7%	35%
PF Operating Income	53%	110%	149%	43%	41%	51%	29%	-9%	-8%	-1%	10%	10%

Source: Company reports and J.P. Morgan estimates

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 89: Amazon Annual Balance Sheet

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
ASSETS:				
Cash/Equivalents	2539.1	2417.5	3456.0	4929.0
ST Investments	573.0	674.0	674.0	674.0
Inventories	1200.0	1499.8	1928.6	2394.3
A/R, net and other current	852.0	874.9	1199.9	1481.9
Total Current Assets	5164.1	5466.2	7258.5	9479.2
Equipment, Net	543.0	746.0	751.0	838.0
Other LT Assets	296.0	722.0	722.0	722.0
L.T. Investments	260.0	278.0	278.0	278.0
Goodwill/Intang.	0.0	0.0	0.0	0.0
Goodwill	222.0	405.0	405.0	405.0
Total Other Assets	1321.0	2151.0	2156.0	2243.0
Total Assets	6485.1	7617.2	9414.5	11722.2
LIABILITIES:				
Accounts Payable	2795.0	2999.6	3708.0	4470.1
Accrued Expense	902.0	999.9	1352.4	1670.3
Unearned Revenue	0.0	0.0	0.0	0.0
Oth. Curr. Liab.	0.0	0.0	0.0	0.0
Curr.Port.LT Debt	17.0	0.0	0.0	0.0
Advertising		0.0	0.0	0.0
Total Current Liabs	3714.0	3999.4	5060.3	6140.5
Long Term Debt	1574.0	895.0	895.0	895.0
Capital Leases		0.0	0.0	0.0
Total Long Term Debt	1574.0	895.0	895.0	895.0
Total Liabilities	5288.0	4894.4	5955.3	7035.5
SHAREHOLDER EQUITY:				
Total Equity	1197.1	2722.8	3459.2	4686.7
Liabilities + Equity	6485.1	7617.2	9414.5	11722.2

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 90: Amazon Annual Cash Flow Statement

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
OPERATING CASH FLOWS				
Net Income	476.5	571.3	523.4	673.3
Depreciation and amortization	246.0	291.0	370.0	426.0
Stock-Based Amort.	185.0	282.0	345.0	383.0
Other operating expense		(31.0)	-	-
Excess tax benefit on stock awards				-
Equity in Loss	-	-	-	-
Amort. Intangibles	3.0	-	-	-
Merger/Acquisition	-	-	-	-
Mrktbl.Secs.	-	(3.0)	-	-
Remeasurement and other	10.0	(16.0)	-	-
Investment Inc/Loss	-	-	-	-
Interest Expense	-	-	-	-
Accounting Change	-	-	-	-
Deferred Taxes	(99.0)	(46.0)	-	-
Changes current assets	835.0	105.2	150.0	460.7
Inventories	(303.0)	(314.8)	(299.8)	(428.8)
Prepaid Exp./Other	(254.0)	(57.5)	147.3	(171.4)
Accounts Payable	928.0	232.6	204.6	708.4
Accrued Expense	430.0	177.9	97.9	352.5
Other Operating	200.0	67.0	-	-
Non-Cash Items	(166.0)	-	-	-
Interest Payable	-	-	-	-
Cash From Operations	1406.5	993.4	1388.4	1943.0
FCF	1183.5	661.4	1038.4	1473.0
Y/Y Growth	*143.9%*	*-44.1%*	*57.0%*	*41.8%*
INVESTING CASH FLOWS				
Mat./ST Investments	1,269.6	1,034.0	-	-
Purch./ST Investment	(930.0)	(1,229.0)	-	-
Capital Expenditures	(223.0)	(332.0)	(350.0)	(470.0)
Sale of Subsidiary	-	-	-	-
Invst. in Affiliates	-	-	-	-
Acquisitions	(76.0)	(407.0)	-	-
Cash From Investing	40.6	(934.0)	(350.0)	(470.0)
FINANCING CASH FLOWS				
Options Exercised	91.0	10.0	-	-
Tax benefit of stock awards		160.0	-	-
Issuance of Common	-	-	-	-
Options/Common Issue	-	-	-	-
Proceeds/LT Debt	36.0	53.0	-	-
Repay. LTD	(69.4)	(26.0)	-	-
Repayment of Debt	(17.0)	(331.0)	-	-
Financing Costs	-	-	-	-
Purch./Sale of Stock	(248.0)	-	-	-
Long Term Debt	-	-	-	-
Cash From Financing	49.6	(134.0)	-	-
Foreign Exch Effects	20.0	(47.0)	-	-
Net Change In Cash	1,516.7	(121.6)	1,038.4	1,473.0
Beginning Cash	1,022.4	2,539.1	2,417.5	3,456.0
Ending Cash	2,539.1	2,417.5	3,456.0	4,929.0

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Blue Nile, Inc., Underweight, ($23.67)

We expect luxury goods spending to be negatively impacted by deteriorating market conditions in 2009, and, as such, are forecasting a 5.6% Y/Y revenue decline in F'09. Additionally, we think operating margins will contract due to SG&A deleverage. Blue Nile trades at 12.9x our F'09 EBITDA estimate of $25.8M. Given our expectation for negative EBITDA growth, we believe this premium is undeserved and thus maintain our Underweight rating. We are introducing a $20 December 2009 price target.

- **We expect revenue to decline in 2009 as discretionary spending continues to slow.** With the tightening of the credit markets and further macroeconomic weakness, we think consumers will continue to cut back on discretionary spending, especially high-ticket items such as jewelry. We believe Blue Nile will see both order volume and AOV declines in 1H'09 as consumers purchase less and trade down to lower price points.
- **We expect EBITDA margins to decline in F'09.** We think roughly 35-50% of Blue Nile's SG&A expenses are fixed. As such, with revenue expected to decline in 2009, we are also forecasting a 50bps Y/Y decline in F'09 EBITDA margins. In addition, we are concerned with the company's online advertising costs, as keyword pricing remains up on a Y/Y basis.
- **We expect international growth to continue to slow in 2009.** We think Blue Nile's international growth will continue to be pressured by FX headwinds as well as global economic deterioration. However, we believe once the economy starts to recover, NILE will benefit from further international expansion.
- **2009 drivers.** In our view, the following factors will drive NILE shares in 2009: (1) more limited access to credit for luxury purchases, (2) less discretionary spend, and (3) operating expense deleverage.
- **Maintaing 4Q'08 estimates.** We are maintaining our 4Q'08 revenue, EBITDA, and GAAP EPS estimates of $100.9M, $11.3M, and $0.42, respectively.

Our current and newly introduced 2010 estimates are in the table below:

Table 91: Blue Nile Financial Snapshot

$ in millions, except per share data

NILE	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	100.9	310.4	293.0	322.9	-3%	-6%	10%
EBITDA	11.3	28.7	25.8	33.7	-4%	-10%	30%
EPS	$0.42	$0.94	$0.76	$0.95	-10%	-19%	25%
Consensus							
Revenue	101.7	310.8	320.0	362.7	-3%	3%	13%
EBITDA	10.5	26.2	26.4	33.9	-13%	1%	28%
EPS	$0.39	$0.90	$0.93	$1.20	-13%	3%	29%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We are now modeling F'09 revenue, EBITDA, and GAAP EPS estimates of $293.0M, $25.8M, and $0.76, representing Y/Y declines of 5.6%, 10.2%, and 18.9%, respectively.

We think macroeconomic weakness will continue to negatively impact consumer discretionary spending in 2009, causing both order volume and AOV to decline. As such, we are forecasting a 5% Y/Y decrease in F'09 order volume, as well as a 2% decrease in F'09 AOV.

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and GAAP EPS estimates of $322.9M, $33.7M, and $0.95, representing Y/Y growth rates of 10.2%, 30.5%, and 25.4%, respectively.

We support our estimates with the assumption that the U.S. macro economy will recover in 2010, thus increasing consumer discretionary spending. As such, we think increases in order volume and AOV will drive revenue growth in 2010 and are forecasting 7% Y/Y growth in F'10 order volume and 3% growth in F'10 AOV.

In addition, we expect Blue Nile to benefit from further international expansion in 2010, with possible entrance into new markets outside Canada and the U.K. Operating margins will likely recover.

We Are Introducing a Price Target of $20

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for Blue Nile of a ~20% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock should be trading closer to a 20x EV/EBIT multiple to our F'09 EBIT estimate (reflecting a more cautious sales outlook than the current valuation of 24x our F'09 estimate) and thus arrive at our December 2009 price target of $20.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 92: Key Valuation Assumptions

5 yr forward EBIT CAGR	20%
1x EBIT Growth	20
2009 EBIT	$13.6
Implied Enterprise Value	$272.3
+ Cash	$26.6
- Debt	$-
Market Value	$298.9
Share count	15.2
2009 Price Target	$19.67

Source: Company reports and J.P. Morgan estimates.

Our EV/EBIT valuation is based on the following projections for revenue and operating income growth

Table 3: 5-Year Growth Outlook

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	293.0	322.9	387.5	457.2	525.8	604.6
Y/Y change		*10.2%*	20%	18%	15%	15%
Less: Operating Expenses	279.4	305.3	366.1	432.1	496.9	571.4
As % of total revenues	*95.4%*	*94.6%*	*94.5%*	*94.5%*	*94.5%*	*94.5%*
Operating Income (Loss)	13.6	17.6	21.3	25.1	28.9	33.3
Operating margin	*4.6%*	*5.4%*	5.5%	5.5%	5.5%	5.5%

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

On an EV/EBITDA basis, NILE trades at 12.9x our F'09 EBITDA estimate of $25.8M vs. its e-commerce peers, which trade at 6.5x F'09 estimates. We think this premium is undeserved given our expectation for negative EBITDA growth and are thus maintaining our Underweight rating.

Risks to Our Rating

Blue Nile is highly dependent on its diamond and jewelry suppliers, and it would be difficult for the company's business model to tolerate large price fluctuations in the price to acquire diamonds and jewelry. Blue Nile faces competition from both offline and online competitors, which operate in different spaces in the jewelry market. Online competitors include: diamond.com, amazon.com, walmart.com, mondera.com, and Ashford. If the company successfully executes its international business strategy or gains market share in the US from traditional retailers, our estimates could prove to be too conservative. Further, if the economy and consumer spending turn around more quickly than we expect, the stock could outperform.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 93: NILE Annual Income Statement

$ in millions, except per share data

	2007	2008E	2009E	2010E
Total Revenue	319.3	310.4	293.0	322.9
Cost of Revenue	254.1	246.4	232.4	256.1
Pro forma FAS123R adjustment				
Pro forma Cost of Revs	254.1	246.4	232.4	256.1
Gross Profit (Rpt)	65.2	64.0	60.6	66.7
Gross Profit (Pforma)	65.2	64.0	60.6	66.7
Gross Margin (Rpt)	20.4%	20.6%	20.7%	20.7%
Gross Margins (PF)	*20.4%*	*20.6%*	*20.7%*	*20.7%*
SG&A	42.8	44.7	46.9	49.2
Restructuring	-			
FAS 123R Stock based compensation	5.8	7.2	8.1	9.2
Total Expenses	42.8	44.7	46.9	49.2
Total Recurring Expenses	37.0	37.5	38.8	40.0
Operating Profit (Reported)	22.4	19.3	13.6	17.6
Operating Profit (Pro Forma)	28.2	26.5	21.7	26.8
Operating Margin (Reported)	7.0%	6.2%	4.6%	5.4%
Operating Margin (Pro Forma)	8.8%	8.5%	7.4%	8.3%
EBITDA	30.0	28.7	25.8	33.7
EBITDA Margin	9.4%	9.3%	8.8%	10.4%
Y/Y EBITDA Growth	33.7%	-4.1%	-10.2%	30.5%
Other Income (Expense)	4.2	2.7	3.6	4.0
Total Other	4.2	2.7	3.6	4.0
Income Before Taxes (Reported)	26.6	22.0	17.2	21.6
Income Before Taxes (Pro Forma)	32.4	29.2	25.3	30.8
Income Taxes (Rpt)	9.1	7.7	6.1	7.6
Income Taxes (Pforma)	11.1	10.2	8.9	10.8
Tax Rate	34.6%	34.8%	35.2%	35.2%
Pforma Tax Rate				
Inc From Ops After Taxes (Rpt)	17.5	14.3	11.2	14.0
Inc From Ops After Taxes (PF)	21.2	19.0	16.4	20.0
Extraordinary Item	-			
Reported Net Income	17.5	14.3	11.2	14.0
Pro Forma Net Income	21.2	19.0	16.4	20.0
Reported EPS	1.04	0.94	0.76	0.95
Pro Forma EPS	1.27	1.23	1.12	1.36
Diluted Shares	16.7	15.5	14.7	14.7
% of Total Revenue				
Cost of Revenue	79.6%	79.4%	79.3%	79.3%
Gross Profit	20.4%	20.6%	20.7%	20.7%
SG&A	13.4%	14.4%	16.0%	15.2%
Y/Y Change				
Total Revenue	26.9%	-2.8%	-5.6%	10.2%
Cost of Revenue	26.6%	-3.0%	-5.7%	10.2%
SG&A	24.8%	4.3%	5.1%	4.7%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 94: NILE Quarterly Income Statement

$ in millions, except per share data

	FY 2007				FY 2008E				FY 2009E			
	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Total Revenue	67.9	72.1	67.4	111.9	70.5	73.7	65.4	100.9	59.5	65.1	63.4	104.9
Cost of Revenue	54.7	57.2	54.0	88.3	56.5	58.6	52.1	79.2	47.7	51.8	50.5	82.4
Pro forma FAS123R adjustment												
Pro forma Cost of Revs	54.7	57.2	54.0	88.3	56.5	58.6	52.1	79.2	47.7	51.8	50.5	82.4
Gross Profit (Rpt)	13.2	14.9	13.4	23.7	13.9	15.1	13.3	21.7	11.8	13.3	12.9	22.6
Gross Profit (Pforma)	13.2	14.9	13.4	23.7	13.9	15.1	13.3	21.7	11.8	13.3	12.9	22.6
Gross Margin (Rpt)	19.5%	20.7%	19.8%	21.1%	19.8%	20.5%	20.3%	21.5%	19.8%	20.5%	20.3%	21.5%
Gross Margins (PF)	*19.5%*	*20.7%*	*19.8%*	*21.1%*	*19.8%*	*20.5%*	*20.3%*	*21.5%*	*19.8%*	*20.5%*	*20.3%*	*21.5%*
SG&A	9.6	9.9	9.7	13.6	10.9	10.8	10.0	13.0	11.2	11.1	10.2	14.5
Restructuring												
FAS 123R Stock based compensation	1.3	1.4	1.4	1.7	1.8	1.9	1.6	1.9	2.0	2.1	1.9	2.1
Total Expenses	9.6	9.9	9.7	13.6	10.9	10.8	10.0	13.0	11.2	11.1	10.2	14.5
Total Recurring Expenses	8.3	8.5	8.3	11.9	9.1	8.9	8.4	11.1	9.2	9.0	8.3	12.4
Operating Profit (Reported)	3.7	5.0	3.6	10.1	3.0	4.4	3.3	8.7	0.6	2.3	2.7	8.1
Operating Profit (Pro Forma)	5.0	6.4	5.0	11.8	4.8	6.3	4.9	10.6	2.6	4.4	4.6	10.2
Operating Margin (Reported)	5.4%	7.0%	5.4%	9.0%	4.3%	5.9%	5.0%	8.6%	1.0%	3.5%	4.2%	7.7%
Operating Margin (Pro Forma)	7.3%	8.9%	7.4%	10.5%	6.8%	8.5%	7.5%	10.5%	4.4%	6.7%	7.2%	9.7%
EBITDA	5.4	6.8	5.4	12.4	5.2	6.8	5.4	11.3	2.6	6.3	6.3	10.6
EBITDA Margin	7.9%	9.5%	8.0%	11.0%	7.4%	9.2%	8.3%	11.2%	4.4%	9.7%	10.0%	10.1%
Y/Y EBITDA Growth	36.9%	37.4%	41.9%	27.3%	-3.0%	-0.2%	0.4%	-8.7%	-50.3%	-7.4%	16.2%	-6.1%
Other Income (Expense)	1.2	0.8	1.0	1.2	0.9	0.6	0.3	0.9	1.0	0.8	0.8	1.0
Total Other	1.2	0.8	1.0	1.2	0.9	0.6	0.3	0.9	1.0	0.8	0.8	1.0
Income Before Taxes (Reported)	4.9	5.8	4.6	11.3	4.0	4.9	3.6	9.6	1.6	3.1	3.5	9.1
Income Before Taxes (Pro Forma)	6.2	7.2	6.0	13.0	5.7	6.8	5.2	11.5	3.6	5.2	5.4	11.2
Income Taxes (Rpt)	1.7	2.1	1.6	3.8	1.4	1.7	1.2	3.4	0.6	1.1	1.2	3.2
Income Taxes (Pforma)	2.2	2.6	2.1	4.3	2.0	2.4	1.8	4.0	1.3	1.8	1.9	3.9
Tax Rate	34.9%	35.4%	35.0%	33.3%	34.9%	35.0%	34.4%	35.0%	35.2%	35.2%	35.2%	35.2%
Pforma Tax Rate	34.9%	35.4%	35.0%	33.3%	34.9%	35.0%	35.0%	35.0%	35.2%	35.2%	35.2%	35.2%
Inc From Ops After Taxes (Rpt)	3.2	3.8	3.0	7.5	2.6	3.2	2.3	6.2	1.0	2.0	2.2	5.9
Inc From Ops After Taxes (PF)	4.0	4.7	3.9	8.7	3.7	4.4	3.4	7.5	2.3	3.4	3.5	7.2
Extraordinary Item												
Reported Net Income	3.2	3.8	3.0	7.5	2.6	3.2	2.3	6.2	1.0	2.0	2.2	5.9

Table 94: NILE Quarterly Income Statement (cont.)

	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Pro Forma Net Income	4.0	4.7	3.9	8.7	3.7	4.4	3.4	7.5	2.3	3.4	3.5	7.2
Reported EPS	0.19	0.23	0.18	0.45	0.16	0.20	0.15	0.42	0.07	0.14	0.15	0.40
Pro Forma EPS	0.24	0.28	0.23	0.51	0.23	0.28	0.22	0.51	0.16	0.23	0.24	0.49
Diluted Shares	16.5	16.6	16.9	16.9	16.3	16.0	15.2	14.7	14.7	14.7	14.7	14.7
% of Total Revenue												
Cost of Revenue	80.5%	79.3%	80.2%	78.9%	80.2%	79.5%	79.7%	78.5%	80.2%	79.5%	79.7%	78.5%
Gross Profit	19.5%	20.7%	19.8%	21.1%	19.8%	20.5%	20.3%	21.5%	19.8%	20.5%	20.3%	21.5%
SG&A	14.1%	13.7%	14.5%	12.1%	15.5%	14.6%	15.3%	12.9%	18.8%	17.0%	16.1%	13.8%
Q/Q change												
Total Revenue	-25.2%	6.2%	-6.6%	66.1%	-37.0%	4.6%	-11.3%	54.3%	-41.0%	9.4%	-2.6%	65.5%
Cost of Revenue	-24.1%	4.6%	-5.5%	63.4%	-35.9%	3.6%	-11.0%	52.0%	-39.7%	8.4%	-2.3%	63.0%
SG&A	-9.6%	3.6%	-1.7%	39.3%	-19.7%	-1.3%	-7.2%	30.4%	-14.0%	-1.1%	-7.7%	41.8%
Y/Y Change												
Total Revenue	34.0%	26.7%	26.5%	23.3%	3.8%	2.2%	-2.9%	-9.8%	-15.5%	-11.7%	-3.0%	4.0%
Cost of Revenue	35.6%	25.4%	26.1%	22.5%	3.4%	2.5%	-3.5%	-10.3%	-15.6%	-11.7%	-3.0%	4.0%
SG&A	24.1%	27.9%	17.8%	28.4%	13.9%	8.6%	2.4%	-4.1%	2.7%	2.9%	2.3%	11.3%

Source: Company reports and J.P. Morgan estimates.

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Table 95: NILE Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Assets				
Cash and cash equivalents	122.8	61.6	74.1	100.6
Restricted cash	-	-	-	-
Marketable securities	-	-	-	-
Accounts receivable	3.6	3.4	3.6	3.9
Inventories	20.9	23.0	25.7	28.7
Deferred income taxes	0.8	0.5	0.5	0.5
Prepaids and other current assets	1.1	2.0	2.8	3.8
Total Current Assets	149.1	90.5	106.8	137.6
Property and equipment, net	7.6	7.4	5.7	8.6
Intangible assets, net	0.3	0.3	0.3	0.3
Deferred income taxes, net	3.5	4.7	2.0	2.0
Other assets	0.1	0.1	0.1	0.1
Total Long Term Assets	11.4	12.5	8.1	10.9
Total Assets	160.6	103.0	114.9	148.5
Liabilities				
Accounts payable	85.9	82.9	79.3	86.0
Accrued liabilities	9.5	8.5	9.2	10.0
Accrued marketing	-	-	-	-
Current portion of deferred rent	0.2	0.1	0.2	0.2
Current portion of note payable to related party	-	-	-	-
Current portion of subordinated notes payable	-	-	-	-
Current portion of capital lease obligations	0.0	-	-	-
Total Current Liabilities	95.7	91.5	88.7	96.3
Deferred rent, less current portion	0.5	0.4	0.4	0.4
Note payable to related party, less current portion	-	-	-	-
Capital lease obligations, less current portion	0.9	-	-	-
Redeemable convertible preferred stock	-	-	-	-
Total Long Term Liabilities	1.4	0.4	0.4	0.4
Total Liabilities	97.1	91.9	89.1	96.7
Shareholder Equity				
Preferred stock	-	-	-	-
Common Stock	0.0	-	-	-
Additional Paid in Capital	134.2	-	-	-
Deferred compensation	(0.0)	-	-	-
Accumulated deficit	24.6	-	-	-
Treasury stock	(95.4)	-	-	-
Total Equity	63.5	11.0	25.8	51.8
Total Liabilities + Equity	160.6	103.0	114.9	148.5

Source: Company reports and J.P. Morgan estimates.

Table 96: NILE Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Operating Cash Flows				
Net income	17.5	14.3	11.2	14.0
Depreciation and amortization	1.8	2.2	2.6	2.6
Loss on asset retirement	(0.0)	0.0	-	-
Stock-based compensation expense	5.8	7.2	8.1	9.2
Warrant based interest expense	-	-	-	-
Restructuring charges	-	-	-	-
Deferred income taxes	(1.4)	(1.1)	(0.7)	(0.7)
Tax benefit from exercise of stock options	6.8	0.5	-	-
Excess tax benefit from exercise of stock options	(1.8)	(0.1)	-	-
Changes in working capital	12.8	(7.1)	(6.7)	3.4
Receivables, net	(1.9)	0.2	(0.3)	(0.3)
Inventories	(6.3)	(2.1)	(2.7)	(3.0)
Prepaid expenses and other assets	(0.3)	(0.9)	(0.9)	(0.9)
Accounts payable	19.2	(3.0)	(3.6)	6.8
Accrued liabilities	2.2	(1.1)	0.7	0.8
Deferred rent	(0.1)	(0.2)	0.0	0.0
Cash From Operations	41.5	15.9	14.5	28.5
FCF	36.6	14.0	12.5	26.5
	-5.3%	-61.8%	-10.4%	111.8%
Investing Cash Flows				
Purchases of property and equipment	(4.9)	(2.0)	(2.0)	(2.0)
Proceeds from sales of property and equipment	0.0	0.0	-	-
Transfers to restricted cash	0.1	-	-	-
Purchase/Sale of marketable securities	19.8	-	-	-
Cash From Investing	15.0	(1.9)	(2.0)	(2.0)
Financing Cash Flows				
Proceeds from sale of common stock, net of issuance costs				
Proceeds from sale of mandatorily redeemable convertible preferred stock, net of issuance costs	-	-	-	-
Repurchase of restricted and common stock	(20.0)	(78.3)	-	-
Proceeds from stock option exercises	5.9	3.0	-	-
Excess tax benefit from exercise of stock options	1.8	0.1	-	-
Net repayments on line of credit	(0.0)	(0.0)	(0.0)	-
Payments on subordinated notes payable	-	-	-	-
Payments on capital lease obligations	0	-	-	-
Payments on note payable to related party	0	-	-	-
Payment on note payable	0	-	-	-
Proceeds from warrant and stock option exercises	0	-	-	-
Cash From Financing	(12.3)	(75.2)	(0.0)	-
F/X Effects	0.1	0.0	-	-
Net Increase (decrease) in cash	44.3	(61.2)	12.5	26.5
Beginning Cash	78.6	122.8	61.6	74.1
Ending Cash	122.8	61.6	74.1	100.6

Source: Company reports and J.P. Morgan estimates.

Dice Holdings, Neutral, ($4.11)

We are downgrading Dice Holdings from Overweight to Neutral. Although we believe the company is well-run, we think the current environment, esp. in the financial sector, will not present Dice with significant opportunities for growth. As such, we believe investors would do better to stay on the sidelines.

- **Economic, employment outlook present significant headwinds**. With companies in a wide variety of fields announcing layoffs, we believe unemployment is likely to keep rising in the near term, and we expect a hiring recovery to lag the broader economy; in the last two recessions, unemployment peaked after growth had resumed. Even while a majority of package customers are likely to renew, we think churn may rise as employers shelve hiring plans.
- **eFC segment's exposure to financials could stymie growth…** eFC accounted for nearly a quarter of Dice Holdings revenue in F'08. As the financial industry is likely poised to continue shedding jobs for several quarters, especially in the US and UK, growth in the segment could be very hard to come by, and we don't think the unit's operations outside the US and UK have reached the scale to make a meaningful contribution to growth.
- **…and the tech picture is not much brighter**. Numerous technology firms have announced layoffs as well as hiring slowdowns. We do not expect hiring to pick up in the near term, until after consumer spending turns around. Thus, we believe the outlook for growth in the company's tech vertical remains similarly clouded.
- **Cost control by management likely to maintain profitability through tough times**. We believe management is very conscious of costs and quite willing to make the expense structure, especially in Sales and Marketing, appropriate to the revenue stream.
- **2009 drivers.** In our view, the following factors will drive shares in 2009: (1) the employment outlook in the US and UK, (2) the health of the financial industry and hiring trends within finance, and (3) the continuing shift of employment advertising from offline to online resources.
- **Maintaining 4Q'08 estimates**. We are maintaining our 4Q'08 estimates of $36M in revenue, $16 of EBITDA and EPS of $0.07, as well as our F'08 and F'09 estimates, which are outlined in the table below, along with our newly introduced F'10 estimates:

Table 97: Dice Holdings Financial Snapshot

$ in millions, except per share data

DHX	4Q'08E	F'08E	F'09E	F'10E	Y/Y F'08E	Y/Y F'09E	Y/Y F'10E
JPM							
Revenue	36	156	147	154	9%	-6%	5%
EBITDA	16	67	64	68	7%	-5%	6%
EPS	$ 0.07	$ 0.35	$ 0.28	$ 0.29	34%	-20%	2%
Consensus							
Revenue	36	156	143	138	10%	-8%	-4%
EBITDA	16	66	57	58	5%	-14%	2%
EPS	$ 0.08	$ 0.35	$ 0.29	$ 0.38	32%	-16%	29%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We think the employment market is likely to remain pressured through F'09. We are modeling a Y/Y decline in revenue for Dice Holdings, to $147M, down 6% Y/Y. Our EBITDA estimate is $64M, and we are modeling ~20 bps of margin expansion as the company has committed to manage its marketing costs against the tougher climate. We are also maintaining our F'09 EPS estimate of $0.28.

Our Estimates and Outlook for 2010

We are introducing estimates for F'10. We believe the company could begin to see revenue rebound in that year, and we are modeling 5% revenue growth in F'10, to $154M. Our new F'10 EBITDA estimate is $68M, and we are projecting EPS to rise 1c Y/Y, to $0.29.

Valuation and Rating Analysis

DHX trades at 4.7x our F'09E EBITDA, a 27% discount to the 6.5x peer group average. Despite the company's international growth prospects and strong free cash flow generation, we believe the difficult outlook for the employment market makes multiple expansion unlikely in the near term. As such, we are downgrading DHX to Neutral, from Overweight.

Investment Risks

We believe there are several risks to our Neutral rating on Dice:

- Upside risks: Our Neutral thesis is predicated on prolonged economic challenges on both a macro level and in the financial and tech sectors more specifically. Should our expectations prove too pessimistic for the macro economy or for one of the specific industries, the company could outperform our estimates. Additionally, if the company is better able to retain clients than we expect in this environment, results could exceed our expectations.

- Downside risks: should the economic challenges persist longer than we expect (either broadly or in one of the two verticals on which Dice is focused), or should the company have trouble managing costs against declining revenue, the stock could see further weakness. Additionally, Dice operates in a highly competitive landscape, with over 1,000 websites offering job postings, including some, such as Monster, CareerBuilder and HotJobs, with significantly more financial resources than Dice. In addition, social networking sites, such as Facebook and LinkedIn, have been generating significant traffic growth and are looking at job listings as a way to monetize traffic, while online classified companies, such as Craigslist, offer job listings for free or a small fee. Success of any of Dice's competitors in the technology and financial verticals could negatively impact our growth expectations.

Table 98: Dice Holdings Annual Income Statement

$ in millions

	FY -2007	FY-2008E	FY-2009E	FY-2010E
Reported Revenue				
DCS online revenue	102.2	107.6	103.8	108.4
eFC - UK/ROW revenue	29.7	37.5	33.5	35.0
Other Segments	10.5	10.4	9.4	10.3
Total revenues:	142.3	155.5	146.6	153.6
Y/Y revenue growth	*70.7%*	*9.2%*	*-5.7%*	*4.8%*
Proforma Total revenues:	143.9	155.5	146.6	153.6
Y/Y revenue growth	*37.8%*	*8.1%*	*-5.7%*	*4.8%*
Reported operating expenses:				
Cost of Revenues (includes stock-based compensation)	8.6	9.8	9.1	9.4
Product Development (includes stock-based compensation)	4.2	4.6	4.4	4.7
Sales and marketing (includes stock-based compensation)	53.4	57.9	54.9	57.6
General and Administrative (includes stock-based compensation)	19.2	21.6	20.8	21.5
Share Based Compensation	4.1	5.6	6.3	7.2
Depreciation	3.0	3.8	5.0	5.4
Amortization	19.1	16.8	16.4	17.0
Impairment of intangibles				
Total reported operating expenses	110.4	114.6	110.6	115.7
Total proforma operating expenses	81.4	88.4	82.9	86.1
Pro Forma EBITDA	62.5	67.1	63.7	67.5
EBITDA Margin	*43.5%*	*43.2%*	*43.4%*	*44.0%*
Income from operations reported	32.0	40.9	36.0	37.9
Operating margin	*28.1%*	*29.9%*	*28.9%*	*29.4%*
Other income				
Interest income	0.2	2.0	1.2	1.2
Interest expense	(13.1)	(9.9)	(8.1)	(8.9)
Other expense	0.0	(1.0)	0.0	0.0
Income before taxes reported	19.0	32.0	29.1	30.2
Reported Income tax expense	(6.7)	(9.4)	(10.2)	(10.6)
Tax rate	*35.1%*	*29.3%*	*35.0%*	*35.0%*
Minority interest	0.0	0.0	0.0	0.0
Income from continuing operations-reported	12.4	22.6	18.9	19.7
Loss from discontinued operations & Min Int	(1.7)	0.5	0.0	0.0
Income tax benefit of discontinued operations	4.0	-	0.0	0.0
Loss from discontinued operations, net tax	2.3	0.5	0.0	0.0
Net Income reported	14.6	23.2	18.9	19.7
Reported Basic EPS	0.27	0.37	0.30	0.31
Reported Diluted EPS	0.26	0.35	0.28	0.29
Basic sharecount	58.7	62.2	62.3	62.7
Diliuted sharecount	61.0	65.6	66.9	68.1
As % Revenue:				
Dice revenue	71.0%	69.2%	70.8%	70.6%
eFinancial Careers revenue	21.2%	24.1%	22.8%	22.8%
Other revenue	7.8%	6.7%	6.4%	6.7%
Cost of Revenues	6.0%	6.3%	6.2%	6.1%
Product Development	2.9%	3.0%	3.0%	3.1%
Sales and marketing	37.1%	37.3%	37.4%	37.5%
General and Administrative	13.3%	13.9%	14.2%	14.0%
Share Based Compensation	2.8%	3.6%	4.3%	4.7%
Depreciation	2.1%	2.4%	3.4%	3.5%
Amortization	13.2%	10.8%	11.2%	11.1%
Total operating expenses	56.5%	56.8%	56.6%	56.0%
Reported revenue (Y/Y growth)				
DCS online revenue	28.8%	5.3%	-3.5%	4.4%
eFC - UK/ROW revenue	80.2%	23.0%	-10.8%	4.5%
Other	NM	-0.5%	-10.1%	9.6%
ProForma EBITDA Growth	65.6%	7.3%	-5.1%	6.0%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 99: Dice Holdings Quarterly Income Statement

$ in millions

	FY 07				FY 08E				FY 09E			
	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E
Reported Revenue												
DCS online revenue	23.4	25.2	26.6	27.1	27.1	27.4	27.2	25.9	25.7	26.0	26.0	26.1
eFC - UK/ROW revenue	5.1	6.5	8.3	9.7	9.8	9.9	9.9	7.9	8.3	8.4	8.4	8.3
Other Segments	1.9	2.6	3.2	2.8	2.7	2.9	2.6	2.2	2.4	2.5	2.3	2.2
Total revenues:	30.4	34.4	38.1	39.5	39.6	40.3	39.6	36.0	36.4	36.9	36.7	36.6
Q/Q revenue growth	*14.4%*	*13.1%*	*10.9%*	*3.7%*	*0.1%*	*1.8%*	*-1.6%*	*-9.2%*	*1.0%*	*1.4%*	*-0.4%*	*-0.2%*
Y/Y revenue growth	*89.3%*	*78.9%*	*76.5%*	*48.8%*	*30.2%*	*17.2%*	*4.1%*	*-8.9%*	*-8.1%*	*-8.5%*	*-7.4%*	*1.8%*
Pro Forma Revenue:												
DCS online revenue	23.4	25.2	26.6	27.1	27.1	27.4	27.2	25.9	25.7	26.0	26.0	26.1
eFC - UK/ROW revenue	5.5	6.8	8.5	9.7	9.8	9.9	9.9	7.9	8.3	8.4	8.4	8.3
Other Segments	2.3	2.8	3.3	2.8	2.7	2.9	2.6	2.2	2.4	2.5	2.3	2.2
Proforma Total revenues:	31.1	34.9	38.3	39.5	39.6	40.3	39.6	36.0	36.4	36.9	36.7	36.6
Q/Q revenue growth	*5.4%*	*12.0%*	*9.9%*	*3.1%*	*0.1%*	*1.8%*	*-1.6%*	*-9.2%*	*1.0%*	*1.4%*	*-0.4%*	*-0.2%*
Y/Y revenue growth	*42.9%*	*38.3%*	*37.9%*	*33.7%*	*27.0%*	*15.5%*	*3.4%*	*-8.9%*	*-8.1%*	*-8.5%*	*-7.4%*	*1.8%*
Reported operating expenses:												
Cost of Revenues (1)	1.8	1.9	2.4	2.4	2.4	2.5	2.6	2.3	2.3	2.2	2.3	2.3
Product Development (1)	1.0	1.0	1.2	1.0	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Sales and marketing (1)	13.2	13.8	13.5	12.9	14.9	15.9	14.4	12.8	13.8	13.9	13.8	13.4
General and Administrative (1)	3.9	4.4	5.2	5.6	5.5	5.4	5.4	5.4	5.1	5.2	5.2	5.3
Share Based Compensation	0.6	1.2	1.1	1.2	1.3	1.4	1.4	1.5	1.5	1.5	1.6	1.7
Depreciation	0.6	0.7	0.8	0.8	0.9	1.0	1.0	1.0	1.2	1.2	1.3	1.3
Amortization	5.2	4.8	4.7	4.4	4.2	4.2	4.2	4.2	4.1	4.1	4.1	4.1
Impairment of intangibles				2.9								
Total reported operating expenses	25.8	26.6	27.8	30.1	29.1	30.1	28.6	26.8	27.6	27.8	27.8	27.5
Total proforma operating expenses	19.4	19.9	21.2	20.9	22.7	23.5	22.0	20.2	20.8	21.0	20.8	20.4
Pro Forma EBITDA	11.8	14.9	17.2	18.6	16.8	16.8	17.6	15.9	15.6	15.9	15.9	16.3
EBITDA Margin	*37.7%*	*42.9%*	*44.8%*	*47.2%*	*42.5%*	*41.7%*	*44.5%*	*44.0%*	*42.9%*	*43.2%*	*43.3%*	*44.4%*
Income from operations reported	4.6	7.7	10.3	9.4	10.4	10.2	11.0	9.3	8.8	9.1	8.9	9.2
Operating margin	*37.7%*	*27.2%*	*30.5%*	*26.7%*	*29.6%*	*28.8%*	*31.5%*	*29.7%*	*28.4%*	*28.8%*	*28.5%*	*29.7%*
Other income												
Interest income	0.1	0.1	0.4	0.5	0.5	0.5	0.5	0.5	0.3	0.3	0.3	0.3
Interest expense	(2.3)	(4.3)	(3.4)	(3.1)	(2.7)	(2.5)	(2.4)	(2.3)	(2.0)	(2.0)	(2.0)	(2.1)
Other expense	-	-	-	-	(2.3)	1.2	0.1	-	-	-	-	-
Income before taxes reported	2.3	3.5	7.3	6.8	6.0	9.3	9.3	7.5	7.1	7.4	7.2	7.4
Reported Income tax expense	0.9	(1.7)	(2.8)	(3.1)	(2.2)	(1.8)	(2.9)	(2.5)	(2.5)	(2.6)	(2.5)	(2.6)
Tax rate	*nm*	*47.8%*	*38.2%*	*45.9%*	*36.7%*	*19.1%*	*31.2%*	*33.7%*	*35.0%*	*35.0%*	*35.0%*	*35.0%*
Minority interest	-	-	-	-	-	-	-	-	-	-	-	-
Income from continuing operations-reported	3.2	1.8	4.5	3.7	3.8	7.6	6.4	4.9	4.6	4.8	4.7	4.8

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

J.P.Morgan

Table 99: Dice Holdings Quarterly Income Statement (cont.)

Loss from discontinued operations & Min Int	(0.9)	0.2	(0.5)	(0.5)	0.5							
Income tax benefit of discontinued operations	5.6	(0.5)	0.2	(1.3)	-							
Loss from discontinued operations, net tax	4.7	(0.2)	(0.3)	(1.9)	0.5	-	-	-	-	-	-	-
Net Income reported	7.9	1.6	4.2	1.8	4.3	7.6	6.4	4.9	4.6	4.8	4.7	4.8
Reported Basic EPS	0.14	0.03	0.07	0.03	0.07	0.12	0.10	0.08	0.07	0.08	0.07	0.08
Reported Diluted EPS	0.14	0.03	0.07	0.03	0.07	0.12	0.10	0.07	0.07	0.07	0.07	0.07
Basic sharecount	55.3	55.3	62.1	62.1	62.1	62.1	62.2	62.2	62.2	62.2	62.3	62.4
Diliuted sharecount	55.3	58.5	64.4	65.8	65.3	65.5	65.8	65.9	66.3	66.7	67.0	67.3
Segments as % of Revenue												
Dice	76.8%	73.4%	69.7%	68.5%	68.4%	68.1%	68.6%	71.9%	70.6%	70.4%	70.8%	71.3%
eFinancial Careers	16.9%	18.9%	21.9%	24.5%	24.7%	24.6%	24.9%	22.0%	22.9%	22.9%	22.8%	22.7%
Other	6.2%	7.6%	8.4%	7.0%	6.9%	7.3%	6.5%	6.1%	6.6%	6.7%	6.3%	6.0%
Operating Expenses as % of Revenue												
Cost of Revenues	5.9%	5.6%	6.4%	6.2%	6.1%	6.2%	6.5%	6.5%	6.2%	6.1%	6.4%	6.2%
Product Development	3.1%	2.8%	3.1%	2.6%	3.0%	2.9%	3.0%	3.1%	3.0%	3.0%	3.0%	3.0%
Sales and marketing	42.4%	39.6%	35.1%	32.8%	37.7%	39.5%	36.2%	35.5%	38.0%	37.8%	37.5%	36.5%
General and Administrative	12.7%	12.6%	13.6%	14.2%	14.0%	13.3%	13.5%	14.9%	14.0%	14.0%	14.2%	14.5%
Share Based Compensation	1.8%	3.5%	3.0%	3.0%	3.3%	3.5%	3.6%	4.0%	4.1%	4.1%	4.4%	4.6%
Depreciation	2.0%	2.0%	2.2%	2.1%	2.2%	2.4%	2.4%	2.7%	3.3%	3.3%	3.5%	3.5%
Amortization	16.8%	13.7%	12.2%	11.1%	10.7%	10.5%	10.6%	11.6%	11.3%	11.1%	11.2%	11.2%
Total operating expenses	62.3%	57.1%	55.2%	52.8%	57.5%	58.3%	55.5%	56.0%	57.1%	56.8%	56.7%	55.6%
					-4.8%							
Reported revenue (Y/Y growth)												
DCS online revenue	51.2%	36.3%	27.6%	20.3%	16.0%	8.7%	2.4%	-4.4%	-5.2%	-5.3%	-4.4%	0.9%
eFC - UK/ROW revenue	NM	NM	NM	230.6%	90.1%	52.7%	18.1%	-18.0%	-15.0%	-15.0%	-15.0%	5.0%
Other	208.0%	279.7%	319.4%	146.5%	43.2%	11.9%	-18.9%	-21.0%	-12.0%	-16.0%	-10.0%	0.0%
Total revenues:	89.3%	78.9%	76.5%	48.8%	30.2%	17.2%	4.1%	-8.9%	-8.1%	-8.5%	-7.4%	1.8%
Pro forma revenue (Y/Y growth)												
DCS online revenue	40.3%	31.7%	26.4%	20.2%	16.0%	8.7%	2.4%	-4.4%	-5.2%	-5.3%	-4.4%	0.9%
eFC - UK/ROW revenue	67.0%	69.6%	81.3%	96.5%	77.1%	45.9%	16.1%	-18.0%	-15.0%	-15.0%	-15.0%	5.0%
Other	22.9%	38.8%	55.9%	30.6%	19.4%	3.3%	-21.4%	-21.0%	-12.0%	-16.0%	-10.0%	0.0%
Total revenues:	42.9%	38.3%	37.9%	33.7%	27.0%	15.5%	3.4%	-8.9%	-8.1%	-8.5%	-7.4%	1.8%
ProForma EBITDA Growth	51.5%	70.2%	64.1%	73.6%	43.1%	12.4%	2.7%	-15.0%	-7.2%	-5.2%	-9.9%	2.7%

Source: Company reports and J.P. Morgan estimates.

Note: (1) Expense line includes stock-based compensation.

Table 100: Dice Holdings Annual Balance Sheet

$ in millions

	FY 2007	FY 2008E	FY 2009E	FY 2010E
Current assets:				
Cash and cash equivalents	57.5	73.3	113.6	157.5
Marketable securities	0.2	8.3	8.3	8.3
Accounts Receivable	19.1	14.4	14.7	15.5
Prepaid expenses and other current assets	2.6	2.3	2.4	2.4
Deferred income taxes	9.9	5.4		
Current assets of discotinued operations	0.2	-		
Total current assets	89.4	103.7	138.9	183.7
Other assets:				
Fixed assets, net	5.8	6.4	7.2	8.3
Intangible assets, net	78.6	60.7	44.3	27.3
Goodwill	159.8	154.5	154.5	154.5
Deferred financing costs	3.5	2.9	2.9	2.9
Other Assets	0.7	0.3	0.3	0.3
Non-current assets of discontinued operations	0.1	-	-	-
Deferred tax asset	-	-	-	-
Reorg value in excess of amounts allocated to identifiable assets	-	-	-	-
Restricted cash	-	-	-	-
Total other assets	248.5	224.7	209.1	193.2
Total assets	337.9	328.4	348.1	376.9
Liabilities and stockholders' equity				
Current liabilities:				
Accounts payable and accrued expenses	12.0	11.8	12.1	12.9
Total Deferred revenue	46.2	41.4	42.1	44.7
Current portion of long-term debt	0.8	-	-	-
Other current liabilities	-	-	-	-
Liabilities of discontinued operations	1.4	-	-	-
Amounts due under acquisition agreements			-	-
Federal income tax payable			-	-
Total current liabilities	60.4	53.3	54.3	57.5
Long-Term Debt	123.7	99.0	97.8	96.6
Deferred Income Taxes - non-current	26.1	19.2	19.2	19.2
Other long-term liabilities (includes hedging liabilities)	7.5	7.2	7.2	7.2
Minority interest in net assets of subsidiary				
Total Long Term Liabilities	157.2	125.4	124.2	123.0
Total liabilities	217.6	178.6	178.5	180.5
Stockholder's Equity				
Convertible preferred stock	-	-	-	-
Common stock	0.6	0.6	0.6	0.6
Additional paid-in capital	218.6	224.9	231.2	238.4
Unearned stock based compensation	-	-	-	-
Accumulated other comprehensive income (loss)	4.5	4.5	4.5	4.5
Treasury stock, 7 shares	-	-	-	-
Accumulated deficit	(103.3)	(80.2)	(61.3)	(41.6)
Total Stockholders' Equity	120.3	149.7	169.6	196.4
Total Liabilities & Stockholders' Equity	337.9	328.4	348.1	376.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 101: Dice Holdings Annual Cash Flow Statement

$ in millions

DICE Statement of Cash Flows, $ in millions	FY 2007	FY 2008E	FY 2009E	FY 2010E
Net income	14.6	23.2	18.9	19.7
Depreciation	3.0	3.8	5.0	5.4
Amortization	19.1	16.8	16.4	17.0
Deferred income taxes	7.3	1.4	-	-
Gain of sale of joint venture				
Amortization of deferred financing costs	0.8	0.6	-	-
Share based compensation	4.1	5.6	6.3	7.2
Loss on interest rate hedges				
Provision for doubtful accounts / Impairment		-	-	-
Charge related to issuance of stock options		-	-	-
Changes in operating assets and liabilities, net of effects of acquisition:	5.7	3.1	0.7	2.4
Accounts receivable	(4.1)	4.1	(0.3)	(0.9)
Prepaid expenses and other assets	(1.3)	(0.5)	(0.1)	-
Accounts payable and accrued expenses	(0.1)	0.6	0.3	0.7
Deferred revenue	11.7	(4.2)	0.7	2.5
Change in restricted cash	-	-	-	-
Other, net	(0.5)	3.1	-	-
Net cash provided by operating activities of continuing operations	54.5	54.5	47.3	51.6
Purchase of fixed assets	(3.8)	(4.4)	(5.8)	(6.5)
Acquisitions	-	-	-	-
Proceeds from sales/divestures	-	0.1	-	-
Purchases of marketable securities	(0.2)	(49.2)	-	-
Marutities and sales of marketable securities	1.0	40.9	-	-
Other, net	(0.0)	-	-	-
Net cash used for investing activities of continuing operations	(3.0)	(12.7)	(5.8)	(6.5)
Proceeds from LTD	113.0	-	-	-
Payments on LTD	(77.6)	(24.4)	(1.2)	(1.2)
Dividends paid on convertible preferred stock	(107.7)	-	-	-
Dividends paid on common stock	(0.2)	-	-	-
Payments to holders of vested stock options in lieu of dividends	(4.6)	-	-	-
Issuance of Common Stock	81.0	-	-	-
Issuance of convertible preferred stock	-	-	-	-
Cash received from transfer agent on behalf of former shareholders of Dice, Inc.	-	-	-	-
Payments of costs associated with stock issuance	(2.9)	(0.4)	-	-
Proceeds from stock option exercise	0.3	0.1	-	-
Financing costs paid	(2.4)	-	-	-
Other, net				
Net cash provided by financing activities of continuing operations	(1.1)	(24.7)	(1.2)	(1.2)
Net cash provided by operating activities of discontinued operations				
Net cash used in investing activities of discontinued operations				
Net cash provided by discontinued operations	-	-	-	-
Effects of exchange rate changes				
Net change in cash and cash equivalents for the period	50.5	17.1	40.3	43.9
Cash and cash equivalents, beginning of period	5.8	57.5	73.3	113.6
Cash and cash equivalents, end of period	57.5	73.3	113.6	157.5

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

eBay, Neutral, ($13.96)

We are maintaining our Neutral rating on eBay. We believe weakness in usage and conversion, as well as a more competitive broader eCommerce market, present challenges that will make it difficult for eBay stock to outperform in the coming months. Our 12-month price target is $17.

- **Marketplaces usage metrics point the wrong way**. ComScore data indicates that the number of US users coming to eBay's sites declined 17% Y/Y in the three months ended 10/08. We believe the decreased usage and difficulties in optimizing the search algorithm have resulted in significant weakening of conversion for eBay listings. These factors are offsetting the gains from revitalized listings growth on the platform.
- **Are online auctions a mature market?** Auctions traffic has been anemic, as we believe a more mature eCommerce market is increasingly driving buyers to expect a top-flight user experience and an ability to order items, especially new items, immediately. We think this shift presents a challenge to eBay: auctions are a near-monopoly for the company, whereas consumers seeking immediate purchases have a wealth of options, of which eBay is only one.
- **PayPal unit remains a prize asset**. Payments revenue was up 32% Y/Y through 9M'08, and we are projecting 22% growth in F'09 as the off-eBay side of PayPal remains a key growth contributor; additionally, we expect a slight benefit as the impact of the Bill Me Later acquisition is folded in.
- **2009 drivers**. In our view, the following factors will drive shares in 2009: (1) changes in Marketplaces conversion driven by better search, (2) corporate structure changes such as a sale of Skype, and (3) the impact of any credit market developments on the receivables book at Bill Me Later.
- **Maintaining 4Q'08, F'09 estimates**. We are maintaining our 4Q'08 and F'09 revenue, EBITDA and EPS estimates; we are introducing new F'10 estimates; all these are summarized in the table below:

Table 102: eBay Financial Snapshot

$ in millions, except per share data

EBAY					Y/Y		
	4Q'08E	F'08E	F'09E	F'10E	F'08E	F'09E	F'10E
JPM							
Revenue	2,185	8,690	9,572	10,770	13%	10%	13%
EBITDA	691	3,101	3,202	3,470	7%	3%	8%
EPS	$ 0.38	$ 1.69	$ 1.75	$ 1.99	10%	4%	14%
Consensus							
Revenue	2,112	8,621	8,793	9,251	12%	2%	5%
EBITDA	767	3,190	3,182	3,331	10%	0%	5%
EPS	$ 0.40	$ 1.70	$ 1.65	$ 1.74	11%	-3%	6%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Key Financial Metrics and Estimates

The following tables summarize our revenue forecasts by business segment, as well as our estimate for Y/Y growth in key business metrics.

Table 103: eBay Revenue Forecast by Segment

$ in millions

	2007A	2008E	2009E	2010E
Gross Merchandise Volume (GMV)	$59,353.0	$60,838.0	$60,975.3	$66,861.6
% Change Y-Y	13%	3%	0%	10%
Total transactions:	$6,519.4	$7,157.2	$7,807.9	$8,729.8
eBay online revenue	$4,680.8	$4,773.6	$4,901.2	$5,323.5
Payment revenue	$1,838.5	$2,383.7	$2,906.7	$3,406.2
Marketing Services Revenue:	$788.4	$1,011.0	$1,128.7	$1,300.3
Marketplaces	$683.1	$901.2	$1,016.2	$1,177.9
Payments	$88.1	$85.3	$84.0	$89.7
Communications	$17.3	$24.5	$28.5	$32.7
Skype	$364.6	$522.1	$635.0	$740.0
Total revenue	$7,672.3	$8,690.4	$9,571.5	$10,770.1

Source: Company reports and J.P. Morgan estimates.

Table 104: eBay Auction and Payments Metrics Forecasts

Auctions in millions

	2007	2008E	2009E	2010E
Listings (M)	2,340	2,779	3,068	3,291
% Chg Y-Y	-1.1%	18.7%	10.4%	7.3%
GMV/Listing	$25.4	$22.0	$19.9	$20.3
% Chg Y-Y	14.5%	-13.2%	-9.8%	2.1%
Marketplaces Revenue/Listing	$2.00	$1.73	$1.60	$1.62
% Chg Y-Y	12.7%	-13.6%	-7.7%	1.3%
Total # of Payments	731.2	875.0	996.9	1,120.1
% Chg Y-Y	19.7%	19.7%	13.9%	12.4%
TPV per Payment	64.8	70.1	72.6	74.6
% Chg Y-Y	10.6%	8.2%	3.5%	2.8%

Source: Company reports and J.P. Morgan estimates.

Our Estimates and Outlook for 2009

We believe the company's focus on the buyer is well-placed, and several of the measures taken by management, including the DSR system, are a step toward improving the buyer experience on the site. At the same time, we believe F'09 will present continued challenges in (1) improving the appearance of items on the sites and (2) fine-tuning the search and finding functions to better put the right items in front of users.

We think eBay is likely to continue making some modifications to its fee structure in order to spur the necessary changes and in order to help keep sellers afloat in a tough environment. We think these operational concerns, as well as macro challenges and an FX headwind, will drive flat Y/Y GMV growth and a 3% increase in Marketplaces Transactional revenue. We think the PayPal business remains healthy, and project 22% revenue growth in F'09, down from 30% in F'08. We anticipate a significant slowdown in the growth of eBay's Advertising and Non-Transactional revenue, to 12% in F'09, from 28% in F'08.

We are maintaining our F'09 revenue estimate of $9.57B, our F'09 EBITDA estimate of $3.20B and our F'09 EPS estimate of $1.75. We are projecting a ~240 bps compression in eBay's gross margin due to the continued shift in business mix toward lower-margin revenue (such as PayPal). We think the company can drive operational efficiencies across its businesses and thus think the operating margin will contract by only ~160 bps Y/Y.

Our Estimates and Outlook for 2010

In F'10, we think the company is likely to see growth rates rebound somewhat as the economy begins to recover and as the FX headwind is anniversaried in. We are projecting 10% GMV growth and a 9% rise in Marketplaces Transaction revenue, as well as continued growth at PayPal, with Transaction revenue up 17%. Further, we expect a rebound to 15% Y/Y growth across eBay's streams of Advertising and Non-Transactional revenue.

Our newly introduced forecast calls for F'10 revenue of $10.77B, EBITDA of $3.47B and pro forma EPS of $1.99. We believe business mix will continue to hamper gross margins, down ~80 bps Y/Y in F'10 to 71.8%. At the same time, we expect eBay will continue to successfully manage costs in order to minimize the operating margin impact; for F'10 we are forecasting a ~20 bps Y/Y decline on the operating margin side to 29.4%.

We Are Introducing a Price Target of $17

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for eBay of a ~9% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 9x EV/EBIT multiple to our F'09 EBIT estimate (reflecting better forward visibility than the current valuation of 7x our F'09 estimate) and thus arrive at our December 2009 price target of $17.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 105: Key Valuation Assumptions

5 yr forward EBIT CAGR	9%
1x EBIT Growth	9
2009 EBIT	$ 2,172
Implied Enterprise Value	$ 19,109
+ Cash	$ 3,777
- Debt	$ 52
Market Value	$ 22,835
Share count	1373
2009 Price Target	$ 17

Source: Company reports and J.P. Morgan estimates.

Our EV/EBIT valuation is based on the following projections for revenue and operating income growth

Table 106: Growth Profile

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	9,571.5	10,770.1	12,003.3	13,131.6	14,234.6	15,295.1
Y/Y change		*12.5%*	11%	9%	8%	7%
Less: Operating Expenses	7,400.0	8,360.4	9,338.6	10,242.6	11,131.5	11,991.4
As % of total revenues	*77.3%*	*77.6%*	*77.8%*	*78.0%*	*78.2%*	*78.4%*
Operating Income (Loss)	2,171.5	2,409.7	2,664.7	2,888.9	3,103.2	3,303.7
Operating margin	*22.7%*	*22.4%*	22.2%	22.0%	21.8%	21.6%

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

On a GAAP P/E basis, eBay trades 10.1x our F'09 estimate of $1.39 (which implies 3% Y/Y EPS growth). Due to the challenges we have enumerated above, we believe the stock is unlikely to significantly outperform its peer group in the coming months, and thus we rate it Neutral.

Risks to Our Rating

Downside risks associated with our Neutral rating include: barriers to international expansion, risks related to the repositioning of eBay's pricing structure, competition from sponsored search vendors, the company's dependence on eBay Motors, competition from hardline retailers, risks associated with patent litigation, and valuation risks.

International expansion is a concrete part of eBay's growth strategy. As the company continues to grow outside the U.S., it may face regulatory challenges and/or markets that make its business less profitable than it is in the U.S. or other countries where it is already established. Thus far, we believe eBay's international expansion has been carried out in a strategic and timely manner.

eBay also faces risks from hardline retailers. Although the bulk of eBay's revenues come from the beginning and end of the retail life cycle, with each passing quarter, the percentage of revenue it earns from the in-season retail and fixed price sales continues to increase. This puts the company in competition with traditional retailers and other e-tailers, including Amazon.com, Wal-Mart, BestBuy, and Home Depot. Failure to meet these challenges could lead to relative stock price underperformance.

There may be upside risks to our rating should the company be able to improve its search technology more rapidly than we expect, resulting in an acceleration of trade on the platform. Additionally, if the company takes steps that help the market value the separate parts of the enterprise more fully, the stock could outperform.

Table 107: eBay Annual Income Statement

$ in millions

	FY 2007A	FY 2008E	FY 2009E	FY 2010E
Gross Merchandise Volume (GMV)	$59,353.0	$60,838.0	$60,975.3	$66,861.6
% Change Y-Y	13%	2.5%	0%	10%
Payment revenue	1,838.5	$2,383.7	$2,906.7	$3,406.2
eBay online revenue	4,680.8	$4,773.6	$4,901.2	$5,323.5
Total transactions	6,519.4	$7,157.2	$7,807.9	$8,729.8
3rd party adv rev	321.7	$0.0	$0.0	$0.0
Marketing Svcs Rev	$788.4	$1,011.0	$1,128.7	$1,300.3
Marketplaces	$683.1	$901.2	$1,016.2	$1,177.9
Payments	$88.1	$85.3	$84.0	$89.7
Communications	$17.3	$24.5	$28.5	$32.7
Skype	364.6	$522.1	$635.0	$740.0
Total Online Revenue	7,672.3	$8,690.4	$9,571.5	$10,770.1
Total revenue	7,672.3	8,690.4	9,571.5	10,770.1
Cost of revenue	1,763.0	2,226.4	2,618.4	3,033.8
COGS pro forma adjustment	(37.0)	(59.6)	-	-
Gross Profit	5,909.4	$6,464.0	$6,953.1	$7,736.3
Gross Profit (pro forma)	5,946.4	$6,523.6	$6,953.1	$7,736.3
Pro Forma Gross Margin	77.5%	75.1%	72.6%	71.8%
Sales and Marketing	1,925.4	2,006.3	2,297.2	2,561.0
Product Development	619.7	746.7	882.8	982.5
General and Admin.	1,156.0	1,320.0	1,351.6	1,513.0
Amort., Payroll Taxes, merger other	1,595.0	332.5	250.0	270.0
Total Operating Expenses	5,296.2	4,405.4	4,781.6	5,326.6
Pro forma op ex adjustments:				
Sales & marketing	(81.29)	(72.10)	-	-
Product development	(76.03)	(71.63)	-	-
G&A	(107.53)	(93.85)	-	-
Payroll exp on empl stock options	(5.36)	(2.55)	-	-
Amort of acq'd assets	(1,610.4)	(169.15)	-	-
Total	(1,881)	(589)	(660)	(755)
Pro forma operating expenses	3,415.6	3,816.2	4,121.6	4,571.6
Operating Profit (reported)	613.2	2,058.6	2,171.5	2,409.7
Operating Margin (reported)	8.0%	23.7%	22.7%	22.4%
Operating Profit (pro forma)	2530.8	2707.4	2831.5	3164.7
Operating Margin (pro forma)	33.0%	31.2%	29.6%	29.4%
Interest and other income, net	154.3	103.6	69.0	93.0
Interest Expense	(16.6)	(3.5)	-	-
Net Interest Income	137.7	100.1	69.0	93.0
EBITDA	2,907.6	3,101.0	3,201.5	3,469.7
Y/Y Growth	*27%*	*7%*	*3%*	*8%*
IBT(reported)	750.9	2,158.6	2,240.5	2,502.7
IBT(pro forma)	2,668.5	2,807.5	2,900.5	3,257.7
Income Taxes	402.6	401.1	481.7	538.1
Pro forma adjustment	260.1	145.0	-	-
Pro forma tax	568.0	591.0	652.6	733.0
	-	-	-	-
Net Income (reported)	348.3	1,757.5	1,758.8	1,964.6
Net Income (pro forma)	2,100.4	2,216.5	2,247.9	2,524.7
FASB Adjustment net of Taxes				
Reported Net Income Adj. for FASB123	348.3	1,757.5	1,758.8	1,964.6
Pro Forma NI Adj. for FASB 123	2,100.4	2,216.5	2,247.9	2,524.7
EPS (reported)	0.25	1.35	1.39	1.57
EPS (pro forma)	1.53	1.69	1.75	1.99
Reported EPS Adj. for FASB123	0.25	1.35	1.39	1.57
EPS (pro forma) y/y	*46%*	*10%*	*3.9%*	*13.7%*

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 107: eBay Annual Income Statement (cont.))

GAAP Diluted Share count	1,367.7	1,305.8	1,268.9	1,253.6
Pro Forma Diluted Outstanding Shares	1,376.3	1,315.1	1,283.9	1,268.6
As a % of Revenue				
Payment revenue	24.0%	27.4%	30.4%	31.6%
eBay online revenue	61.0%	54.9%	51.2%	49.4%
Third Party Advertising revenue	4.2%	0.0%	0.0%	0.0%
Skype Revenue	4.8%	6.0%	6.6%	6.9%
Cost of goods sold	23.0%	25.6%	27.4%	28.2%
Sales & marketing	25.1%	23.1%	24.0%	23.8%
Product development	8.1%	8.6%	9.2%	9.1%
G&A	15.1%	15.2%	14.1%	14.0%
Total operating expenses	69.0%	50.7%	50.0%	49.5%
Operating income (reported)	8.0%	23.7%	22.7%	22.4%
Operating income (pro forma)	33.0%	31.2%	29.6%	29.4%
Net income (reported)	4.5%	20.2%	18.4%	18.2%
Net income (pro forma)	27.4%	25.5%	23.5%	23.4%
Tax Rate	53.6%	18.6%	21.5%	21.5%
Pro forma tax rate	21.3%	21.1%	22.5%	22.5%
Year-Over-Year Growth				
Payment revenue	31.2%	29.7%	21.9%	17.2%
eBay online revenue	11.4%	2.0%	2.7%	8.6%
Third Party Advertising revenue	87.2%			
End-to-end services revenue	NM	NM	NM	NM
Communications Revenue	89.1%	43.2%	21.6%	16.5%
Total online revenue	28.5%	13.3%	10.1%	12.5%
Sales & marketing	16.4%	4.2%	14.5%	11.5%
Product development	25.3%	20.5%	18.2%	11.3%
G&A	22.8%	14.2%	2.4%	11.9%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 108: eBay Quarterly Income Statement

$ in millions

	FY 2007				FY 2008E				FY 2009E			
	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Gross Merchandise Volume (GMV)	$14,281.0	$14,464.0	$14,395.0	$16,213.0	$16,036.0	$15,684.0	$14,284.0	$14,834.0	$14,846.2	$14,723.2	$15,195.6	$16,210.4
% Change Y-Y	14.2%	12.2%	13.9%	12.3%	12.3%	8.4%	-0.8%	-8.5%	-7.4%	-6.1%	6.4%	9.3%
% Change Q-Q	-1%	1%	0%	13%	-1%	-2%	-9%	4%	0%	-1%	3%	7%
Payment revenue	419.0	432.3	448.0	539.3	559.7	580.3	576.3	667.4	693.6	686.4	721.5	805.1
eBay online revenue	1,111.4	1,133.3	1,155.9	1,280.3	1,267.6	1,233.3	1,163.9	1,108.7	1,196.8	1,182.3	1,217.2	1,304.9
Total transactions	1,530.4	1,565.6	1,603.8	1,819.6	1,827.4	1,813.6	1,740.2	1,776.1	1,890.4	1,868.8	1,938.7	2,110.0
3rd party adv rev (old metric)	60.5	76.2	77.0	108.1								
Marketing Services Rev	163.7	182.5	191.6	250.6	245.1	251.9	240.1	273.9	276.3	281.9	264.9	305.6
Marketplaces	138.8	157.3	164.7	222.2	216.7	224.7	213.0	246.8	248.0	254.6	236.3	277.2
Payments	20.3	21.9	22.4	23.4	21.9	21.5	20.9	21.1	20.8	20.4	21.3	21.5
Communications	4.5	3.3	4.4	5.0	6.5	5.7	6.3	6.0	7.5	6.8	7.2	6.9
Skype	74.0	86.4	93.8	110.4	119.8	130.2	137.2	135.0	145.0	155.0	165.0	170.0
Total Online Revenue	1,768.1	1,834.4	1,889.2	2,180.6	2,192.2	2,195.7	2,117.5	2,185.0	2,311.7	2,305.6	2,368.6	2,585.7
Total revenue	$1,768.1	$1,834.4	$1,889.2	$2,180.6	$2,192.2	$2,195.7	$2,117.5	$2,185.0	$2,311.7	$2,305.6	$2,368.6	$2,585.7
Cost of revenue	393.7	416.8	446.5	506.0	525.4	562.1	561.0	577.9	623.0	625.8	655.3	714.3
COGS pro forma adjustment	(8.8)	(9.6)	(9.1)	(9.5)	(16.6)	(17.6)	(10.4)	(15.0)				
Gross Profit	1,374.4	1,417.6	1,442.7	1,674.6	1,666.8	1,633.6	1,556.6	1,607.1	1,688.7	1,679.8	1,713.2	1,871.3
Gross Profit (pro forma)	1,383.2	1,427.3	1,451.8	1,684.1	1,683.4	1,651.2	1,567.0	1,622.1	1,688.7	1,679.8	1,713.2	1,871.3
Pro Forma Gross Margin	78.2%	77.8%	76.8%	77.2%	76.8%	75.2%	74.0%	74.2%	73.1%	72.9%	72.3%	72.4%
Sales and Marketing	443.3	477.8	485.2	519.1	527.2	512.8	457.2	509.1	557.1	558.0	559.0	623.1
Product Development	137.6	147.9	164.9	169.3	176.8	186.8	190.8	192.3	210.4	212.1	225.0	235.3
General and Admin.	278.4	283.5	287.4	306.7	355.3	333.7	331.7	299.3	335.2	322.8	331.6	362.0
Amort., Payroll Taxes, merger other	47.35	51.55	1,442.8	53.3	54.83	54.9	52.7	170.0	70.0	60.0	60.0	60.0
Total Operating Expenses	906.6	960.7	2380.4	1048.5	1114.0	1088.2	1032.493	1170.7	1172.7	1152.9	1175.6	1280.4
Pro forma op ex adjustments:												
Sales & marketing	(19.2)	(23.1)	(22.2)	(16.8)	(23.8)	(24.6)	(23.75)	-	-	-	-	-
Product development	(16.0)	(19.4)	(21.4)	(19.3)	(23.5)	(24.7)	(23.46)	-	-	-	-	-
G&A	(28.0)	(27.5)	(27.9)	(24.1)	(29.6)	(31.6)	(32.65)	-	-	-	-	-
Payroll exp on employee stock options	(1.8)	(1.3)	(2.3)	-	(0.3)	(1.7)	(0.50)	-	-	-	-	-
Amortization of acquired assets	(51.9)	(56.9)	(1,448.3)	(53.3)	(54.8)	(54.9)	(59.40)					
Total	(116.9)	(128.2)	(1,522.0)	(113.5)	(132.0)	(137.5)	(139.8)	(180.00)	(150.00)	(150.00)	(180.00)	(180.00)
Pro forma operating expenses	789.7	832.5	858.4	935.0	982.0	950.7	892.7	990.7	1022.7	1002.9	995.6	1100.4
Operating Profit (reported)	467.8	456.9	-937.7	626.1	552.8	545.4	524.1	436.3	516.0	526.9	537.6	590.9
Operating Margin (reported)	26.5%	24.9%	-49.6%	28.7%	25.2%	24.8%	24.7%	20.0%	22.3%	22.9%	22.7%	22.9%
Operating Profit (pro forma)	593.5	594.7	593.4	749.1	701.4	700.5	674.2	631.3	666.0	676.9	717.6	770.9
Operating Margin (pro forma)	33.6%	32.4%	31.4%	34.4%	32.0%	31.9%	31.8%	28.9%	28.8%	29.4%	30.3%	29.8%
Interest and other income, net	30.0	34.0	38.4	51.9	29.6	23.4	38.6	12.0	15.0	16.0	18.0	20.0
Interest Expense	(4.5)	(2.7)	(2.7)	(6.6)	(2.9)	(0.6)	0.0	-	-	-	-	-
Net Interest Income	25.5	31.2	35.6	45.3	26.7	22.8	38.6	12.0	15.0	16.0	18.0	20.0
EBITDA	683.2	683.2	685.6	855.6	806.1	810.6	792.9	691.3	771.0	781.9	797.6	850.9

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 108: eBay Quarterly Income Statement (cont.)

Y/Y Growth	*29%*	*27%*	*25%*	*28%*	*18%*	*19%*	*16%*	*-19%*	*-4%*	*-4%*	*1%*	*23%*
IBT(reported)	$493.3	$488.1	($902.1)	$671.5	$579.5	$568.1	$562.6	$448.3	$531.0	$542.9	$555.6	$610.9
IBT(pro forma)	$619.0	$626.0	$629.1	$794.4	$728.1	$723.3	$712.8	$643.3	$681.0	$692.9	$735.6	$790.9
Income Taxes	116.1	112.3	33.6	140.6	119.8	107.8	70.4	103.1	114.2	116.7	119.5	131.3
Pro forma adjustment	42.3	42.5	31.7	48.9	46.8	47.928	50.3					
Pro forma tax	158.4	154.8	65.3	189.4	166.6	155.7	120.7	148.0	153.2	155.9	165.5	178.0
Net Income (reported)	377.2	375.8	(935.6)	530.9	459.7	460.3	492.2	345.2	416.9	426.2	436.2	479.6
Net Income (pro forma)	460.5	471.1	563.8	605.0	561.5	567.5	592.1	495.4	527.8	537.0	570.1	612.9
FASB Adjustment net of Taxes												
Reported Net Income Adj. for FASB123	377.2	375.8	(935.6)	530.9	459.7	460.3	492.2	345.2	416.9	426.2	436.2	479.6
Pro Forma NI Adj. for FASB 123	460.5	471.1	563.8	605.0	561.5	567.5	592.1	495.4	527.8	537.0	570.1	612.9
EPS (reported)	0.27	0.27	(0.69)	0.39	0.34	0.35	0.38	0.27	0.33	0.34	0.34	0.38
EPS (pro forma)	0.33	0.34	0.41	0.44	0.42	0.43	0.46	0.38	0.41	0.42	0.44	0.48
Reported EPS Adj. for FASB123	0.27	0.27	(0.69)	0.39	0.34	0.35	0.38	0.27	0.33	0.34	0.34	0.38
EPS (pro forma) y/y	*39%*	*40%*	*59%*	*44%*	*26%*	*25%*	*11%*	*-13%*	*-2%*	*-2%*	*-3%*	*25%*
GAAP Diluted Share count	1,384.3	1,379.7	1,354.8	1,352.1	1,333.8	1,312.0	1,288.9	1,288.6	1,274.7	1,270.8	1,267.0	1,263.1
Pro Forma Diluted Outstanding Shares	1,384.3	1,379.7	1,373.3	1,368.1	1,344.0	1,325.1	1,297.5	1,293.6	1,289.7	1,285.8	1,282.0	1,278.1
As a % of Revenue												
Payment revenue	23.7%	23.6%	23.7%	24.7%	25.5%	26.4%	27.2%	30.5%	30.0%	29.8%	30.5%	31.1%
eBay online revenue	62.9%	61.8%	61.2%	58.7%	57.8%	56.2%	55.0%	50.7%	51.8%	51.3%	51.4%	50.5%
Third Party Advertising revenue	3.4%	4.2%	4.1%	5.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Skype Revenue	4.2%	4.7%	5.0%	5.1%	5.5%	5.9%	6.5%	6.2%	6.3%	6.7%	7.0%	6.6%
Cost of goods sold	22.3%	22.7%	23.6%	23.2%	24.0%	25.6%	26.5%	26.4%	26.9%	27.1%	27.7%	27.6%
Sales & marketing	25.1%	26.0%	25.7%	23.8%	24.0%	23.4%	21.6%	23.3%	24.1%	24.2%	23.6%	24.1%
Product development	7.8%	8.1%	8.7%	7.8%	8.1%	8.5%	9.0%	8.8%	9.1%	9.2%	9.5%	9.1%
G&A	15.7%	15.5%	15.2%	14.1%	16.2%	15.2%	15.7%	13.7%	14.5%	14.0%	14.0%	14.0%
Total operating expenses	51.3%	52.4%	126.0%	48.1%	50.8%	49.6%	48.8%	53.6%	50.7%	50.0%	49.6%	49.5%
Operating income (reported)	26.5%	24.9%	-49.6%	28.7%	25.2%	24.8%	24.7%	20.0%	22.3%	22.9%	22.7%	22.9%
Operating income (pro forma)	33.6%	32.4%	31.4%	34.4%	32.0%	31.9%	31.8%	28.9%	28.8%	29.4%	30.3%	29.8%
Net income (reported)	21.3%	20.5%	-49.5%	24.3%	21.0%	21.0%	23.2%	15.8%	18.0%	18.5%	18.4%	18.5%
Net income (pro forma)	26.0%	25.7%	29.8%	27.7%	25.6%	25.8%	28.0%	22.7%	22.8%	23.3%	24.1%	23.7%
Tax Rate	23.5%	23.0%	-3.7%	20.9%	20.7%	19.0%	12.5%	23.0%	21.5%	21.5%	21.5%	21.5%
Pro forma tax rate	25.6%	24.7%	10.4%	23.8%	22.9%	21.5%	16.9%	23.0%	22.5%	22.5%	22.5%	22.5%
Year-Over-Year Growth												
Payment revenue	27.7%	30.7%	31.7%	33.8%	33.6%	34.2%	28.7%	23.7%	23.9%	18.3%	25.2%	20.6%
eBay online revenue	12.2%	13.7%	13.6%	6.8%	14.1%	8.8%	0.7%	-13.4%	-5.6%	-4.1%	4.6%	17.7%
Third Party Advertising revenue	65.3%	96.2%	86.5%	96.1%								
Communications Revenue	110.4%	95.6%	87.6%	74.0%	61.9%	50.7%	46.2%	22.3%	21.0%	19.1%	20.3%	25.9%
Total online revenue	27.2%	30.0%	30.4%	26.8%	24.0%	19.7%	12.1%	0.2%	5.4%	5.0%	11.9%	18.3%
Offline Revenue	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Sales & marketing	10.7%	20.0%	22.9%	12.5%	18.9%	7.3%	-5.8%	-1.9%	5.7%	8.8%	22.3%	22.4%
Product development	15.6%	19.3%	36.9%	29.0%	28.5%	26.3%	15.7%	13.6%	19.0%	13.6%	17.9%	22.4%
G&A	29.3%	27.2%	26.5%	11.2%	27.6%	17.7%	15.4%	-2.4%	-5.6%	-3.3%	0.0%	20.9%

Source: Company reports and J.P. Morgan estimates

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 109: eBay Annual Balance Sheet

$ in millions

	FY 2007A	FY 2008E	FY 2009E	FY 2010E
Assets				
Cash and cash equivalents	4,221.2	2,692.0	5,163.7	7,986.4
ST investments in marketable securities*	676.3	301.1	301.1	301.1
Accounts receivable, net	480.6	447.9	568.8	636.8
Funds receivable*	1,513.6	1,606.0	1,939.3	2,171.0
Other assets*	230.9	372.2	372.2	372.2
Total current assets	7,122.5	5,419.2	8,345.1	11,467.6
Investments	138.2	133.6	133.6	133.6
Property and equipment, net	1,120.5	1,175.5	1,055.5	970.5
Intangible assets, net	6,853.2	6,639.7	6,639.7	6,639.7
Other assets, net	131.7	243.0	243.0	243.0
Total assets	15,366.0	13,611.0	16,416.9	19,454.4
Liabilities and stockholders' equity				
Accounts payable	156.6	207.6	155.1	173.7
Funds payable	1,513.6	1,606.0	1,939.3	2,171.0
Deferred Revenue	166.5	185.7	181.0	202.6
Short term debt	-	-	-	-
Taxes payable	111.8	96.2	96.2	96.2
Other current liabilities	1,151.1	804.6	804.6	804.6
Total current liabilities	3,099.6	2,900.1	3,176.2	3,448.1
Debt	-	-	-	-
Deferred taxes	510.6	639.9	639.9	639.9
Other long term	51.3	51.8	51.8	51.8
Total liabilities	3,661.4	3,591.9	3,868.0	4,139.9
	-	-	-	-
Total stockholders' equity	11,704.6	10,019.2	12,548.9	15,314.5
Total L&S	15,366.0	13,611.0	16,416.9	19,454.4

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 110: eBay Annual Cash Flow Statement

$ in millions

	FY 2007A	FY 2008E	FY 2009E	FY 2010E
OPERATING CASH FLOWS				
Net Income	348.3	1,757.5	1,758.8	1,964.6
Depreciation	601.7	687.9	680.0	680.0
Amortization	-	-	-	-
Stock based comp expense related to stock options and purchases	301.8	354.5	350.0	380.0
Tax Benefit	143.2	68.2	120.0	120.0
Excess tax benefit from stock-based compensation	(84.8)			
Impairment	-	-	-	-
Minority Interest	-	-	-	-
Doubtful Accounts/Losses	235.7	285.7	301.0	301.0
Other	1,390.9	-	-	-
Changes in Working Capital	(295.7)	(261.6)	(178.1)	(27.8)
Accounts Receivable	(185.62)	(59.08)	(120.92)	(67.98)
Fund Receivable	(25.78)	(92.40)	(333.27)	(231.74)
Other	(504.99)	(138.34)	-	-
Deferred Tax	(141.40)	(110.95)	-	-
Accounts Payable	36.95	23.60	(52.44)	18.54
Funds Payable	336.88	92.40	333.27	231.74
Accrued Charges	(18.83)	(105.12)	-	-
Deferred Revenue	37.81	17.43	(4.73)	21.63
Income Taxes	169.29	110.85	-	-
Cash From Operations	2,641.1	2,887.5	3,031.7	3,417.8
% Chg Y-Y	*17.5%*	*9.3%*	*5.0%*	*12.7%*
FCF	2,187.1	2,350.8	2,471.7	2,822.8
% Chg Y-Y	*26.3%*	*7.5%*	*5.1%*	*14.2%*
% Chg Q-Q				
	-			
INVESTING CASH FLOWS	-			
Capital Expenditures	(454.0)	(536.7)	(560.0)	(595.0)
Net Investment	618.1	(65.7)	-	-
ST Investment Purch.	-	-	-	-
ST Investments Mat.	-	-	-	-
Acquisitions	(863.6)	(1,369.1)	-	-
Purchase of intangibles and other non current assets	6.3	(51.4)	-	-
Cash From Investing	(693.1)	(2,022.9)	(560.0)	(595.0)
FINANCING CASH FLOWS				
Common Stock Issued	507.0	98.7	-	-
Excess tax benefit from stock-based compensation		4.7	-	-
Shares Repurchased	(1,485.4)	(2,179.6)	-	-
Payment of headquarters facility lease obligation	-	-	-	-
Long Term Debt	200.2	(200.2)	-	-
Cash From Financing	(693.4)	(2,276.4)	-	-
Foreign Exch Effects	303.8	(117.5)	-	-
Net Change In Cash	1,558.4	(1,529.2)	2,471.7	2,822.8
Cash at Beginning	2,662.7	4,221.1	2,691.9	5,163.6
Cash at End	4,221.1	2,691.9	5,163.6	7,986.4

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Expedia, Overweight, ($7.80)

We expect Expedia's Y/Y revenue to fall in 2009 as the company faces decreased travel volume, falling ADRs, difficult FX ratios, and reduced airline capacity. However, we do think some of the negative economic effects will be slightly offset by strength in non-transaction revenue streams, improved conversion rates, and careful cost control measures. Expedia trades at 3.6x our F'09 EBITDA estimate of $756M, hence our Overweight rating. We are introducing a $12 December 2009 price target.

- **We think 2009 gross bookings will decline 3% on a Y/Y basis**. We expect domestic gross bookings to decline 3% due to airline capacity cuts, weak ADRs, and lower volumes. We think European gross bookings will decline 10%, as we see European travel weakness mimicking that of the US and expect FX effects to contribute an additional 13 points of declines.
- **Non-transaction revenue could slightly offset bookings weakness.** Although we expect the growth rate to decelerate, we think insurance waivers, co-branded credit cards, and expanded ad revenue streams on transaction sites will supply some lift to the 2009 revenue growth rate.
- **Expense cuts should aid bottom-line performance**. Management has expressed its intention to manage sales and marketing spend around revenue performance. Additionally, we think there is slight room for cost reductions in call centers, credit card processing fees, and air fulfillment expenses.
- **2009 drivers.** In our view, the following factors will drive EXPE shares in 2009: (1) advertising and other non-transaction performance, (2) cost savings returns on prior investments, and (3) ADR and air capacity trends.
- **Maintaining 4Q'08 estimates.** We are looking for revenue, EBITDA, and pro forma EPS of $648M, $166M, and $0.27.

Our current and newly introduced 2010 estimates are in the table below:

Table 111: Expedia Financial Snapshot

$ in millions, except per share data

EXPE	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	648.1	2,964.2	2,919.1	3,287.6	11.2%	-1.5%	12.6%
EBITDA	165.8	781.3	755.9	883.0	7.2%	-3.3%	16.8%
Pro Forma EPS	0.27	1.30	1.26	1.40	5.8%	-2.6%	11.0%
Consensus							
Revenue	679.3	2,971.7	2,869.8	3,063.8	11.5%	-3.4%	6.8%
EBITDA	169.0	757.1	713.8	745.0	3.9%	-5.7%	4.4%
Pro Forma EPS	0.25	1.30	1.23	1.39	6.0%	-5.4%	13.0%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Our Estimates and Outlook for 2009

We are modeling F'09 revenue of $2.92B, EBITDA of $756M, and pro forma EPS of $1.26, representing Y/Y declines of 2%, 3%, and 3%, respectively. We expect most of the revenue decline to be driven by the international market, where travel weakness and foreign currency exchange rate downside is expected to lead to a gross bookings decline of 10% Y/Y. We think US gross bookings will be weak due to expected ADR declines and air capacity decreases, however we think the non-transactional revenue will slightly offset this. Therefore, we are looking for a North America gross bookings decline of 3% Y/Y but a total revenue decline of only 2% Y/Y. We expect the OIBA margin decline to moderate to only 70 bps Y/Y, as we think management will work to manage sales and marketing spend around revenue performance.

Table 112: Key Booking and Revenue Y/Y Growth Trends

	4Q'07	1Q'08	2Q'08	3Q'08
Advertising and Media Revenue	88.9%	73.0%	68.2%	53.7%
Number of Transactions	19.3%	15.6%	10.2%	5.9%
Merchant hotel room nights	18.6%	22.9%	13.6%	15.0%
ADR	7.0%	3.0%	1.0%	-1.0%
Air Tickets Sold	15.0%	11.0%	4.0%	-5.0%
Airfare	9.0%	8.0%	12.0%	11.0%

Source: Company reports and J.P. Morgan estimates.

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and EPS estimates of $3.29B, $883M, and $1.40, which represent Y/Y growth of 13%, 17%, and 11%, respectively. We expect much of the revenue growth to stem from European gross booking increases, which we modeled growing 23% Y/Y due to an expected easing of economic headwinds and flat foreign currency exchange rates. Domestically, we expect gross bookings growth to rebound to 10% Y/Y from down 3% in 2009 due to an easing in economic conditions and the comping of air capacity cuts. We expect OIBA margins to decline an additional 70 bps as selling and marketing expenses rise.

We Are Introducing a Price Target of $12

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for Expedia of a ~7% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 7x EV/EBIT multiple to our F'09 EBIT estimate (reflecting better forward visibility than the current valuation of 5x our F'09 estimate) and thus arrive at our December 2009 price target of $12.

The parameters of our EV/EBIT multiple analysis are in the table below:

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 113: Growth Outlook

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	2,919.1	3,287.6	3,616.3	3,905.6	4,140.0	4,347.0
Y/Y change		*12.6%*	10%	8%	6%	5%
Less: Operating Expenses	2,372.2	2,692.9	2,969.0	3,210.4	3,403.1	3,573.2
As % of total revenues	*81.3%*	*81.9%*	*82.1%*	*82.2%*	*82.2%*	*82.2%*
Operating Income (Loss)	546.9	594.7	647.3	695.2	736.9	773.8
Operating margin	*18.7%*	*18.1%*	17.9%	17.8%	17.8%	17.8%

Source: Company reports and J.P. Morgan estimates.

Table 114: EV/EBIT Multiple Analysis

$ in millions

5 yr forward EBIT CAGR	7%
1x EBIT Growth	7
2009 EBIT	546.9
Implied Enterprise Value	3,828.6
+ Cash	666.7
- Debt	894.4
Market Value	3,600.9
Share count	291.7
2009 Price Target	$12

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

We believe Expedia is undervalued given the potential for international growth and increased advertising revenue opportunities. On an EV/EBITDA basis, Expedia trades at 3.6x our F'09 EBITDA estimate of $756 million, versus its peers at 6.5x. As such, we rate the stock Overweight.

Risks to Our Rating

The company's shares could underperform if the company is unable to (1) withstand the competitive threat that the travel suppliers and travel search engines pose, (2) achieve a high ROI on selling and marketing investments, (3) achieve strong gross bookings growth in a weak economy, and (4) achieve further expansion into international markets.

Table 115: EXPE Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
North America	13,937	14,663	14,254	15,660
Europe	3,872	4,665	4,218	5,183
Other	1,822	2,300	2,576	2,834
Total Gross Bookings	19,631	21,627	21,048	23,677
% North America	71%	68%	68%	66%
% Europe	20%	22%	20%	22%
% Other	9%	11%	12%	12%
Y/Y Growth				
North America	9.4%	5.2%	-2.8%	9.9%
Europe	42.2%	20.5%	-9.6%	22.9%
growth ex-FX				
Other	27.9%	26.2%	12.0%	10.0%
Total GB	16.3%	10.2%	-2.7%	12.5%
Total Revenue	2,665.3	2,964.2	2,919.1	3,287.6
Revenue as a % GB	13.6%	13.7%	13.9%	13.9%
Cost of Revenues	559.5	641.9	638.4	735.0
Gross Profit	2,105.8	2,322.4	2,280.7	2,552.5
Gross Margin	79.0%	78.3%	78.1%	77.6%
Selling and Marketing expense	980.1	1,109.7	1,098.7	1,245.2
General and Administrative expense	289.4	312.0	312.6	352.1
Technology and Content	166.9	192.2	191.4	215.5
Amortization of intangibles	77.6	68.4	60.0	60.0
Stock Based Compensation	62.8	67.0	71.0	85.0
Total Operating Expenses	1,576.8	1,749.3	1,733.7	1,957.8
Total Operating Expenses (Pro forma)	1,436.3	1,613.9	1,602.7	1,812.8
Operating Profit	529.0	573.0	546.9	594.7
Operating Profit (Pro forma)	669.5	708.4	677.9	739.7
Operating Margin	19.8%	19.3%	18.7%	18.1%
Operating Margin (Pro forma)	25.1%	23.9%	23.2%	22.5%
EBITDA	729.0	781.3	755.9	883.0
OIBA	669.5	708.4	677.9	739.7
OIBA Margin	25.1%	23.9%	23.2%	22.5%
Net Interest Income	(13.5)	(35.5)	(44.0)	(36.0)
Other	(18.6)	(37.0)	-	-
Equity Income of Unconsolidated Affiliates	-	-	-	-
EBT (Earnings Before Taxes)	497.0	500.5	502.9	558.7
EBT (Earnings Before Taxes - Pro forma)	656.0	652.7	633.9	703.7
Minority Interest Income	2.0	3.2	2.0	2.0
Income Tax Expense	(203.1)	(202.9)	(196.1)	(217.9)
Tax Rate	41%	40%	39%	39%
Net Income (Reported)	295.8	300.8	308.8	342.8
Net Income (Pro Forma)	391.0	392.2	386.7	429.3
EPS (Reported)	0.94	1.03	1.06	1.18
EPS (Pro Forma)	1.23	1.30	1.26	1.40
Sharecount	314.3	292.9	291.7	291.7

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 116: EXPE Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
North America	3,559	3,723	3,519	3,136	4,087	4,099	3,561	2,916	3,883	3,894	3,561	2,916
Europe	940	939	1,074	919	1,257	1,223	1,272	913	1,119	1,040	1,119	940
Other	425	466	465	466	559	611	580	550	637	684	650	605
Total Gross Bookings	4,924	5,128	5,058	4,521	5,902	5,933	5,413	4,379	5,639	5,618	5,330	4,461
Total Revenue	550.5	689.9	759.6	665.3	687.8	795.0	833.3	648.1	659.7	764.0	826.1	669.2
Revenue as a % GB	11.2%	13.5%	15.0%	14.7%	11.7%	13.4%	15.4%	14.8%	11.7%	13.6%	15.5%	15.0%
Cost of Revenues	120.4	143.0	150.5	145.6	151.3	168.3	176.5	145.8	146.5	169.6	175.1	147.2
Gross Profit	430.1	546.9	609.1	519.7	536.5	626.7	656.8	502.3	513.3	594.4	651.0	522.0
Gross Margin	78.1%	79.3%	80.2%	78.1%	78.0%	78.8%	78.8%	77.5%	77.8%	77.8%	78.8%	78.0%
Selling and Marketing expense	219.0	253.1	276.6	231.3	283.4	296.7	296.3	233.3	262.6	286.5	307.3	242.2
General and Administrative expense	68.5	68.7	75.7	76.5	79.5	76.7	81.4	74.5	78.5	74.9	81.0	78.3
Technology and Content	38.2	38.0	44.0	46.7	47.9	49.3	48.4	46.7	46.2	47.4	53.7	44.2
Amortization of intangibles	21.2	19.5	18.6	18.3	18.1	18.7	15.8	15.8	15.0	15.0	15.0	15.0
Stock Based Compensation	15.9	14.0	14.4	18.6	17.8	14.9	15.4	19.0	18.0	16.0	17.0	20.0
Total Operating Expenses	362.8	393.3	429.3	391.4	446.6	456.2	457.3	389.3	420.3	439.8	474.0	399.7
Total Operating Expenses (Pro forma)	325.7	359.8	396.3	354.5	410.7	422.7	426.1	354.5	387.3	408.8	442.0	364.7
Operating Profit	67.3	153.6	179.8	128.3	90.0	170.5	199.6	112.9	93.0	154.7	177.0	122.3
Operating Profit (Pro forma)	104.4	187.1	212.8	165.2	125.9	204.0	230.8	147.8	126.0	185.7	209.0	157.3
Operating Margin	12.2%	22.3%	23.7%	19.3%	13.1%	21.4%	24.0%	17.4%	14.1%	20.2%	21.4%	18.3%
Operating Margin (Pro forma)	19.0%	27.1%	28.0%	24.8%	18.3%	25.7%	27.7%	22.8%	19.1%	24.3%	25.3%	23.5%
EBITDA	118.8	200.7	228.1	181.3	142.9	222.3	250.4	165.8	145.0	204.7	229.0	177.3
OIBA	104.4	187.1	212.8	165.2	125.9	204.0	230.8	147.8	126.0	185.7	209.0	157.3
OIBA Margin	19.0%	27.1%	28.0%	24.8%	18.3%	25.7%	27.7%	22.8%	19.1%	24.3%	25.3%	23.5%
Net Interest Income	(3.9)	0.7	(1.1)	(9.2)	(7.6)	(4.3)	(12.6)	(11.0)	(11.0)	(11.0)	(11.0)	(11.0)
Other	(5.5)	5.9	(13.9)	(5.2)	(3.7)	(5.1)	(23.2)	(5.0)				
Equity Income of Unconsolidated Affiliates												
EBT (Earnings Before Taxes)	57.9	160.2	164.8	114.0	78.7	161.1	163.7	96.9	82.0	143.7	166.0	111.3
EBT (Earnings Before Taxes - Pro forma)	100.5	187.7	211.8	156.0	118.3	199.7	197.9	136.8	115.0	174.7	198.0	146.3
Minority Interest Income	0.5	0.0	0.3	1.2	1.5	0.9	0.3	0.5	0.5	0.5	0.5	0.5
Income Tax Expense	(23.6)	(64.1)	(65.5)	(49.9)	(29.0)	(65.9)	(69.2)	(38.8)	(32.0)	(56.0)	(64.7)	(43.4)
Tax Rate	41%	40%	40%	44%	37%	41%	42%	40%	39%	39%	39%	39%
Net Income (Reported)	34.8	96.1	99.6	65.4	51.3	96.0	94.8	58.7	50.5	88.1	101.8	68.4
Net Income (Pro Forma)	59.3	114.0	123.1	94.6	71.0	120.8	118.3	82.1	70.2	106.5	120.8	89.2
EPS (Reported)	0.11	0.30	0.32	0.22	0.17	0.33	0.33	0.20	0.17	0.30	0.35	0.23
EPS (Pro Forma)	0.18	0.35	0.39	0.31	0.24	0.40	0.39	0.27	0.23	0.35	0.39	0.29
Sharecount	323.7	320.2	312.8	300.5	294.0	294.0	291.7	291.7	291.7	291.7	291.7	291.7

Source: Company reports and J.P. Morgan estimates.

Table 117: EXPE Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
ASSETS				
Cash and Cash Equivalents	617.4	378.0	712.3	1,089.9
Restricted Cash and Cash Equivalents	16.7	7.1	23.0	23.0
Marketable Securities	-	-	-	-
Accounts and Notes Receivable	268.0	291.3	291.3	291.3
Receivables from IAC and Subsidiaries	-	-	-	-
Deferred Income Taxes	-	-	-	-
Other Current Assets	143.6	257.8	257.8	257.8
Total Current Assets	1,045.6	934.1	1,284.3	1,661.9
Goodwill	6,006.3	6,303.9	6,303.9	6,303.9
Intangible Assets, Net	970.8	1,075.4	1,075.4	1,075.4
Long-Term Investments and Other	93.2	82.0	82.0	82.0
Property, Plant and Equipment, Net	179.5	264.2	361.1	469.5
Total Assets	8,295.4	8,659.6	9,106.7	9,592.6
LIABILITIES				
Accounts Payable, Trade	852.3	746.8	746.8	746.8
Deferred Merchant Bookings	609.1	644.3	644.3	644.3
Deferred Revenue	12.0	14.7	14.7	14.7
Income Tax Payable	-	-	-	-
Deferred income taxes	-	-	-	-
Short term borrowings	-	-	-	-
Other Current Liabilities	301.0	224.1	224.1	224.1
Total Current Liabilities	1,774.4	1,629.9	1,629.9	1,629.9
Long Term Debt	500.0	894.4	894.4	894.4
Credit Facility	585.0	250.0	250.0	250.0
Other Long-Term Liabilities	204.9	236.9	236.9	236.9
Deferred Income Taxes	351.2	389.6	389.6	389.6
Derivative liabilities	-	-	-	-
Minority Interest	61.9	57.9	57.9	57.9
Total Liabilities	3,477.3	3,458.6	3,458.6	3,458.6
INVESTED EQUITY				
Invested Capital	-	-	-	-
Accumulated Other Comprehensive Income	-	-	-	-
Total Invested Equity	4,818.1	5,200.9	5,648.0	6,134.0
LIABILITIES AND INVESTED EQUITY	8,295.4	8,659.6	9,106.7	9,592.6

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 118: EXPE Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
CASH FLOW FROM OPERATIONS				
Net Income	295.8	300.9	308.8	342.8
Adjustments to Reconcile Cash to Income	-	-	-	-
Depreciation and Amortization	59.5	72.9	78.0	84.0
Amortization of non-cash distributing & mktg	-	-	-	-
Amortization of non-cash compensation expense	-	-	-	-
Amortization of intangibles & stock-based comp	140.4	135.4	131.0	145.0
Deferred Income Taxes	(1.6)	(10.0)	(1.9)	(1.9)
Unralized gain on derivative instrument	5.7	(4.6)	-	-
Equity in Losses of Unconsolidated Affiliates	2.6	(0.8)	(5.4)	-
Minority Interest in Income of Subsidiaries	(2.0)	(3.1)	(1.3)	-
Other	3.8	22.1	-	-
Impairment of Intangible Asset	-	-	-	-
Foreign exchange gain/loss	(12.5)	56.0	-	-
Changes in Current Assets and Current Liabilities	-	-	-	-
Accounts and Notes Receivable	(44.4)	14.3	-	-
Prepaids and Other Assets	(32.4)	(44.8)	-	-
Accounts Payable and Accrued Liabilities	51.7	15.2	-	-
Accounts Payable, merchants	101.1	(65.6)	-	-
Deferred Revenue	1.6	2.6	-	-
Deferred Merchant Bookings	142.6	35.3	-	-
Other, Net	-	-	-	-
Net Cash Provided by Operating Activities	712.0	525.9	509.2	570.0
Free Cash Flow (FCF)	625.4	366.9	334.3	377.6
CASH FLOW FROM INVESTING				
Acquisitions, Net of Cash Required	(59.6)	(529.4)	-	-
Capital Expenditures	(86.7)	(159.0)	(174.9)	(192.4)
Purchase of Marketable Securities	-	-	-	-
Proceeds from Sale of Marketable Securities	-	-	-	-
Increase in Long-Term Investments & Notes Rec.	(33.2)	8.3	-	-
Proceeds from Sale of Business	-	1.6	-	-
Other, Net	-	(100.6)	-	-
Net Cash Provided by Investing Activities	(179.5)	(779.1)	(174.9)	(192.4)
CASH FLOW FROM FINANCING				
Transfers to IAC	-	-	-	-
Short term borrowings	585.0	(335.0)	-	-
Proceeds from issuance of long term debt	-	392.4	-	-
Proceeds from Sale of Subsidiary Stock, inc. Options	29.5	9.5	-	-
Changes in Restricted Cash	(6.5)	8.0	-	-
Principal payments on long term obligations	-	-	-	-
Treasury stock activity	(1,397.2)	(12.6)	-	-
Other, Net	(0.8)	-	-	-
Net Cash Provided by Investing Activities	(790.0)	62.4	-	-
Effect of FX on Cash & Equivalents	21.5	(48.5)	-	-
Net Increase in Cash & Equivalents	(235.9)	(239.4)	334.3	377.6
Cash & Equivalents at Beginning of Period	853.3	617.4	378.0	712.3
Cash & Equivalents at End of Period	617.4	378.0	712.3	1,089.9

Source: Company reports and J.P. Morgan estimates.

Google, Overweight, ($303.11)

Although we think Google's growth will be afflicted in the near term by the current recession, we believe the company is strengthening its long-term strategic position through market share gains, increased search spend penetration of total advertising budgets, and greater cost efficiency. At 14.3x our F'09 GAAP EPS estimate of $18.36, we find Google's valuation attractive and are introducing a $430 December 2009 price target. As such, we maintain our Overweight rating.

- **Market share gains are likely to continue**. We think advertisers will simplify their ad spend and move toward better performing platforms. As such, we expect Google to continue to take market share from search competitors. Additionally, we see Google likely to increase coverage to meet advertiser demand. We think coverage will increase 110 bps in 2009 and O&O revenue will increase 13% Y/Y.
- **Google will likely benefit from increased search spend penetration**. According to Nielsen research, even though people spend 29% of their time on the Internet, this medium only has an 8% market share of total advertiser spend. Thus, we think advertisers will shift ad spend toward search to better align audience usage and to use the performance-based advertising platform.
- **Google is striving to achieve a more efficient cost structure.** In the first 3 quarters of 2008, we estimate that Google grew its operating expenses 40% Y/Y, roughly in-line with net revenue growth of 41%. In 2009, we think Google will be controlling its costs much more carefully, specifically in the areas of contract employees and non-core product development.
- **2009 drivers.** In our view, the following factors will drive GOOG shares in 2009: (1) improved cost efficiencies, (2) search outperformance relative to other advertising media, and (3) increased monetization and coverage enhancements.
- **Lowering our 4Q'08 estimates.** Due to the greater-than-expected economic deterioration, we are lowering our 4Q estimates. We are now looking for 4Q revenue, EBITDA, and pro forma EPS of $4.05B, $2.33B, and $4.83 vs. our prior estimates of $4.39B, $2.49B, and $5.22, respectively. Although we think there may be upside to our estimates, we are being most conservative in our 4Q outlook. We are looking for 1% sequential growth in O&O properties but think network properties may underperform and are modeling (20)% Q/Q growth.

Our current and newly introduced 2010 estimates are in the table below:

Table 119: Google Financial Snapshot

$ in millions, except per share data

GOOG	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	4,049.2	15,688.9	17,596.5	21,762.2	34.6%	12.2%	23.7%
EBITDA	2,327.6	9,142.4	10,209.7	12,277.8	32.1%	11.7%	20.3%
Pro Forma EPS	4.83	19.23	21.16	25.26	23.3%	10.1%	19.3%
Consensus							
Revenue	4,237.9	15,888.8	19,000.0	22,218.2	36.3%	19.6%	16.9%
EBITDA	2,490.1	9,276.0	10,953.0	12,781.4	34.0%	18.1%	16.7%
Pro Forma EPS	5.05	19.44	21.88	22.35	24.7%	12.6%	2.1%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We are lowering our 2009 net revenue, EBITDA, and pro forma EPS estimates to $17.602B, $10.21B, and $21.16 from our prior estimates of $19.52B, $11.12B, and $23.36, respectively. Our new estimates call for Y/Y revenue, EBITDA, and EPS growth of 12%, 12%, and 10%, respectively.

In 2009, we are expecting Google to continue to make progress on the international front, both through search volume growth and increasing advertiser demand. However, we expect this to be offset by weaker advertiser spend due to the economy and unfavorable foreign currency exchange rates. We are modeling international gross revenue growth of 5% Y/Y to $11.1B in 2009. Because of the foreign currency exchange rate headwinds, this is the first year that we expect international revenues to decline to 50.9% of total revenue from 51.2% in 2008.

Beyond international, we believe Google will generate above-average market share growth through continued volume share gains from its domestic competitors. We continue to believe Google has the strongest brand in search. Google’s rapid innovation of new web offerings should lead to increased attention from consumers, which should contribute to sustained volume share growth in 2009. We think paid clicks will grow 10% Y/Y as search volume increases and as Google continues to take market share.

Although we think Google's attempts to diversify revenue are going to be successful in the long term, we think advertisers will shy away from more experimental advertising forms in the current economic environment. Hence, we do not expect a meaningful return on video and mobile investments in the near term.

Our Estimates and Outlook for 2010

We are introducing 2010 estimates, which call for Y/Y revenue, EBITDA, and pro forma EPS growth of 24%, 20%, and 19%, respectively. Specifically, our F’10 revenue, EBITDA, and pro forma EPS estimates are $21.8B, $12.3B, and $25.26, respectively.

In 2010, we are expecting the economic recession to subside and foreign currency exchange rates to be flat. Thus, we are expecting search revenue growth to accelerate. We are modeling Google.com search volumes to grow ~21% in 2010. We believe international search revenues will make up 53% of total company revenues in 2010.

We Are Introducing a Price Target of $430

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for Google of a ~17% F’09 - F’14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H’09, we believe the stock can achieve a 17x EV/EBIT multiple to our F’09 EBIT estimate (reflecting better forward visibility than the current valuation of 12x our F'09 estimate) and thus arrive at our December 2009 price target of $430.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 120: Growth Outlook

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	17,596.5	21,762.2	25,461.8	29,281.1	33,380.4	37,719.9
Y/Y change		*23.7%*	17%	15%	14%	13%
Less: Operating Expenses	10,311.8	12,844.4	14,971.5	17,129.4	19,360.7	21,877.5
As % of total revenues	*58.6%*	*59.0%*	*58.8%*	*58.5%*	*58.0%*	*58.0%*
Operating Income (Loss)	7,284.7	8,917.8	10,490.3	12,151.7	14,019.8	15,842.4
Operating margin	*41.4%*	*41.0%*	41.2%	41.5%	42.0%	42.0%

Source: Company reports and J.P. Morgan estimates.

Table 121: EV/EBIT Multiple Analysis

$ in millions

5 yr forward EBIT CAGR	17%
1x EBIT Growth	17
2009 EBIT	7,284.7
Implied Enterprise Value	123,839.5
+ Cash	12,531.7
- Debt	-
Market Value	136,371.1
Share count	317.8
2009 Price Target	429.14

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

We believe GOOG shares are fundamentally attractive due to secular industry growth trends, improving fundamentals in the international market, and expansion of new product categories such as contextual ad and local search. Google remains an Overweight pick. Google trades at 14x its F'09 EPS vs. its large-cap Internet peers at 26x. Given Google's higher growth rate, we think it deserves a premium. Hence, our OW rating.

Risks to Our Rating

Google has experienced very fast revenue growth over the past few years. Our Overweight rating is based on the assumption that Google will continue to be the market leader in the paid search space and will continue to enjoy strong revenue growth. If the content publishers like Yahoo! and Microsoft are able to gain market share through user defection from Google's user base, then our rating could be too optimistic. However, we have not seen any trends that would support this argument thus far.

Our Overweight rating is also predicated on the company's success in the international market. If the company cannot successfully build out a larger international advertising base, the company will not be able to increase its monetization rate abroad. Additionally, as Google continues to expand its business internationally, it may face regulatory hurdles that make the business climate less hospitable and potentially less profitable than the markets where it currently operates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 122: GOOG Annual Income Statement

$ in millions

	2007	2008E	2009E	2010E
Gross Revenue	16,594.0	21,405.2	22,616.7	27,090.5
TAC	4,935.8	5,716.3	5,020.2	5,328.3
TAC %	85.3%	88.9%	89.6%	90.0%
Google websites	10,624.7	14,310.3	16,182.0	20,297.6
Google Network websites	852.1	714.3	580.8	592.0
DoubleClick(1)		284.2	428.8	467.6
Licensing and other Revenues	181.3	664.4	833.8	872.6
Net Revenues	11,658.1	15,688.9	17,596.5	21,762.2
Y/Y growth	59.8%	34.6%	12.2%	23.7%
Q/Q growth				
Cost of Revenues	1,690.9	2,684.2	3,287.9	4,245.9
Gross Profit	9,967.2	13,004.7	14,308.6	17,516.3
Gross Margins	85.5%	82.9%	81.3%	80.5%
Contribution GM				
R&D	1,550.2	2,052.1	2,269.8	2,872.6
Sales & Marketing	1,329.6	1,736.0	1,939.8	2,426.2
General & Administrative	1,134.4	1,576.5	1,649.4	2,039.7
Stock based compensation	868.6	1,118.6	1,165.0	1,260.0
			-	-
Total Expenses	6,573.7	9,167.4	10,311.8	12,844.4
				-
Operating Income	5,084.4	6,521.4	7,284.7	8,917.8
Pro Forma Operating Income	5,953.0	7,640.0	8,449.7	10,177.8
Operating Margins	43.6%	41.6%	41.4%	41.0%
Pro Forma Operating Margins	51.1%	48.7%	48.0%	46.8%
Interest Income (Expense)	589.6	321.5	345.0	415.0
EBT	5,674	6,843	7,630	9,332.8
Less Taxes	1,470	1,623	1,745	2,134.1
Tax Rate	26%	23.7%	22.9%	22.9%
EBITDA	6,920.7	9,142.4	10,209.7	12,277.8
Margins	59.4%	58.3%	58.0%	56.4%
EAT	4,203.7	5,220.3	5,885.1	7,198.7
Tax Benefit --> Stock Comp & Foundation	143.0	229.1	266.5	288.2
Pro forma EAT	4,929.3	6,109.8	6,783.7	8,170.6
GAAP EPS	13.29	16.43	18.36	22.25
Pro forma EPS	15.59	19.23	21.16	25.26
Diluted Sharecount	316.2	317.8	320.5	323.5

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 123: GOOG Quarterly Income Statement

$ in millions

	Q1 -07	Q2-07	Q3-07	Q4-07	Q1 -08	Q2-08	Q3-08	Q4-08E	Q1 -09E	Q2-09E	Q3-09E	Q4-09E
Gross Revenue	3,664.0	3,872.0	4,231.4	4,826.7	5,186.0	5,367.2	5,541.4	5,310.6	5,454.4	5,552.8	5,588.2	6,021.2
TAC	1,125.0	1,150.0	1,221.0	1,439.8	1,486.0	1,474.0	1,495.0	1,261.3	1,286.6	1,218.5	1,194.2	1,320.9
TAC %	83.6%	85.1%	83.9%	88.0%	88.1%	89.0%	89.0%	89.5%	89.5%	89.5%	89.5%	90.0%
Google websites	2,282.1	2,486.3	2,734.8	3,121.5	3,400.4	3,530.1	3,672.1	3,707.6	3,818.5	3,988.1	4,046.1	4,329.3
Google Network websites	220.3	202.1	233.7	196.0	200.1	181.3	184.9	148.0	150.9	143.0	140.1	146.8
DoubleClick(1)					-	87.5	93.0	103.7	98.5	103.2	107.9	119.2
Licensing and other Revenues	36.5	33.6	41.9	69.3	99.5	181.8	189.4	193.7	198.5	203.2	207.9	224.2
Net Revenues	2,538.9	2,722.0	3,010.4	3,386.9	3,700.0	3,893.2	4,046.4	4,049.2	4,167.9	4,334.2	4,394.1	4,700.3
Y/Y growth	65.8%	62.9%	61.5%	51.9%	45.7%	43.0%	34.4%	19.6%	12.6%	11.3%	8.6%	16.1%
Q/Q growth	13.9%	7.2%	10.6%	12.5%	9.2%	5.2%	3.9%	0.1%	2.9%	4.0%	1.4%	7.0%
Cost of Revenues	341.0	402.6	437.5	509.8	615.4	664.2	667.7	737.0	766.9	801.8	826.1	893.1
Gross Profit	2,197.9	2,319.4	2,572.8	2,877.1	3,084.7	3,229.0	3,378.7	3,312.3	3,401.0	3,532.4	3,568.0	3,807.2
Gross Margins	86.6%	85.2%	85.5%	84.9%	83.4%	82.9%	83.5%	81.8%	81.6%	81.5%	81.2%	81.0%
Contribution GM	83.9%	80.9%	81.1%	81.6%	76.4%	77.7%	77.8%	65.7%	67.6%	68.8%	54.4%	76.0%
R&D	287.6	375.1	418.1	469.4	479.3	494.9	535.3	542.6	541.8	550.4	571.2	606.3
Sales & Marketing	275.3	319.2	350.9	384.2	404.3	442.0	444.3	445.4	454.3	489.8	483.3	512.3
General & Administrative	230.0	278.9	288.0	337.5	374.1	441.4	376.4	384.7	391.8	407.4	413.0	437.1
Stock based compensation	183.9	241.5	198.0	245.3	280.8	272.8	280.0	285.0	285.0	285.0	295.0	300.0
Total Expenses	1,317.7	1,617.3	1,692.5	1,946.1	2,153.8	2,315.2	2,303.7	2,394.6	2,439.8	2,534.5	2,588.7	2,748.9
Operating Income	1,221.2	1,104.6	1,317.8	1,440.7	1,546.2	1,578.0	1,742.7	1,654.6	1,728.1	1,799.8	1,805.4	1,951.4
Pro Forma Operating Income	1,405.1	1,346.1	1,515.8	1,686.0	1,827.0	1,850.7	2,022.7	1,939.6	2,013.1	2,084.8	2,100.4	2,251.4
Operating Margins	48%	41%	44%	43%	42%	41%	43%	41%	41%	42%	41%	42%
Pro Forma Operating Margins	55.3%	49.5%	50.4%	49.8%	49.4%	47.5%	50.0%	47.9%	48.3%	48.1%	47.8%	47.9%
Interest Income (Expense)	130.7	137.1	154.4	167.3	167.3	57.9	21.2	75.0	75.0	80.0	85.0	105.0
EBT	1,352	1,242	1,472	1,608	1,714	1,636	1,764	1,730	1,803	1,880	1,890	2,056
Less Taxes	350	317	402	402	406	388	418	410	415	432	435	463
Tax Rate	26%	25%	27%	25%	24%	24%	24%	24%	23%	23%	23%	23%
EBITDA	1,610.1	1,569.5	1,765.2	1,976.0	2,163.5	2,242.3	2,409.0	2,327.6	2,423.1	2,516.8	2,548.4	2,721.4
Margins	63.4%	57.7%	58.6%	58.3%	58.5%	57.6%	59.5%	57.5%	58.1%	58.1%	58.0%	57.9%
EAT	1,002.2	925.1	1,070.0	1,206.4	1,307.1	1,247.4	1,346.2	1,319.7	1,388.4	1,447.4	1,455.6	1,593.7
Tax Benefit --> Stock Comp & Foundation	26.8	43.0	31.0	42.3	50.7	47.8	63.1	67.5	65.6	65.6	67.9	67.5
Pro forma EAT	1,159.3	1,123.6	1,236.9	1,409.5	1,537.1	1,472.4	1,563.1	1,537.1	1,607.8	1,666.9	1,682.7	1,826.2
GAAP EPS	3.18	2.93	3.38	3.79	4.12	3.92	4.24	4.15	4.35	4.52	4.53	4.95
Pro forma EPS	3.68	3.56	3.91	4.43	4.84	4.63	4.92	4.83	5.04	5.21	5.24	5.67
Diluted Sharecount	314.9	315.5	316.6	317.9	317.4	318.0	317.8	318.0	319.0	320.0	321.0	322.0

Source: Company reports and J.P. Morgan estimates.

Table 124: GOOG Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash and Cash Equivalents	3,909.0	7,183.3	12,965.0	20,889.8
Short term investments	8,137.0	6,042.1	6,042.1	6,042.1
Accounts Receivable	2,162.5	2,429.5	2,350.1	2,391.1
Income taxes receivable	145.3	-	-	-
Deferred Income Tax	68.5	111.4	111.4	111.4
Prepaid revenue share,expenses and other assets	694.2	809.8	705.0	777.1
Total Current Assets	15,116.5	16,576.2	22,173.8	30,211.6
			-	-
Non-marketable equity securities	1,059.7	1,100.9	1,100.9	1,100.9
Property, Plant, and Equipment	4,039.3	5,587.2	7,095.2	8,595.2
Goodwill	2,299.4	4,821.6	4,821.6	4,821.6
Intangible Assets	446.6	1,047.7	1,047.7	1,047.7
Deferred income taxes, net	33.2	-	-	-
Prepaid revenue share, expenses and other non current assets	168.5	426.5	426.5	426.5
Total Assets	23,163.2	29,560.1	36,665.7	46,203.5
Accounts Payable	282.1	445.4	423.0	478.2
Accrued Compensation and benefits	588.4	647.9	799.1	1,076.0
Accrued Expenses and other current liabilities	465.0	465.7	540.5	687.5
Accrued revenue share	522.0	516.3	564.0	717.3
Deferred revenue	178.1	200.5	232.8	316.8
Income taxes payable	-	-	-	-
Current portion of equipment leases	-	-	-	-
Total Current Liabilities	2,035.6	2,275.8	2,559.4	3,275.9
Long term portion of equipment leases	-	-	-	-
Deferred revenue, long term	30.2	30.0	30.0	30.0
Liability for stock options exercised early, long term	-	-	-	-
Deferred income taxes	-	20.4	20.4	20.4
Income taxes payable, long-term	478.4	-	-	-
Other long term liabilities	101.9	161.1	161.1	161.1
Total Long Term Liabilities	610.5	211.5	211.5	211.5
			-	-
Total Stockholders' equity	20,517.1	27,072.8	33,894.8	42,716.2
			-	-
Total Liabilities & Equity	23,163.2	29,560.1	36,665.7	46,203.5

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 125: GOOG Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Operating Activities				
Net income	4,203.7	5,220.3	5,885.1	7,198.7
Depreciation and Amortization	807.7	1,224.8	1,492.0	1,800.0
Amortization of Warrants	-	-	-	-
Amortization of Intangibles	159.9	277.6	268.0	300.0
In process R&D	-	-	-	-
Stock based compensation	868.6	1,118.6	1,165.0	1,260.0
Excess tax benefit from stock-based award activity	(379.2)	(214.8)	(260.0)	(260.0)
Other	(204.0)	(100.2)	-	-
Changes in WC	(48.3)	(46.1)	(16.6)	23.6
Accounts Receivables	(837.2)	(330.3)	(79.4)	41.0
Income taxes	744.8	552.7	300.0	350.0
Prepaid revenue share,expenses and other assets	(298.7)	(227.6)	(104.8)	72.1
Accounts Payable	70.1	52.5	(22.4)	55.2
Accrued Expenses and other liabilities	418.9	(29.1)	74.9	146.9
Accrued revenue share	150.3	(4.1)	47.7	153.3
Deferred revenue	70.3	21.5	32.2	84.1
Tax Benefit from exercise Option	-	-	-	-
Non Recurring Portion	-	-	-	-
Net Cash provided by Operating Activities	4,674.6	7,516.0	8,781.8	11,224.8
FCF	2,271.8	4,825.3	5,781.8	7,924.8
Investing Activities				
Purchase of PP&E	(2,402.8)	(2,690.6)	(3,000.0)	(3,300.0)
Purchase of short term investments	(15,997.1)	(7,814.3)	-	-
Maturities and sale of short term investments	15,659.5	9,634.9	-	-
Investments in non-marketable equity securities	(34.5)	(45.9)	-	-
Acquisitions, net of cash acquired	(906.7)	(3,386.6)	-	-
Change in other assets	-	-	-	-
Net Cash used in Investing Activities	(3,681.6)	(4,302.6)	(3,000.0)	(3,300.0)
Financing Activities				
Proceeds from issuance of convertible preference stock	-	-	-	-
Proceeds from IPO/Public Offering	-	-	-	-
Proceeds from exercise of stock options	23.9	(38.3)	-	-
Proceeds from exercise of warrants	-	-	-	-
Payments of notes receivables from shareholders	-	-	-	-
Excess tax benefits from stock-based award activity	379.2	114.8	-	-
Payment of Principal on capital leases and eqpt loans	-	-	-	-
Net Cash provided by Financing Activities	403.1	76.5	-	-
Effect of Exchange rate changes	40.0	(15.6)	-	-
Net Increase (Decrease) in Cash & Equivalents	1,436.1	3,274.3	5,781.8	7,924.8
Cash and Cash Equivalents - Beginning	2,473.1	3,909.2	7,183.4	12,965.2
Cash and Cash Equivalents - Ending	3,909.2	7,183.4	12,965.2	20,890.0

Source: Company reports and J.P. Morgan estimates.

IAC, Neutral, ($15.77)

We expect IAC's growth to moderate in 2009 due to weakness in the Media & Advertising group, likely pressure on personals pricing increases, and exposure to foreign currency effects (19% of the business is in int'l markets, and currency is not hedged). However, we do feel the company is better positioned than some of its competitors, with only 4% of its business tied to display advertisements and a cash balance of ~$2B. IAC trades at 3.6x our F'09 EBITDA estimate of $234M. We are introducing a $16 December 2009 price target and reiterating our Neutral rating.

- **We think Ask.com revenue will grow only 1% Y/Y in F'09**. We think the Ask.com business will be significantly impacted by a combination of lower commercial oriented query volumes, CPC declines, and the anniversary of the new Google contract. We also note that the Media & Advertising segment has international exposure, which will likely be negatively impacted by the strengthening dollar.
- **We are concerned that the growth in Personals revenue is unsustainable.** In F'08, we estimate that a little over half the revenue growth was due to pricing increases. Given the weak consumer environment, we think it is unlikely that IAC can continue to raise prices in 2009, and it may have to start being more promotional.
- **We believe management will begin to allocate its large cash reserve**. We think it is likely that management will take advantage of low valuations and the frozen credit market through strategic acquisitions in search, local, and content as well as possible share repurchases of IAC stock.
- **2009 drivers.** In our view, the following factors will drive EXPE shares in 2009: (1) possible share buybacks, (2) reduction in the emerging businesses investment, and (3) paid-click growth.
- **Adjusting 4Q'08 estimates.** We are maintaining our 4Q'08 revenue and EBITDA estimates of $381M and $52M, respectively, but are lowering our pro forma EPS estimate to $0.23 from $0.26 to account for lower-than-expected interest rates.

Our current and newly introduced 2010 estimates are in the table below:

Table 126: IAC Financial Snapshot

$ in millions, except per share data

IACI	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	381.4	1,475.5	1,548.1	1,687.3	10.7%	4.9%	9.0%
EBITDA	51.9	176.1	234.3	258.3	25.5%	33.1%	10.2%
Pro Forma EPS	0.23	0.34	1.02	1.10	-25.9%	202.7%	7.4%
Consensus							
Revenue	370.1	1,462.0	1,522.9	1,640.5	9.7%	4.2%	7.7%
EBITDA	53.4	189.0	231.7	235.8	34.7%	22.6%	1.8%
Pro Forma EPS	0.21	0.48	0.96	1.18	5.4%	100.0%	22.9%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Our Estimates and Outlook for 2009

We are slightly adjusting our F'09 revenue, EBITDA, and pro forma EPS estimates. We are now modeling F'09 revenue, EBITDA, and EPS of $1.55B, $234M, and $1.02 vs. our prior estimates of $1.54B, $234M, and $1.11, respectively. This represents Y/Y growth of 5%, 33%, and 203%, respectively.

We are looking for 1% Y/Y revenue growth in the Media & Advertising segment, as we think it will be significantly impacted by a combination of lower commercial oriented query volumes, CPC declines, and the anniversary of the new Google contract. We are looking for 2% Y/Y OIBA growth, as we think there will be some residual benefit of the new Google contract in the first quarter.

Table 127: Media & Advertising Growth by Type

$ in millions

	F'08E	F'09E
Proprietary Revenue	548.5	591.9
Network Revenue	250.5	215.1
Proprietary Revenue Y/Y Growth	31.1%	7.9%
Network Revenue Y/Y Growth	-26.3%	-14.1%

Source: Company reports and J.P. Morgan estimates.

We think the Match business will decline 4% Y/Y to a revenue base of $357M. We feel this business will be pressured by both lower demand in a weak economic environment and pricing pressures, as the environment could potentially become more promotional.

Table 128: Match Business Metrics

$ in millions

	F'08E	F'09E
Match revenue	$370	$357
y/y % growth	6.2%	-3.6%
Paid subscribers	1,322.1	1,314.1
y/y % growth	2.8%	-0.6%
Revenue per paid subscriber	$280	$272
y/y % growth	3.4%	-3.0%

Source: Company reports and J.P. Morgan estimates.

Finally, we expect ServiceMagic to grow F'09 revenue by 25% Y/Y, a deceleration from F'08 expected growth of 36% Y/Y.

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and pro forma EPS estimates of $1.69B, $258M, and $1.10, which represent Y/Y growth of 9%, 10%, and 7%, respectively. Our estimates assume the beginning of an economic recovery and flat foreign currency exchange rates. Thus, we see revenue growing 6% Y/Y in the Media & Advertising segment, as we think increases in ad spend will be slightly offset by search market share losses. We see ServiceMagic and Match revenue growing 22% and 7% Y/Y, respectively as we expect both businesses to benefit from an economic recovery.

We Are Introducing a Price Target of $16

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for IAC of a ~8% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 8x EV/EBIT multiple to our F'09 EBIT estimate (in line with the current valuation of 8x our F'09 estimate) and thus arrive at our December 2009 price target of $16.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 129: Growth Outlook

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	1,548.1	1,687.3	1,805.4	1,895.7	1,990.4	2,090.0
Y/Y change		*9.0%*	7%	5%	5%	5%
Less: Operating Expenses	1,517.4	1,652.0	1,765.7	1,854.0	1,946.6	2,044.0
As % of total revenues	*98.0%*	*97.9%*	*97.8%*	*97.8%*	*97.8%*	*97.8%*
Operating Income (Loss)	30.7	35.3	39.7	41.7	43.8	46.0
Operating margin	*2.0%*	*2.1%*	2.2%	2.2%	2.2%	2.2%

Source: Company reports and J.P. Morgan estimates.

Table 130: EV/EBIT Multiple Analysis

EV/EBIT Multiple Analysis	
5 yr forward EBIT CAGR	8%
1x EBIT Growth	8
2009 EBIT	30.7
Implied Enterprise Value	245.9
+ Cash	1,971.5
- Debt	-
Market Value	2,217.4
Share count	140.1
2009 Price Target	15.83

Source: Company reports and J.P. Morgan estimates

Valuation and Rating Analysis

On an EV/EBITDA basis, IACI trades at 4x our $234M FY09 EBITDA estimate, vs. its e-commerce peer group which trades at 6x. Although we think IAC deserves a similar multiple as the group, we see greater upside potential in other stocks in our coverage universe, hence the Neutral rating.

Risks to Our Rating

Shares could outperform those of other companies in our coverage universe if the company is able to sustain growth in its Media & Advertising business and in the Personals business despite a competitive search market and international pressures or if the company introduces a large share buyback program. The company's shares could underperform if the company is unable to achieve higher query volumes from Ask.com, macroeconomic pressures impact ServiceMagic more than expected,

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

and/or international weakness weights on Personals. Strategic acquisitions could also weigh on the company's performance.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 131: IACI Annual Income Statement

$ in millions

	2007	2008E	2009E	2010E
Revenue	1,332.6	1,475.5	1,548.1	1,687.3
COGS and SG&A	1,192.2	1,299.4	1,313.8	1,429.0
Stock-based compensation	73.5	94.8	82.8	91.2
Depreciation	59.9	68.7	74.4	81.7
Amortization of non-cash marketing	49.7	15.0	12.8	13.8
Amortization of intangibles	35.7	32.6	33.6	36.3
Extraordinary expense				-
Operating Income	(78.5)	(35.0)	30.7	35.3
OIBA	80.4	107.4	159.9	176.6
Operating Margin	-5.9%	-2.4%	2.0%	2.1%
EBITDA	140.4	176.1	234.3	258.3
EBITDA margin	10.5%	11.9%	15.1%	15.3%
Other income	74.4	(134.8)	72.0	72.0
Pretax income	(4.1)	(169.8)	102.7	107.3
Proforma pretax income	116.4	104.1	231.9	248.6
Income tax expense (benefit)	2.3	(94.5)	40.1	41.8
Tax rate (as reported)	NA	NA	39%	39%
Proforma tax expense (benefit)	48.6	56.9	90.5	96.9
Tax rate (pro forma)	NA	NA	39.0%	39.0%
Minority interest in (income) loss of consol. subsid	2.0	1.6	1.6	2.0
Earnings from cont. ops	(4.4)	(73.7)	64.3	67.4
Proforma earnings from cont. ops	69.8	48.8	143.1	153.6
Discontinued operations				
Gain Loss on sale of discontinued ops net tax				
Earnings before preferred dividends	(4.4)	(73.7)	64.3	67.4
Proforma earnings before preferred dividends	69.8	48.8	143.1	153.6
Preferred dividends	-	-	-	-
Net income	(4.4)	(73.7)	64.3	67.4
Proforma net income	69.8	48.8	143.1	153.6
GAAP Diluted EPS	(0.97)	(2.65)	0.46	0.48
Pro forma EPS	0.46	0.34	1.02	1.10
GAAP Diluted Weighted Ave. Shares	145.68	139.76	140.10	140.10
Adjusted EPS weighted shares outstanding	152.875	143.225	140.1	140.1

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 132: IACI Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	299.8	318.6	335.4	378.9	370.7	354.2	369.3	381.4	391.0	377.4	380.1	399.7
COGS and SG&A	278.4	281.4	282.5	349.9	334.7	313.7	321.5	329.6	340.1	316.9	313.8	343.0
Stock-based compensation	17.7	18.0	16.6	21.2	18.9	18.6	38.7	18.6	20.7	20.7	20.7	20.7
Depreciation	14.2	14.7	15.1	15.9	17.3	17.5	17.3	16.6	18.5	18.5	18.7	18.7
Amortization of non-cash marketing	0.5	23.5	9.1	16.6	2.8	3.1	6.1	3.0	3.1	3.1	3.3	3.3
Amortization of intangibles	8.0	8.0	10.3	9.4	8.1	7.7	8.3	8.5	8.3	8.3	8.5	8.5
Extraordinary expense												
Operating Income	(19.0)	(27.0)	1.7	(34.2)	(11.1)	(6.4)	(22.6)	5.2	0.3	9.8	15.1	5.5
OIBA	7.2	22.5	37.7	13.1	18.7	23.0	30.5	35.3	32.4	41.9	47.6	38.0
Operating Margin	-6.4%	-8.5%	0.5%	-9.0%	-3.0%	-1.8%	-6.1%	1.4%	0.1%	2.6%	4.0%	1.4%
EBITDA	21.4	37.2	52.8	29.0	36.0	40.5	47.8	51.9	50.9	60.4	66.3	56.7
EBITDA margin	7.1%	11.7%	15.8%	7.6%	9.7%	11.4%	12.9%	13.6%	13.0%	16.0%	17.4%	14.2%
Other income	10.5	15.6	12.9	35.4	11.7	(100.5)	(64.0)	18.0	18.0	18.0	18.0	18.0
Pretax income	(8.5)	(11.4)	14.6	1.2	0.6	(106.9)	(86.6)	23.2	18.3	27.8	33.1	23.5
Proforma pretax income	20.1	36.2	44.1	16.0	25.4	52.1	(26.6)	53.3	50.4	59.9	65.6	56.0
Income tax expense (benefit)	(2.7)	(5.1)	11.1	(1.0)	4.0	(22.3)	(85.3)	9.0	7.1	10.9	12.9	9.2
Tax rate (as reported)	NA	NA	NA	NA	NA	NA	NA	39%	39%	39%	39%	39%
Proforma tax expense (benefit)	3.9	12.9	20.3	11.5	15.0	27.0	(5.9)	20.8	19.7	23.4	25.6	21.8
Tax rate (pro forma)	19%	36%	46%	71%	59%	52%	22%	39%	39%	39%	39%	39%
Minority interest in (income) loss of consol. subsid	(0.1)	0.2	1.5	0.5	0.3	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Earnings from cont. ops	(6.0)	(6.1)	4.9	2.8	(3.1)	(84.2)	(0.9)	14.5	11.6	17.4	20.6	14.7
Proforma earnings from cont. ops	16.1	23.4	25.3	5.1	10.7	25.5	(20.3)	32.9	31.1	37.0	40.4	34.6
Discontinued operations	66.7	65.7	67.1	-372.7	55.9	-360	-14.7	-	-	-	-	-
Gain Loss on sale of discontinued ops net tax	-	35.1	(1.6)	-	-	22.5	0.8					
Earnings before preferred dividends	60.7	94.7	70.4	(369.9)	52.8	(421.7)	(14.8)	14.5	11.6	17.4	20.6	14.7
Proforma earnings before preferred dividends	16.1	23.4	25.3	5.1	10.7	25.5	(20.3)	32.9	31.1	37.0	40.4	34.6
Preferred dividends	-	-		-	-	-	-	-	-	-	-	-
Net income	60.7	94.6	70.5	(369.9)	52.8	(421.6)	(14.8)	14.5	11.6	17.4	20.6	14.7
Proforma net income	16.1	23.4	25.3	5.1	10.7	25.5	(20.3)	32.9	31.1	37.0	40.4	34.6
GAAP Diluted EPS	0.42	0.66	0.47	(2.53)	0.38	(3.02)	(0.11)	0.10	0.08	0.12	0.15	0.11
Pro forma EPS	0.10	0.15	0.17	0.03	0.07	0.17	(0.14)	0.23	0.22	0.26	0.29	0.25
GAAP Diluted Weighted Ave. Shares	143.6	143.7	149.0	146.4	139.4	139.4	140.1	140.1	140.1	140.1	140.1	140.1
Adjusted EPS weighted shares outstanding	155.1	154.4	152.3	149.7	146.5	146.2	140.1	140.1	140.1	140.1	140.1	140.1

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 133: IACI Annual Balance Sheet

$ in millions

	FY'07	FY'08E	FY'09E	FY'10E
Current Assets				
Cash and cash equivalents (including restricted cash)	$1,585.3	$1,850.0	$1,998.0	$2,152.9
Marketable securities	$326.8	$121.5	$121.5	$121.5
Receivables from IAC and subsidiaries	$116.7	$118.1	$118.1	$118.1
Assets held for sale	$0.0	$0.0	$0.0	$0.0
Other current assets	$377.4	$186.0	$186.0	$186.0
Current assets of discontinued operations	1020.034	0	0	$0.0
Total current assets	$3,426.2	$2,275.7	$2,423.6	$2,578.6
Property, plant and equipment, net	$334.3	$343.9	$329.5	$323.8
Goodwill	$1,823.8	$1,910.9	$1,910.9	$1,910.9
Intangible assets, net	$401.9	$410.7	$410.7	$410.7
Long-term investments and other non-current assets	$301.0	$256.8	$256.8	$256.8
Preferred interest exchangeable for common stock	$0.0	$0.0	$0.0	$0.0
Other non-current assets	$201.8	$401.4	$401.4	$401.4
Non-current assets of discontinued operations	$6,101.7	$0.0	$0.0	$0.0
Total Assets	$12,590.8	$5,599.5	$5,733.0	$5,882.3
Liabilities and Shareholders' Equity				
Current maturiries of long term obligations and short term borrowings	$12.1	$0.0	$0.0	$0.0
Liabilities held for sale	$0.0	-	-	-
Other current liabilities	$456.8	$404.7	$404.7	$404.7
Current liabilities of discontinued operations	$1,265.3	$0.0	$0.0	$0.0
Total Current Liabilities	$1,734.2	$404.7	$404.7	$404.7
Long term obligations, net of current maturities	$834.5	$95.8	$95.8	$95.8
Non-current liabilities held for sale	$0.0	$0.0	$0.0	$0.0
Other long term liabilities	$13.9	$14.6	$14.6	$14.6
Non-current liabilities of discontinued operations	$1,127.5	$0.0	$0.0	$0.0
Deferred income taxes	$264.1	$382.3	$382.3	$382.3
Common stock exchangeable for preferred interest	$0.0	$0.0	$0.0	$0.0
Minority Interest	$32.9	$32.1	$32.1	$32.1
Total Liabilities	$4,007.1	$929.5	$929.5	$929.5
Shareholders' Equity				
Preferred stock $0.01 par value	0	0	0	0
Common stock $0.01 par value	0.209	0.21	0.21	0.21
Class B convertible common stock $0.01 par value	0.016	0.016	0.016	0.016
Additional paid-in capital	$14,744.5	$11,096.5	$11,096.5	11096.47
Retained earnings	$567.8	$516.4	$649.9	799.1631
Accumulated other comprehensive income	$39.8	-$28.8	-$28.8	-28.792
Treasury stock	-$6,768.7	-$6,914.3	-$6,914.3	-6914.33
Note receivable from key executive for common stock insurance	$0.0	$0.0	$0.0	0
Total Shareholder Equity	$8,583.7	$4,669.7	$4,803.3	$4,952.5
Total Liabilities and Shareholders' equity	$12,590.8	$5,599.5	$5,733.0	$5,882.3

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 134: IACI Annual Cash Flow Statement

$ in millions

Cash flows from operating activities:	FY'07	FY'08E	FY'09E	FY'10E
Earnings from continuing operations	(4.4)	(73.6)	64.3	67.4
Adjustments to reconcile earnings from continuing operations to net cash provided by operating activities		0.0	0.0	0.0
Depreciation and Amortization	95.6	101.2	108.0	118.0
Goodwill and Other Impairment	0.0	132.6	0.0	0.0
Amortization of non-cash distribution and marketing expense	49.7	15.0	12.8	13.8
Amortization of non-cash compensation expense	73.6	94.8	82.8	91.2
Deferred income taxes	(4.4)	(79.8)	0.0	0.0
Gain on sale of investments	(16.7)	34.1	0.0	0.0
Increase in fair value of derivative assets	(29.4)	(12.7)	0.0	0.0
Equity in income of unconsolidated affiliates, including VUE	(22.4)	(30.7)	(61.5)	(61.5)
Non-cash interest income		0.0	0.0	0.0
Minority interest in income of consolidated subsidiaries	(2.0)	(0.8)	1.6	2.0
Changes in current assets and liabilities	(166.1)	7.2	0.0	0.0
Accounts and notes receivables	(8.9)	(6.5)	0.0	0.0
Loans available for sale	0.0	0.0	0.0	0.0
Inventories	0.0	0.0	0.0	0.0
Prepaids and other assets	(19.0)	(6.2)	0.0	0.0
Accounts payable and accrued liabilities	51.9	33.7	0.0	0.0
Deferred revenue	5.1	3.5	0.0	0.0
Income taxes payable	(209.7)	(23.4)	0.0	0.0
Other, net	14.5	6.1	0.0	0.0
Net cash provided by operating activities	(26.5)	187.3	208.0	230.9
Cash flows provided by (used in) investing activities		0.0	0.0	0.0
Acquisitions, net of cash acquired	(45.9)	(130.7)	0.0	0.0
Capital Expenditures	(112.9)	(76.3)	(60.0)	(76.0)
(Increase) decrease in long-term investments and notes receivables	(120.0)	1.2	0.0	0.0
Purchase of marketable securities	(783.8)	(140.9)	0.0	0.0
Proceeds from sale of marketable securities	1367.2	330.3	0.0	0.0
Proceeds from sale of VUE	15.7	0.0	0.0	0.0
Proceeds from sale of discontinued operations	4.2	32.7	0.0	0.0
Other, net	13.0	921.0	0.0	0.0
Net cash provided by (used in) investing activities	337.4	937.4	(60.0)	(76.0)
Cash flows used in financing activities		0.0	0.0	0.0
Borrowings	0.0	(514.9)	0.0	0.0
Excess tax benefits from stock-based awards	75.4	0.7	0.0	0.0
Principal payments on long-term obilgations	(7.6)	(0.0)	0.0	0.0
Purchase of treasury stock by IAC	(542.9)	(145.6)	0.0	0.0
Proceeds from issuance of common stock, inluding stock options	(59.2)	(12.8)	0.0	0.0
Redemption of preferred stock	0.0	0.0	0.0	0.0
Preferred Dividends	0.0	0.0	0.0	0.0
Other, net	0.8	(1.4)	0.0	0.0
Net cash in financing activities	(533.5)	(674.0)	0.0	0.0
Net cash used in continuing operations	(222.6)	450.6	148.0	154.9
Total cash from discontinued ops	356.5	(170.2)	0.0	0.0
Effect of exchange rates changes on cash and cash equivalents	23.3	(15.7)	0.0	0.0
Net increase in cash and cash equivalents	157.1	264.7	148.0	154.9
Cash and cash equivalents at the beginning of period	1428.1	1585.3	1850.0	1998.0
Cash and cash equivalents at the end of period	1585.3	1850.0	1998.0	2152.9

Source: Company reports and J.P. Morgan estimates.

MercadoLibre, Overweight, ($15.69)

We are maintaining our Overweight rating on MercadoLibre, as we believe the company remains well-positioned to take advantage of the growth of online commerce in South America. Our 12-month price target is $24.

- **We are modeling nearly flat Y/Y dollar-denominated GMV growth through 3Q'09**. Although we see continued local-currency growth through the coming year, MercadoLibre faces a low-double-digit headwind from foreign exchange, as a result of which we think dollar-denominated GMV could stay roughly flat through the first three quarters even as the volume of trade in each of the countries increases. We are modeling a return to dollar-denominated growth once the FX impact is anniversaried in. We thus estimate 51% GMV growth in 4Q'09, helped also by our expectation of easy comps from 4Q'08 and in line with GMV growth in 2Q'08 and 3Q'08.
- **MercadoPago 3.0 rollout to continue, helping drive 29% projected Y/Y Payments revenue growth**. We expect the seller-pays payment paradigm will expand to additional geographies in the first half of F'09, to at least one of Brazil, Venezuela, or Mexico.
- **Ads and classifieds growth may slow, but remains a longer-term catalyst**. Although we think near-term ad revenue growth could slow, we think these non-GMV related, higher-margin revenue streams can be a contributor for margin expansion in the medium to long term. We are modeling F'10 EBITDA margin of 31.4%, up from 28.9% in F'08E.
- **2009 drivers**. In our view, the following factors will drive shares in 2009: (1) continuing strong Latin America eCommerce growth in local-currency terms, (2) contagion from a US recession as well as the impact of further currency fluctuations, (3) the impact of higher interest rates on financing and deferred-payment plans from MercadoPago and (4) the pace and execution of further MercadoPago rollouts.
- **Maintaining 4Q'08 and F'09 estimates**. We are maintaining our revenue, EBITDA and EPS estimates for 4Q'08 and F'09. We are slightly reducing our F'10 estimates, as we believe the economic challenges could continue for somewhat longer than we had previously expected. Our new estimates are summarized in the table below:

Table 135: MercadoLibre Financial Snapshot

$ in millions, except per share data

MELI	4Q'08E	F'08E	F'09E	F'10E	F'08E	Y/Y F'09E	F'10E
J.P. Morgan							
Revenue	34.2	137.7	163.8	219.0	62%	19%	34%
EBITDA	10.5	39.8	50.5	68.7	70%	27%	36%
EPS	$ 0.12	$ 0.36	$ 0.54	$ 0.75	65%	50%	38%
Consensus							
Revenue	35.1	140.6	181.1	254.3	65%	29%	40%
EBITDA	10.8	42.4	58.7	88.6	81%	39%	51%
EPS	$ 0.13	$ 0.39	$ 0.63	$ 1.03	80%	61%	62%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Key Financial Metrics & Forecasts

The following tables summarize our revenue forecast by business segment and our estimates for Y/Y growth in the company's Marketplaces and Payments segments through F'10.

Table 136: MercadoLibre Marketplaces Forecasts

US$ in millions except where indicated

	2007	2008E	2009E	2010E
Gross Merchandise Volume (GMV)	$ 1,512	$ 2,020	$ 2,261	$ 2,793
% Change Y-Y	*41%*	*34%*	*12%*	*24%*
Take Rate	4.6%	5.4%	5.6%	6.1%
Marketplaces Revenues	$ 69.5	$ 109.1	$ 126.9	$ 169.4
% Change Y-Y	*55%*	*57%*	*16%*	*33%*
GMV per successful item (US$)	$ 86.18	$ 96.37	$ 88.14	$ 90.01
Revenue per successful item (US$)	$ 3.96	$ 5.20	$ 4.95	$ 5.46
Successful items sold (M)	17.5	21.0	25.6	31.0

Source: Company reports and J.P. Morgan estimates.

Table 137: MercadoLibre Payments Forecasts

US$ in millions except where indicated

	2007	2008E	2009E	2010E
Total Payment Volume	$ 158	$ 282	$ 349	$ 457
% Change Y-Y	*77%*	*79%*	*24%*	*31%*
% of GMV	10.4%	14.0%	15.4%	16.3%
Take Rate	9.9%	10.1%	10.6%	10.9%
Payments Revenue	$ 15.6	$ 28.6	$ 36.9	$ 49.6
% Change Y-Y	*113%*	*83%*	*29%*	*34%*

Source: Company reports and J.P. Morgan estimates.

Our Estimates and Outlook for 2009

Our F'09 estimates call for Y/Y revenue, EBITDA and EPS growth of 19%, 27% and 16%, as we expect a tough macro environment as well as double-digit FX headwinds to result in a deceleration of growth. We are modeling revenue of $164M, EBITDA of $50.5M and EPS of $0.54.

We expect GMV to grow 12% in F'09, and we think that take rate growth will slow due to the tough environment, with the Marketplaces take rate rising to 5.6% from 5.4% in F'08E. On the MercadoPago side, we expect TPV growth to decelerate to 24% and revenue growth of 29%.

Our Estimates and Outlook for 2010

We think dollar growth rates are likely to rebound in F'10 once the FX headwind is anniversaried in. We are modeling a 24% increase in GMV and a 31% rise in TPV. We think the company will be able to benefit from a re-acceleration of its advertising and classified businesses, resulting in an F'10 take rate above 6% for the first time, at 6.1%.

We are modeling F'10 revenue of $219M, from $227M previously; EBITDA of $68.7M, from $72.0M; and EPS of $0.75, from $0.83.

We Are Introducing a Price Target of $24

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for MercadoLibre of a ~24% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 24x EV/EBIT multiple to our F'09 EBIT estimate (reflecting better forward visibility than the current valuation of 15x our F'09 estimate) and thus arrive at our December 2009 price target of $24.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 138: Key Valuation Assumptions

5 yr forward EBIT CAGR		24%
1x EBIT Growth		24
2009 EBIT	$	43
Implied Enterprise Value	$	1,037
+ Cash	$	34
- Debt		0
Market Value	$	1,071
Share count		44
2009 Price Target	$	24

Source: Company reports and J.P. Morgan estimates.

Our EV/EBIT valuation is based on the following projections for revenue and operating income growth

Table 139: 5-Year Growth Profile

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	163.8	219.0	280.3	344.8	403.4	459.8
Y/Y change		*33.7%*	28%	23%	17%	14%
Less: Operating Expenses	120.9	159.9	204.0	250.3	292.4	332.9
As % of total revenues	*73.8%*	*73.0%*	*72.8%*	*72.6%*	*72.5%*	*72.4%*
Operating Income (Loss)	42.9	59.1	76.2	94.5	110.9	126.9
Operating margin	*26.2%*	*27.0%*	27.2%	27.4%	27.5%	27.6%

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

On an EV/EBITDA basis, MELI trades at 12.5x our F'09 estimate of $50M, vs. its peer group at 12.5x. We think the company's fundamentals and its strong free cash flow generation would justify a premium valuation, and rate the stock Overweight.

Risks to Our Rating

We believe there are four primary risks to our Overweight rating on Mercadolibre:

- **Economic conditions:** Several of MercadoLibre's core markets have a history of economic turmoil and financial crises. An economic slowdown, brought on by regional or global economic weakness, or an economic upheaval, could negatively impact our estimates for eCommerce growth in the region and therefore growth for MercadoLibre.

- **Political environment and sovereign issues:** MercadoLibre operates in many countries with a history of political instability. Political instability could affect customers' confidence and therefore their willingness to purchase goods online. In addition, governments may limit Internet or commerce activities. We believe MercadoLibre's close work with local governments to monitor sales practices and the ability to track cash flows with MercadoPago mitigates some of this risk.

- **Expansion plans could stress resources:** MercadoLibre has grown through a number of acquisitions since its inception in 1999. As the company looks to grow into new product offerings and markets, it may look to acquire other companies or be forced to spend substantial cash to develop its own products. Either event could stress MercadoLibre's financial resources.

- **Low cost of entry business model.** Creating an online marketplace requires little capital, since the owner does not need to stock merchandise and fulfill orders. In addition, if Latin American e-commerce growth proves to be as attractive as some projections estimate, it might attract the interest of larger players, such as eBay, Google, Yahoo or Amazon, which have greater resources available to them than MercadoLibre. However, we believe both the first mover advantage and the marketplace scale that MercadoLibre has achieved act as barriers to entry for even deep-pocketed competitors.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 140: MercadoLibre Annual Income Statement

$ in millions

	2007	2008E	2009E	2010E
Merchandise GMV	1,511.6	2,020.3	2,260.7	2,793.4
Payment GMV	157.8	282.4	348.8	456.5
Auction Revenues	69.5	109.1	126.9	169.4
Payment Revenues	15.6	28.6	36.9	49.6
Total Revenues	85.1	137.7	163.8	219.0
Blended Take rate	5.1%	6.0%	6.3%	6.7%
Total Cost of Sales	18.9	28.4	35.1	46.1
Gross Profit	66.2	109.3	128.6	172.9
Gross Margin	77.8%	79.4%	78.5%	78.9%
Product & Technology Development	4.4	6.8	8.3	11.1
Sales and Marketing	27.6	41.5	51.6	69.4
General and Administrative	13.2	23.8	25.8	33.3
Acquisition-related compensation		1.9		
Total Operating Expenses	45.2	74.1	85.8	113.8
Income From Operations	21.0	35.2	42.9	59.1
Operating Margin	24.7%	25.6%	26.2%	27.0%
Depreciation and amortization	2.3	3.7	6.1	8.1
EBITDA	23.4	39.8	50.5	68.7
EBITDA Margins	27.4%	28.9%	30.8%	31.4%
Y/Y Growth	215.4%	70.2%	27.0%	36.1%
Interest income	1.6	1.6	1.7	2.1
Interest expense	(2.0)	(4.6)	(5.5)	(6.8)
Exchange gains (losses)	(3.1)	(5.7)	-	-
Other income, net	(3.0)	0.0	-	-
Other income (expense)	(6.5)	(8.6)	(3.8)	(4.7)
Income Before Income Taxes	14.5	26.6	39.1	54.4
Tax Rate	32.6%	39.8%	38.0%	38.0%
Income/ asset tax benefit (expense)	(4.7)	(10.6)	(14.8)	(20.7)
Net Income before disc.	9.8	16.0	24.2	33.7
Net income (loss)	9.8	16.0	24.2	33.7
Add back non-cash effect of warrants	2.0			
Pro forma Net Income	11.7	16.0	24.2	33.7
Accredition of preferred stock	(0.3)	-	-	-
Net income (loss) available to common	9.5	16.0	24.2	33.7
Pro Forma Net Income to common	11.4	16.0	24.2	33.7
Net Attributable to preferred	1.9	-	-	-
Net income ex. attributable to preferred	7.6	16.0	24.2	33.7
EPS ex. Attributable to preferred	0.22	0.36	0.54	0.75
Pro Forma EPS	0.46	0.41	0.54	0.75
Sharecount	24.8	44.3	44.6	45.0
Diluted Sharecount	24.8	44.4	44.8	45.2
% of Revenues				
Payment Revenue	18.3%	20.8%	22.5%	22.7%
Auction Revenue	81.7%	79.2%	77.5%	77.3%
Total Cost of Sales	22.2%	20.6%	21.5%	21.1%
Product and Technology Development	5.1%	5.0%	5.1%	5.1%
Sales and Marketing	32.4%	30.2%	31.5%	31.7%
General and Administrative	15.5%	17.3%	15.8%	15.2%
Total Operating Expenses	53.1%	53.8%	52.4%	52.0%
Y/Y Growth Rates				
Payment Revenues	112.9%	83.4%	28.9%	34.5%
Auction Revenues	55.4%	57.0%	16.3%	33.5%
Total Revenues	63.5%	61.8%	18.9%	33.7%
Product and Technology Development	42.4%	56.2%	22.3%	33.1%
Sales and Marketing	18.1%	50.5%	24.3%	34.5%
General and Administrative	62.4%	79.9%	8.4%	28.9%
Total Operating Expenses	30.7%	63.9%	15.8%	32.7%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 141: MercadoLibre Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Merchandise GMV	312.6	343.0	394.9	461.0	449.7	515.5	590.1	465.0	453.7	512.8	589.9	704.2
Payment GMV	26.4	31.0	43.6	56.8	52.3	66.8	81.5	81.8	70.6	85.5	93.7	99.0
Auction Revenues	14.2	16.1	18.1	21.1	23.5	28.3	31.7	25.6	25.4	28.7	33.3	39.4
Payment Revenues	2.3	2.9	4.7	5.8	5.4	6.2	8.5	8.6	7.3	9.0	10.0	10.6
Total Revenues	16.5	19.0	22.8	26.9	28.8	34.5	40.3	34.2	32.8	37.7	43.3	50.0
Blended Take rate	4.9%	5.1%	5.2%	5.2%	5.7%	5.9%	6.0%	6.2%	6.2%	6.3%	6.3%	6.2%
Total Cost of Sales	3.5	4.1	5.2	6.2	6.0	6.9	8.2	7.3	7.1	8.1	9.3	10.7
Gross Profit	13.0	14.9	17.6	20.7	22.8	27.6	32.1	26.8	25.7	29.6	34.0	39.4
Gross Margin	78.8%	78.5%	77.2%	77.1%	79.1%	80.0%	79.7%	78.5%	78.4%	78.5%	78.5%	78.7%
Product & Technology Development	1.0	1.0	1.2	1.2	1.7	1.7	1.7	1.6	1.9	2.1	2.2	2.1
Sales and Marketing	6.3	6.3	7.0	8.0	9.2	10.3	11.4	10.6	10.5	12.1	13.6	15.5
General and Administrative	2.7	2.8	3.5	4.3	4.9	5.9	7.3	5.7	5.3	6.1	7.0	7.5
Acquisition-related compensation					0.4	1.5						
Total Operating Expenses	10.0	10.2	11.6	13.4	16.3	19.4	20.4	17.9	17.8	20.3	22.7	25.0
Income From Operations	3.0	4.7	6.0	7.3	6.5	8.1	11.7	8.9	7.9	9.3	11.3	14.4
Operating Margin	18.3%	24.9%	26.3%	27.1%	22.7%	23.6%	29.0%	26.0%	24.2%	24.6%	26.1%	28.7%
Pro Forma Operating margin					*24.7%*	*28.1%*	*29.0%*	*26.0%*	*24%*	*25%*	*26%*	*29%*
Depreciation and amortization	0.5	0.6	0.6	0.6	0.7	0.8	1.0	1.2	1.2	1.4	1.6	1.9
EBITDA	3.5	5.3	6.6	7.9	7.3	9.0	13.0	10.5	9.5	11.1	13.3	16.6
EBITDA Margins	21.6%	28.0%	28.8%	29.5%	25.2%	26.1%	32.3%	30.7%	29.1%	29.3%	30.7%	33.2%
Y/Y Growth	182.3%	172.8%	297.7%	211.0%	105.0%	69.4%	98.4%	31.8%	31.0%	23.0%	2.1%	58.5%
Interest income	0.1	0.4	0.4	0.7	0.7	0.3	0.3	0.3	0.4	0.4	0.4	0.5
Interest expense	(0.4)	(0.4)	(0.4)	(0.8)	(1.4)	(1.0)	(1.1)	(1.1)	(1.3)	(1.3)	(1.4)	(1.5)
Exchange gains (losses)	(0.4)	(0.6)	(0.8)	(1.3)	(1.0)	(2.1)	(2.6)					
Other income, net	(0.3)	(1.8)	(1.0)	-	-	0.0	0.0	-	-	-	-	-
Other income (expense)	(1.0)	(2.3)	(1.8)	(1.4)	(1.6)	(2.7)	(3.4)	(0.9)	(0.9)	(0.9)	(1.0)	(1.0)
Income Before Income Taxes	2.0	2.4	4.2	5.9	4.9	5.4	8.3	8.0	7.0	8.4	10.3	13.4
Tax Rate	45.0%	75.5%	33.5%	10.4%	58.1%	45.5%	28.9%	36.0%	38.0%	38.0%	38.0%	38.0%
Income/ asset tax benefit (expense)	(0.9)	(1.8)	(1.4)	(0.6)	(2.9)	(2.5)	(2.4)	(2.9)	(2.7)	(3.2)	(3.9)	(5.1)
Net Income before disc.	1.1	0.6	2.8	5.3	2.1	2.9	5.9	5.1	4.4	5.2	6.4	8.3
Net income (loss)	1.1	0.6	2.8	5.3	2.1	2.9	5.9	5.1	4.4	5.2	6.4	8.3
Add back non-cash effect of warrants	0.2	1.1	0.6									
Pro forma Net Income	1.3	1.7	3.4	5.3	2.1	2.9	5.9	5.1	4.4	5.2	6.4	8.3
Accredition of preferred stock	(0.1)	(0.1)	(0.1)									
Net income (loss) available to common	1.0	0.5	2.7	5.3	2.1	2.9	5.9	5.1	4.4	5.2	6.4	8.3
Pro Forma Net Income to common	1.1	1.6	3.3	5.3	2.1	2.9	5.9	5.1	4.4	5.2	6.4	8.3

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 141: MercadoLibre Quarterly Income Statement (cont.)

Net Attributable to preferred	0.7	0.3	0.9	-	-	-	-	-	-	-	-	-
Net income ex. attributable to preferred	0.3	0.2	1.8	5.3	2.1	2.9	5.9	5.1	4.4	5.2	6.4	8.3
EPS ex. Attributable to preferred	0.02	0.01	0.07	0.12	0.05	0.07	0.13	0.12	0.10	0.12	0.14	0.18
Pro Forma EPS	0.04	0.09	0.09	0.12	0.06	0.10	0.13	0.12	0.10	0.12	0.14	0.18
Sharecount	13.4	14.0	27.5	44.1	44.2	44.2	44.3	44.4	44.5	44.6	44.7	44.8
Diluted Sharecount	13.4	14.0	27.7	44.3	44.4	44.4	44.4	44.6	44.7	44.8	44.9	45.0
% of Revenues												
Payment Revenue	13.8%	15.2%	20.4%	21.6%	18.6%	17.9%	21.2%	25.1%	22.4%	23.8%	23.0%	21.2%
Auction Revenue	86.2%	84.8%	79.6%	78.4%	81.4%	82.1%	78.8%	74.9%	77.6%	76.2%	77.0%	78.8%
Operating Expenses, % of revenues												
Total Cost of Sales	21.2%	21.5%	22.8%	22.9%	20.9%	20.0%	20.3%	21.5%	21.6%	21.5%	21.5%	21.3%
Product and Technology Development	5.9%	5.4%	5.1%	4.5%	6.0%	5.0%	4.3%	4.7%	5.9%	5.7%	5.0%	4.2%
Sales and Marketing	38.4%	33.4%	30.6%	29.6%	32.0%	29.8%	28.4%	31.1%	32.1%	32.1%	31.3%	30.9%
General and Administrative	16.3%	14.8%	15.3%	15.8%	17.2%	17.1%	18.0%	16.7%	16.2%	16.1%	16.1%	14.9%
Total Operating Expenses	60.5%	53.6%	51.0%	50.0%	56.4%	56.3%	50.7%	52.5%	54.2%	53.9%	52.4%	50.0%
Y/Y Growth Rates												
Payment Revenues	60.9%	81.5%	141.8%	141.1%	136.7%	113.4%	82.9%	48.1%	37.0%	45.7%	17.2%	23.3%
Auction Revenues	48.1%	49.1%	60.6%	61.5%	65.4%	76.0%	75.0%	21.2%	8.2%	1.4%	5.0%	54.2%
Total Revenues	49.8%	53.2%	72.4%	73.9%	75.2%	81.7%	76.6%	27.0%	13.6%	9.4%	7.6%	46.4%
Product and Technology Development	38.0%	34.7%	48.0%	48.0%	79.0%	68.2%	51.1%	32.4%	10.9%	24.1%	24.1%	30.9%
Sales and Marketing	24.9%	14.4%	15.4%	18.6%	45.9%	62.2%	63.6%	33.3%	14.1%	17.9%	18.7%	45.5%
General and Administrative	39.1%	48.0%	67.6%	89.7%	84.9%	109.1%	108.4%	34.1%	7.2%	3.2%	-4.0%	30.6%
Total Operating Expenses	29.7%	24.1%	30.4%	37.3%	63.4%	91.0%	75.8%	33.5%	9.0%	4.6%	11.1%	39.5%
Q/Q Growth Rates												
Payment Revenues	-5.9%	27.5%	61.3%	24.5%	-7.6%	14.9%	38.3%	0.8%	-14.5%	22.3%	11.2%	6.1%
Auction Revenues	8.7%	13.3%	12.8%	16.3%	11.3%	20.6%	12.1%	-19.4%	-0.6%	13.0%	16.1%	18.3%
Total Revenues	6.4%	15.3%	20.2%	18.0%	7.2%	19.5%	16.8%	-15.1%	-4.1%	15.1%	14.9%	15.5%
Product and Technology Development	18.9%	5.7%	12.2%	5.0%	43.8%	-0.7%	0.8%	-8.0%	20.3%	11.2%	0.8%	-3.0%
Sales and Marketing	-6.0%	0.2%	10.3%	14.1%	15.6%	11.4%	11.3%	-7.0%	-1.0%	15.1%	12.0%	14.0%
General and Administrative	19.3%	5.1%	23.9%	22.1%	16.3%	18.8%	23.5%	-21.4%	-7.0%	14.4%	14.9%	6.9%

Source: Company reports and J.P. Morgan estimates

Table 142: MercadoLibre Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Assets				
Current assets				
Cash and cash equivalents	15.7	12.5	41.2	80.2
Short-term investments	52.3	20.5	20.5	20.5
Accounts receivable	3.2	4.0	5.9	8.2
Funds receivable from customers	29.2	33.2	47.8	66.0
Prepaid expenses	0.3	1.0	1.5	2.1
Deferred tax assets	3.4	3.9	5.6	7.7
Other current assets	0.9	1.8	2.8	4.0
Total Current Assets	105.0	77.0	125.3	188.6
Non-current assets				
Long-term investments	1.3	3.1	3.1	3.1
Property & equipment, net	4.1	6.1	6.9	7.7
Gooodwill & intangibles, net	23.4	80.6	80.6	80.6
Deferred tax assets	0.3	-	-	-
Other assets	0.4	0.5	0.5	0.5
Total Non-Current Assets	29.5	90.2	91.0	91.8
Total Assets	134.5	167.2	216.3	280.5
Current liabilities				
Accounts payable and accrued expenses	9.3	12.8	19.2	27.1
Funds payable to customers	16.4	15.4	23.7	33.6
Social security payable	3.8	4.5	6.3	8.6
Taxes payable	2.5	3.5	5.1	7.1
Loans payable	9.7	18.5	18.5	18.5
Provisions	0.1	1.0	1.0	1.0
Total Current Liabilities	41.8	55.6	73.8	95.9
Non-current liabilities				
Loans payable	-	-	-	-
Other liabilities	1.1	4.0	5.2	6.4
Total non-current liabilities	1.1	4.0	5.2	6.4
Total Liabilities	42.8	59.6	79.0	102.4
Shareholders equity				
Common stock	0.0	0.0	0.0	0.0
Additional paid-in capital	121.9	125.7	131.2	138.3
Accumulated deficit	(34.4)	(18.3)	5.9	39.6
Accumulated other comprehensive income	4.1	0.1	0.1	0.1
Total shareholders' equity (deficit)	91.7	107.5	137.3	178.1
Total Liabilities and shareholders' equity	134.5	167.2	216.3	280.5

Source: Company reports and J.P. Morgan estimates.

Table 143: MercadoLibre Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Cash flows from operations				
Net income	9.8	16.0	24.2	33.7
Depreciation & amortization	2.3	3.7	6.1	8.1
Interest expense (income)	-	1.0	5.5	6.8
Realized gains on investments	(0.8)	(1.3)	-	-
Unrealized gains on investments	(0.2)	0.2	-	-
Stock-based compensation expense	0.0	0.8	1.6	1.6
Cumulative effect of change in accounting	-	-	-	-
Change in fair value of warrants	3.0	-	-	-
Deferred income taxes	(0.2)	(0.2)	-	-
Changes in working capital	(7.0)	(0.7)	(2.0)	(3.2)
Accounts receivable	(0.7)	6.5	(1.9)	(2.3)
Funds receivable from customers	(15.5)	(7.3)	(14.6)	(18.2)
Prepaid expenses	0.1	(0.7)	(0.5)	(0.6)
Other assets	(1.0)	(0.1)	(1.0)	(1.2)
Accounts payable	4.3	2.5	6.5	7.9
Funds payable to customers	5.4	0.4	8.3	9.9
Provisions	(0.3)	(0.5)	-	-
Other liabilities	0.7	(1.4)	1.2	1.2
Net cash provided by operating activities	6.9	19.7	35.3	46.9
FCF = Operating Cash Flow - Capex	3.8	14.3	28.6	39.0
FCF, % of EBITDA	16.2%	36.0%	56.7%	56.8%
Cash flows from investing activities				
Purchase of investments	(75.3)	(59.6)		
Proceeds from sale of investments	29.8	90.6		
Payment for purchases, net of cash required	-	(39.2)		
Purchase of intangible assets	(0.0)	(0.1)		
Purchase of property and equipment	(3.1)	(5.4)	(6.7)	(7.9)
Net cash provided by investing activities	(48.6)	(13.6)	(6.7)	(7.9)
Cash flows from financing activities				
Increase in short term debt	8.9	0.0	-	-
Decrease in short term debt	-	(9.6)	-	-
Loans paid	(9.0)	-	-	-
Proceeds from stock issuance	49.6	-	-	-
Stock options and warrants exercised	0.8	0.1	-	-
Net cash provided by investing activities	50.2	(9.5)	-	-
Effects of exchange rates on cash	0.1	0.3	-	-
Cash and equivalents, beginning of period	7.1	15.7	12.5	41.2
Net increase (decrease) in cash	8.6	(3.2)	28.6	39.0
Cash and equivalents, end of period	15.7	12.5	41.2	80.2

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Omniture, Overweight, ($9.85)

We are maintaining our Overweight rating on Omniture, as we continue to expect web analytics to become a core necessity for Internet enterprises, and we believe Omniture's standing as the clear leader in the space positions the company well to benefit from this industry growth. Our 12-month price target for OMTR is $17.

- **Cross-selling larger product portfolio is a key growth driver**. Omniture continues to enhance and enlarge its product offerings; most recently the company added online merchandizing technology and personnel acquired from Mercado. We think the ability to use a single sales force (augmented on occasion by more specialized staff) gives Omniture an opportunity to grow its ticket size from existing customers, and improves customer lock-in by creating additional ways to make a more compelling product.
- **F'09 revenue growth likely to see impact from soft IT spending**. We are modeling only a 33% rise in non-GAAP revenue growth in F'09. At the same time, our industry contacts suggest most companies that use a paid analytics product do not see it as discretionary; thus, we don't expect churn to rise. Further, we think a greater focus on costs at search companies and other competitors could work in Omniture's favor. Omniture has the scale to continue investing in product and a paid customer base for such investments to yield positive returns.
- **Profitability growth likely to be muted until revenue growth fades**. Omniture faces significant up-front costs and CapEx as each new customer or product is added, in order to build out network and server capacity to handle traffic from the new customer; new contracts can take two-three quarters to start paying for themselves. As long as Omniture's sales pipeline remains healthy, the client onboarding costs are likely to constrain margins growth. In the longer run, however, we continue to believe 25% EBITDA margins are achievable.
- **2009 drivers.** In our view, the following factors will drive shares in 2009: (1) the IT spending environment, (2) impact from changes in the competitive environment, including both paid competitors and free offerings, (3) international growth and (4) the ability to boost ASP through cross-selling.
- **Maintaining our 4Q'08, F'08 estimates**. We are maintaining our estimates for non-GAAP revenue, EBITDA and EPS for 4Q'08 of $85.0M. Our current and newly introduced 2010 estimates are in the table below:

Table 144: Omniture Financial Snapshot

$ in millions, except per share data

OMTR						Y/Y	
	4Q'08E	F'08E	F'09E	F'10E	F'08E	F'09E	F'10E
J.P. Morgan							
Revenue	85.0	309.1	409.8	511.2	113%	33%	25%
EBITDA	17.0	59.1	77.4	97.8	164%	31%	26%
EPS	$ 0.12	$ 0.42	$ 0.61	$ 0.77	116%	44%	26%
Consensus							
Revenue	84.8	307.22	394.13	506.14	112%	28%	28%
EBITDA	17.52	59.44	83.21	111.23	166%	40%	34%
EPS	$ 0.13	$ 0.43	$ 0.64	$ 0.86	120%	48%	36%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We believe F'09 is likely to turn on two competing forces: on the one hand, we expect both IT and marketing spend to be soft Y/Y. On the other hand, we see analytics as increasingly becoming a must-have tool for enterprise website operators. As such, we are forecasting for Omniture to continue adding customers and tickets, but for revenue growth to slow somewhat.

We are maintaining our F'09 revenue estimate of $410M, representing 33% Y/Y growth; our EBITDA estimate of $77M, up 31% Y/Y, and slightly pushing up our pro forma EPS estimate to $0.61, from $0.59.

Our Estimates and Outlook for 2010

We are introducing our estimates for F'10, as follows. We expect revenue to grow 25% Y/Y in F'10 to $511M. We are modeling 26% Y/Y EBITDA growth, to $98M, representing slight margin expansion, and we are projecting F'10 EPS of $0.77, up 26% Y/Y.

We Are Introducing a Price Target of $17

As our model calls for a negative GAAP EBIT value for Omniture in F'09, our price target is predicated on a DCF analysis, with the following parameters:

Table 145: Key DCF Assumptions

Equity beta	1.37
Risk free rate (10yr yield)	4.3%
Risk premium	7.0%
Cost of Equity	13.9%
Cost of debt	7.5%
Final debt ratio	5.0%
Equity as a % Cap	95.0%

Source: Company reports and J.P. Morgan estimates.

Table 146: Growth Profile

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	409.8	511.2	608.4	699.6	783.6	854.1
Y/Y change		*24.8%*	19%	15%	12%	9%
Less: Operating Expenses	423.5	514.7	602.3	678.6	748.3	802.8
As % of total revenues	*103.3%*	*100.7%*	*99.0%*	*97.0%*	*95.5%*	*94.0%*
Operating Income (Loss)	(13.7)	(3.5)	6.1	21.0	35.3	51.2
Operating margin	*-3.3%*	*-0.7%*	1.0%	3.0%	4.5%	6.0%
Less: taxes	(4.1)	(1.0)	2.1	7.3	12.3	17.9
tax rate	*30.0%*	*30.0%*	*35.0%*	*35.0%*	*35.0%*	*35.0%*
Unlevered Net Income	(9.6)	(2.4)	4.0	13.6	22.9	33.3
Add Back: Depreciation and SBC	91.1	101.3	120.5	138.6	155.3	169.2
Less: Capital Expenditure	(49.0)	(56.0)	(34.0)	(31.9)	(29.4)	(24.7)
As % of total revenues	*12.0%*	*11.0%*	*5.6%*	*4.6%*	*3.8%*	*2.9%*
Plus/(Minus): Working Capital Changes	(0.2)	(4.3)	(4.5)	(4.8)	(5.0)	(5.3)
As % of total revenues	*0.0%*	*-0.8%*	*-0.7%*	*-0.7%*	*-0.6%*	*-0.6%*
Free Cash Flow	32.3	38.5	86.0	115.6	143.8	172.6

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

Given Omniture's industry-leading growth rates, continued market share gains, and strong operating leverage, we continue to think OMTR shares deserve a premium valuation to peers' and are maintaining our Overweight rating. On an EV/EBITDA basis, Omniture currently trades at 10.0x our F'09 EBITDA estimate of $77M, compared to its peer group (platform enablers) which currently trades at 8.7x F'09 estimates.

Risks to Our Rating

Omniture derives more than 85% of its revenue from subscription revenues. If the company undergoes a precipitous rise in churn rates, the company's revenue growth could be impacted. The web analytics space is extremely competitive. The recent acquisition of Visual Sciences is the biggest in Omniture's history, and should the integration of the two companies turn out more challenging than currently expected, the stock could face pressure. Further, Google's offering of free analytics may entice some mid-market customers to discontinue paying for web analytics, or may pressure Omniture's existing pricing dynamics. Also, if Omniture fails to gain market share as we anticipate, our revenue estimates could prove optimistic. Finally, Omniture's numerous enterprise customers could choose to build analytics solutions in-house, which could negatively impact the company's growth rates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 147: Omniture Annual Income Statement

$ in millions

	2007	2008E	2009E	2010E
Subscription	132.0	264.4	365.1	461.4
Professional services and other	11.1	31.8	44.7	49.8
Total Revenues	143.1	296.1	409.8	511.2
Deferred revenue adjustment	1.8	13.0	-	-
Total non-GAAP revenue	145.0	309.1	409.8	511.2
Cost of Revenues	53.4	125.4	148.6	183.7
SBC Componenent of Cost of Revenue	1.9	5.2	4.4	6.1
Gross Profit	89.8	170.7	261.1	327.5
Gross Margin	62.7%	57.6%	63.7%	64.1%
Non-GAAP Gross Margin	67.2%	67.2%	69.7%	69.6%
Amortization of Intangibles in Cost of Revenues	3.8	18.7	20.0	22.0
Sales & marketing	61.6	129.8	169.0	205.8
Research & development	17.3	37.0	42.2	51.8
General and administrative	24.2	46.9	63.7	73.4
Litigation settlement	-	-	-	-
Total Operating Expenses	103.1	213.7	274.9	331.0
Operating Profit (Loss)	(13.3)	(43.0)	(13.7)	(3.5)
Operating Margin	-9.3%	-14.5%	-3.3%	-0.7%
Adjusted EBITDA	22.4	59.1	77.4	97.8
EBITDA Margin	*15.6%*	*20.0%*	*18.9%*	*19.1%*
	178.1%	*164.2%*	*30.9%*	*26.4%*
Other Income (Expense)	4.4	0.4	-	-
Profit (Loss) before provision for income taxes	(8.9)	(42.6)	(13.7)	(3.5)
Provision for income taxes	0.5	1.6	(2.3)	(0.3)
Net Income (Loss) - GAAP	(9.4)	(44.3)	(11.4)	(3.2)
Net Income (Loss) - Pro forma	11.8	32.2	47.8	61.6
EPS - GAAP (w/FAS123R)	$ (0.18)	$ (0.62)	$ (0.15)	$ (0.04)
EPS - Pro forma (ex-FAS123R)	$ 0.20	$ 0.42	$ 0.61	$ 0.77
Basic Shares Outstanding	53.7	71.6	74.2	75.8
Diluted Shares Outstanding	60.2	76.1	78.3	79.9
% of Revenue				
Sales & marketing	43.0%	43.8%	41.2%	40.3%
Research & development	12.1%	12.5%	10.3%	10.1%
General and administrative	16.9%	15.8%	15.5%	14.4%
Growth Y/Y				
Subscription	77.0%	100.3%	38.1%	26.4%
Professional services and other	115.1%	185.6%	40.8%	11.4%
Total Revenues	79.5%	106.9%	38.4%	24.8%
Sales & marketing	74.9%	110.7%	30.2%	21.8%
Research & development	97.6%	114.6%	13.9%	22.8%
General and administrative	100.0%	93.5%	35.9%	15.2%
Total Expenses	83.9%	107.3%	28.6%	20.4%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 148: Omniture Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Subscription	27.3	30.6	34.4	39.728	57.2	64.6	69.6	73.0	87.2	91.6	92.1	94.1
Professional services and other	1.8	2.9	3.0	3.385	6.0	7.0	8.2	10.5	10.8	11.0	11.4	11.6
Total Revenues	29.2	33.5	37.4	43.1	63.2	71.6	77.8	83.5	98.0	102.6	103.5	105.7
Deferred revenue adjustment	0.3	0.6	0.4	0.6	6.4	3.3	1.9	1.5	-	-	-	-
Total non-GAAP revenue	29.5	34.1	37.8	43.7	69.6	74.9	79.7	85.0	98.0	102.6	103.5	105.7
Cost of Revenues	10.7	12.7	13.8	16.0	26.9	30.7	32.9	34.9	35.8	37.3	37.5	38.2
SBC Componenent of Cost of Revenue	0.4	0.5	0.5	0.5	1.9	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Gross Profit	18.4	20.7	23.5	27.1	36.3	40.9	44.9	48.6	62.2	65.4	66.0	67.5
Gross Margin	63.2%	61.9%	63.0%	62.8%	57.4%	57.1%	57.7%	58.2%	63.5%	63.7%	63.8%	63.9%
Non-GAAP Gross Margin	66.9%	67.2%	67.3%	67.2%	70.1%	66.9%	66.1%	66.0%	69.7%	69.6%	69.7%	69.7%
Amortization of Intangibles in Cost of Revenues	*0.6*	*1.0*	*1.0*	*1.2*	*4.3*	*4.8*	*4.8*	*4.9*	*5.0*	*5.0*	*5.0*	*5.0*
Sales & marketing	13.3	15.3	15.7	17.2	31.2	32.2	32.7	33.7	41.9	43.0	42.1	42.0
Research & development	3.1	4.0	4.7	5.5	9.8	8.8	9.2	9.2	10.5	10.9	10.6	10.3
General and administrative	4.4	5.9	6.4	7.6	10.8	11.8	11.4	12.9	15.6	16.0	16.0	16.1
Total Operating Expenses	20.9	25.2	26.8	30.3	51.8	52.8	53.3	55.8	68.0	69.9	68.7	68.3
Operating Profit (Loss)	(2.4)	(4.5)	(3.2)	(3.2)	(15.5)	(11.9)	(8.4)	(7.2)	(5.8)	(4.5)	(2.7)	(0.7)
Operating Margin	-8.4%	-13.3%	-8.6%	-7.5%	-24.6%	-16.6%	-10.8%	-8.6%	-5.9%	-4.4%	-2.6%	-0.7%
Adjusted EBITDA	4.0	5.1	6.1	7.2	12.2	13.7	16.2	17.0	16.3	18.1	20.3	22.7
EBITDA Margin	*13.6%*	*15.1%*	*16.4%*	*16.7%*	*19.3%*	*19.1%*	*20.9%*	*20.3%*	*16.7%*	*17.6%*	*19.6%*	*21.4%*
Other Income (Expense)	0.0	0.5	2.2	1.7	0.7	0.2	(0.5)	-				
Profit (Loss) before provision for income taxes	(2.4)	(4.0)	(1.0)	(1.5)	(14.8)	(11.8)	(8.9)	(7.2)	(5.8)	(4.5)	(2.7)	(0.7)
Provision for income taxes	0.0	0.1	0.1	0.3	(1.9)	(5.3)	8.4	0.4	(0.7)	(0.8)	(0.5)	(0.3)
Net Income (Loss) - GAAP	(2.4)	(4.1)	(1.1)	(1.8)	(12.9)	(6.5)	(17.3)	(7.6)	(5.1)	(3.7)	(2.2)	(0.4)
Net Income (Loss) - Pro forma	0.9	1.9	4.4	4.6	7.3	7.3	8.2	9.4	9.2	11.0	12.8	14.8
EPS - GAAP (w/FAS123R)	$(0.05)	$(0.08)	$0.02)	$(0.03)	$(0.19)	$(0.09)	$(0.24)	$(0.10)	$(0.07)	$(0.05)	$(0.03)	$(0.01)
EPS - Pro forma (ex-FAS123R)	$ 0.02	$ 0.03	$ 0.07	$ 0.07	$ 0.10	$ 0.10	$ 0.11	$ 0.12	$ 0.12	$ 0.14	$ 0.16	$ 0.19
Basic Shares Outstanding	47.8	49.8	57.9	59.4	69.2	71.7	72.2	73.2	73.6	74.0	74.4	74.8
Diluted Shares Outstanding	54.4	56.1	64.3	65.9	74.2	76.5	76.3	77.3	77.7	78.1	78.5	78.9
% of Revenue												
Sales & marketing	45.7%	45.8%	42.0%	40.0%	49.4%	44.9%	42.0%	40.4%	42.8%	41.9%	40.7%	39.7%
Research & development	10.8%	11.9%	12.5%	12.7%	15.5%	12.4%	11.8%	11.0%	10.7%	10.6%	10.2%	9.7%
General and administrative	15.0%	17.5%	17.1%	17.6%	17.1%	16.5%	14.6%	15.4%	15.9%	15.6%	15.5%	15.2%
Growth Y/Y												
Subscription	75.8%	73.9%	75.9%	81.3%	109.3%	111.1%	102.4%	83.9%	52.5%	41.8%	32.5%	28.9%
Professional services and other	104.6%	134.5%	102.5%	117.8%	229.7%	144.1%	172.1%	209.1%	78.1%	57.3%	38.0%	10.4%
Total Revenues	77.4%	77.9%	77.8%	83.8%	116.8%	113.9%	108.1%	93.7%	55.0%	43.3%	33.0%	26.6%

Source: Company reports and J.P. Morgan estimates

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 149: Omniture Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
ASSETS				
Cash & cash equivalents	77.8	71.0	101.5	139.3
Short-term investments	56.9	5.1	5.3	5.6
Accounts receivable, net	52.0	106.5	135.6	176.2
Prepaid expenses & other current assets	5.7	6.7	7.7	9.6
Total Current Assets	192.4	189.2	250.1	330.7
Property and equipment, net	31.2	67.4	84.5	104.0
Intangible assets, net	50.8	131.2	100.1	68.2
Goodwill	95.0	419.5	419.5	419.5
Other assets	1.4	24.1	30.5	39.5
Total Non-Current Assets	178.4	642.1	634.5	631.2
Total Assets	370.7	831.3	884.6	961.9
LIABILITIES				
Accounts Payable	6.5	12.8	16.2	21.0
Accrued Liabilities	17.1	34.9	44.2	57.3
Deferred Revenues	42.0	96.0	117.0	142.6
Current notes payable, capital lease obligations	4.7	5.3	6.8	8.8
Deferred Consideration related to business acq	-	-	-	-
Total Current Liabilities	70.3	149.1	184.2	229.6
Deferred revenues, less current	1.8	10.1	11.9	12.4
Notes payable, less current portion	2.9	7.5	9.5	12.4
Capital lease obligations, less current portion	0.2	0.1	0.1	0.1
Other liabilities	4.4	6.3	8.0	10.4
Total LT Liabilities	9.4	24.0	30.4	39.5
Total Liabilities	79.6	173.1	214.6	269.1
Total Stockholders' Equity	291.1	658.2	670.0	692.8
Total Liabilities & Owners Equity	370.7	831.3	884.6	961.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 150: Omniture Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
OPERATING ACTIVITIES				
Net Income (Loss)	(9.4)	(44.3)	(11.4)	(3.2)
Depreciation	13.9	25.9	31.9	36.5
Amortization	5.8	30.5	31.1	31.9
Stock-based compensation	13.5	32.7	28.1	32.9
Loss on disposal of property and equipment	(0.0)	-	-	-
Patent license and litigation settlement costs	-	-	-	-
Loss on foreign currency forward contract/other	0.2	0.0	-	-
Changes in Working Capital				
Accounts receivable, net	(23.1)	(36.4)	(29.1)	(40.6)
Prepaid expenses and other assets	(1.6)	(2.7)	(7.4)	(11.0)
Account payable	2.1	5.1	3.4	4.8
Accrued and other liabilities	0.6	4.9	9.3	13.1
Deferred revenue	16.2	53.5	23.7	29.3
Deferred gain on extinguishment of debt	-	-	-	-
Net Cash Provided by Operating Activities	18.3	69.2	79.5	93.8
Free Cash Flow (FCF)	6.3	17.6	30.5	37.8
INVESTING ACTIVITIES				
Purchases of short-term investments, net	(55.9)	32.2	-	-
Purchases of property and equipment (CAPX)	(12.0)	(51.6)	(49.0)	(56.0)
Purchase of intangible assets	(4.5)	(3.3)	-	-
Payment related to foreign currency forward contract	(0.3)	(0.3)	-	-
Business acquisitions, net of cash	(78.9)	(60.5)	-	-
Net Cash Provided by Investing Activities	(151.6)	(83.5)	(49.0)	(56.0)
FINANCING ACTIVITIES				
Proceeds from exercise of stock options	3.6	8.6	-	-
Proceeds from employee SPP	0.2	0.3	-	-
Proceeds from issuance of preferred stock, net	-	-	-	-
Repurchase of preferred / vested restr. stock	-	(1.0)	-	-
Repurchase of preferred warrants	-	-	-	-
Proceeds from issuance of notes payable, capital leases	2.4	8.0	-	-
Issuance of common stock through IPO	142.2	-	-	-
Principal payments on notes payable, capital leases	(5.7)	(7.8)	-	-
Net Cash Provided by Financing Activities	142.7	8.1	-	-
Effect of FX on Cash & Equivalents	0.1	(0.6)		
Net Increase in Cash & Equivalents	9.5	(6.8)	30.5	37.8
Cash & Equivalents at Beginning of Period	68.3	77.8	71.0	101.5
Cash & Equivalents at End of Period	77.8	71.0	101.5	139.3

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Orbitz Worldwide, Neutral, ($3.65)

We think Orbitz will have a very difficult 2009, as we believe it is the least well positioned OTA. Despite some progress in diversifying its business away from air tickets, the business still accounts for 72% of total gross bookings. Additionally, Orbitz boasts the largest leverage ratio of over 4x our F'09 EBITDA estimate. However, at 2.2x our F'09 EBITDA estimate of $136M, we think Orbitz's valuation already reflects these weaknesses and has limited downside. We are reiterating our Neutral rating.

- **Domestic growth is likely to be muted due to weaknesses in the air business**. Although we expect all travel bookings to be impacted by the weak economy, we think air products will be hit the hardest, as the industry has significantly lowered air inventory through capacity cuts. With our J.P. Morgan airlines industry equity analyst estimating F'09 capacity declines of 7-8% following F'08's 7-8% declines and over 70% of OWW gross bookings coming from air products, we think this will have a significant impact on OWW top-line performance.
- **Top-line growth may further be hindered by promotional activity.** As consumers have become more focused on value, we think Orbitz may respond with increased promotional activity. Recently, the company introduced its PriceAssurance program and has sent thousands of refund checks. We foresee these types of promotions continuing going forward.
- **High leverage will likely limit cash investments**. With almost $600M in debt, Orbitz is leveraged at over 4x our F'09E EBITDA. We are concerned that this could limit the company's ability to make strategic investments.
- **2009 drivers.** In our view, the following factors will drive OWW shares in 2009: (1) cash balance and leverage ratios, (2) shifts toward non-air products, and (3) advertising revenues.
- **Maintaining 4Q'08 estimates.** We are maintaining our estimates for 4Q revenue, EBITDA, and EPS of $205M, $44M, and $0.05, respectively.

Our current and newly introduced 2010 estimates are in the table below:

Table 151: Orbitz Financial Snapshot

$ in millions, except per share data

OWW	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	205.4	895.4	865.1	921.7	6.1%	-3.4%	6.5%
EBITDA	44.0	145.0	136.2	143.1	-0.9%	-6.1%	5.0%
EPS	0.05	-3.63	-0.27	-0.30	NA	NA	NA
Consensus							
Revenue	195.8	883.3	864.9	877.3	4.6%	-2.1%	1.4%
EBITDA	33.2	130.8	133.4	138.3	-10.6%	2.0%	3.7%
EPS	-0.04	-2.67	-0.16	0.08	NA	NA	NA

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

Our F'09 estimates call for revenue, EBITDA, and EPS of $865M, $136M, and ($0.27). We think domestic gross bookings will decline 4% Y/Y as the company faces airline booking and ADR headwinds. We are modeling international gross bookings to decline 11% Y/Y with the same headwinds and the additional negative effect of foreign currency exchange rates. However, despite the weak top-line growth, we do think the company will carefully control costs and are looking for a 10% reduction in headcount, which should reduce payroll expenses by ~$20M. Although we are encouraged by the company's intention to manage costs, we think margins will be pressured by continued marketing expenses and fixed costs. As such, we are modeling adjusted EBITDA margins to fall to 15.7% from 16.2%.

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and EPS estimates of $922M, $143M, and ($0.30). Our model assumes a healthy rebound of growth due to an easing of the recessionary environment, easier comps, and a flat FX exchange rate. We are looking for US gross bookings growth of 3% Y/Y and international gross bookings growth of 17% Y/Y. We expect the EBITDA margin to decline an additional 20 basis points due to likely keyword inflation.

Valuation and Rating Analysis

Orbitz is trading at 2x our pro forma F'09 EBITDA estimate of $136M, which is a discount to the peer group average of 6x. Given the economic and company-specific headwinds, we believe this discount is justified and reiterate our Neutral rating.

Risks to Our Rating

Orbitz could outperform our expectations if 1) hotel product sales and international sales exceed our expectations, 2) further acquisitions are made in the international space, 3) the company gains market share against its existing online travel agent competitors, or 4) the online travel market achieves penetration levels beyond our current expectations.

The company's shares could underperform if the company is unable to 1) withstand the competitive threat that the travel suppliers and travel search engines pose, 2) maintain its domestic leadership position, 3) economic conditions hinder top-line growth, and 4) if it is unable to successfully expand into the international market or increase hotel sales.

Table 152: OWW Annual Income Statement

$ in millions

	FY 2007	FY 2008E	FY 2009E	FY 2010E
Gross Bookings				
Americas	9,393	9,291	8,913	9,181
International	1,399	1,741	1,551	1,813
Total gross bookings:	10,792	11,032	10,464	10,993
Q/Q gross bookings growth				
Y/Y gross bookings growth	*10.3%*	*2.2%*	*-5.1%*	*5.1%*
Americas Revenue	680	699	697	727
International Revenue	165	196	168	195
Total Revenue	844	895	865	922
Y/Y revenue growth	*16.4%*	*6.1%*	*-3.4%*	*6.5%*
Revenue Margins	*7.8%*	*8.1%*	*8.3%*	*8.4%*
Cost of Goods Sold	152	173	172	191
Total Gross Profit	692	722	693	731
Operating Expenses				
SG&A	297	288	275	288
Marketing	296	312	303	325
Depreciation & Amortization	57	66	72	76
Impairment of Intangible Assets	0	297	0	0
Total Operating Expenses	650	962	650	689
Adjusted EBITDA	146	145	136	143
EBITDA Margin	*17.3%*	*16.2%*	*15.7%*	*15.5%*
Reported EBIT	44.3	(240.0)	43.2	42.1
Operating Margin	*5.2%*	*-26.8%*	*5.0%*	*4.6%*
Interest Expense	(83)	(64)	(64)	(64)
Pretax Income	(39)	(304)	(21)	(22)
Taxes	43	(1)	2	3
Tax rate				
Minority Interest				
Net Income	(83)	(303)	(23)	(25)
EPS	(0.98)	(3.63)	(0.27)	(0.30)
Proforma EPS	0.68	NA	NA	NA
Weighted shares outstanding (diluted)	84.4	83.3	83.4	83.4

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 153: OWW Quarterly Income Statement

$ in millions

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E
Gross Bookings												
Americas	2,530	2,597	2,262	2,004	2,387	2,567	2,313	2,024	2,268	2,439	2,244	1,963
International	345	339	363	352	488	476	421	356	439	428	370	313
Total gross bookings:	2,875	2,936	2,625	2,356	2,875	3,043	2,734	2,380	2,707	2,867	2,614	2,276
Y/Y gross bookings growth	*21.2%*	*9.5%*	*10.9%*	*-0.2%*	*0.0%*	*3.6%*	*4.2%*	*1.0%*	*-5.8%*	*-5.8%*	*-4.4%*	*-4.3%*
Americas Revenue	166	186	175	153	168	178	187	166	163	180	188	165
International Revenue	39	38	44	44	51	53	53	39	46	47	41	34
Total Revenue	205	223	219	197	219	231	240	205	209	228	229	199
Y/Y revenue growth	*17.0%*	*11.1%*	*23.7%*	*14.5%*	*6.8%*	*3.4%*	*9.6%*	*4.3%*	*-4.6%*	*-1.5%*	*-4.5%*	*-3.0%*
Revenue Margins	*7.1%*	*7.6%*	*8.3%*	*8.4%*	*7.6%*	*7.6%*	*8.8%*	*8.6%*	*7.7%*	*7.9%*	*8.8%*	*8.8%*
Cost of Goods Sold	35	40	36	41	43	46	41	43	43	47	41	42
Total Gross Profit	170	183	183	156	176	185	199	162	166	181	188	157
Operating Expenses												
SG&A	68	89	71	69	77	72	75	64	71	72	70	61
Marketing	79	82	78	57	85	81	86	60	81	80	83	59
Depreciation & Amortization	13	12	17	15	15	17	17	17	18	18	18	18
Impairment of Intangible Assets	-	-	-	-	-	-	297	-	-	-	-	-
Total Operating Expenses	160	183	166	141	177	170	475	140	171	170	171	138
Adjusted EBITDA	31	35	43	37	21	37	43	44	18	33	41	44
EBITDA Margin	*15.1%*	*15.8%*	*19.6%*	*18.8%*	*9.6%*	*16.0%*	*17.9%*	*21.4%*	*8.7%*	*14.7%*	*17.8%*	*22.0%*
Reported EBIT	10	0	19	15	(1)	15	(276)	22	(5)	10	18	20
Operating Margin	*4.9%*	*0.1%*	*8.7%*	*7.6%*	*-0.5%*	*6.5%*	*-115.0%*	*10.7%*	*-2.3%*	*4.6%*	*7.7%*	*10.0%*
Interest Expense	(19)	(28)	(19)	(17)	(16)	(15)	(16)	(17)	(16)	(16)	(16)	(16)
Pretax Income	(9)	(28)	-	(2)	(17)	-	(292)	5	(21)	(6)	2	4
Taxes	-	3	32	8	(2)	5	(5)	1	-	-	-	2
Tax rate	*0.0%*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*
Minority Interest				1								
Net Income	(9)	(31)	(32)	(11)	(15)	(5)	(287)	4	(21)	(6)	2	2
EPS	(0.11)	(0.36)	(0.38)	(0.13)	(0.18)	(0.06)	(3.44)	0.05	(0.25)	(0.07)	0.02	0.02
Proforma EPS	0.15	0.18	0.23	0.12	NA	NA	NA	NA	NA	NA	NA	NA
Weighted shares outstanding (diluted)	85.6	85.6	83.1	83.1	83.2	83.2	83.4	83.4	83.4	83.4	83.4	83.4

Source: Company reports and J.P. Morgan estimates

Table 154: OWW Annual Balance Sheet

$ in millions

	FY 2007	FY 2008E	FY 2009E	FY 2010E
Assets				
Current assets:				
Cash and cash equivalents	25	134	139	136
Total Accounts Receivable	60	63	60	64
Current Deferred Income Tax	3	-	-	-
Other current assets	33	41	40	43
Total current assets	121	238	239	242
	-	-	-	-
Other assets:	-	-	-	-
Non-current deferred income tax	12	63	63	63
PP&E	184	192	210	240
Intangible assets	1,562	1,232	1,232	1,232
Intercompany receivables	-	-	-	-
Other assets	46	50	50	50
Total other assets	1,804	1,537	1,555	1,585
	-	-	-	-
Total assets	1,925	1,775	1,794	1,827
	-	-	-	-
Liabilities and stockholders' equity	-	-	-	-
Current liabilities:	-	-	-	-
Restructuring reserves	-	-	-	-
Tax sharing/unfavorable contract liabilitiy	-	-	-	-
Merchant payables/deferred income	283	380	321	343
Other accrued expenses and AP	121	114	205	220
Other current liabilities	18	-	-	-
Total current liabilities	422	494	526	563
	-	-	-	-
Intercompany debt	-	-	-	-
OWW debt	593	573	513	453
Tax sharing liabilities	114	111	111	110
Deferred income taxes	-	-	-	-
Other non-current liabilities	57	70	70	70
Total Liabilities	1,187	1,248	1,220	1,196
	-	-	-	-
Equity	-	-	-	-
Common Stock			1	1
APIC			930	930
Accumulated deficit			(357)	(300)
Accumulated OCI			-	-
Total equity	738	527	574	631
	-	-	-	-
Total liabilities and equity	1,925	1,775	1,794	1,827

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 155: OWW Annual Cash Flow Statement

$ in millions

	FY 2007E	FY 2008E	FY 2009E	FY 2010E
Cash flows from operating activities				
Net income	(85)	(303)	(23)	(25)
Depreciation and Amortization	57	66	72	76
Provision for bad debt	2	2	8	8
Stock Option Expenses	8	17	21	25
Non-cash revenue	(7)	(2)	-	-
Interest expense on intercompany debt	15	19	20	20
Deferred income taxes	38	(3)	-	-
Accounts receivable	(12)	(2)	3	(4)
Deferred income	8	24	-	-
Accts payable, accrued expenses, other	77	67	32	37
Other	(5)	297	-	-
Total cash from operations	96	182	133	137
Cash flows from investing activities				
Capital expenditures	(53)	(57)	(68)	(80)
Proceeds from sale of business, net of cash assumed by buyer	(27)	-	-	-
Total cash from investing	(80)	(57)	(68)	(80)
Cash flows from financing activities				
Proceeds from IPO, net	477	-	-	-
Proceeds from issuance of debt	596	24	-	-
Repayment of note payable to Travelport	(860)	-	-	-
Dividend to Travelport	(109)	-	-	-
Payment for settlement of intercompany balances with Travelport	-	-	-	-
Capital contributions from Travelport	25	-	-	-
Capital lease and debt payments	(3)	(39)	(60)	(60)
Advances to Travelport	(150)	-	-	-
Total cash from financing	(24)	(15)	(60)	(60)
	-	-	-	-
Exchange rate effects on cash flows	5	(1)	-	-
	-	-	-	-
Net cash flows	(3)	109	5	(3)
	-	-	-	-
Beginning cash balance	18	59	134	139
Net change	(3)	109	5	(3)
Ending cash balance	59	134	139	136
Free Cash Flow	43	125	65	57
Non-GAAP Free Cash Flow	93	88	68	63

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Priceline, Overweight, ($70.82)

Priceline's performance is closely tied to hotel ADR trends, volume sold, and penetration growth in Europe. Our 2009 expectations for (0.7)% revenue growth vs. F'08E growth of 31% clearly reflect economic weakness and foreign currency headwinds. However, we think the company is continuing to gain market share both domestically and internationally and is the best positioned OTA. At 8.9x our F'09 EBITDA estimate of $336M, we find Priceline's valuation attractive and are introducing a $86 December 2009 price target. As such, we maintain our Overweight rating.

- **Long-term margin expansion is likely**. In spite of the weak operating environment, management has expressed its desire to maintain operating margins and sees room for expense management. Additionally, we think keyword pricing inflation will ease going forward. In the long term, we note that the company operates a highly scalable business model and are looking for 340 bps pro forma operating margin expansion in F'10.
- **We think Priceline will continue to take market share**. With its focus on having the lowest price offering and its unique opaque business model, we believe Priceline is well positioned to take market share in this price conscious environment. We are modeling F'09 domestic gross bookings growth of 6% Y/Y, ahead of our domestic online travel market growth estimate of 2%.
- **Priceline might be able to benefit from readjusting its convertible debt load.** In 2008, Priceline's diluted share count rose to over 50M shares, as the stock traded at levels well in excess of conversion prices. Not only do we expect the stock to benefit from the opposite effect in F'09, but we think PCLN can take advantage of early conversions, as some convertible bond hedge funds have been forced to liquidate their bond portfolios. This should limit future dilution.
- **2009 drivers.** In our view, the following factors will drive PCLN shares in 2009: (1) lower dilution effects to share count, (2) careful expense management, and (3) market share gains due to its lowest price offering.
- **Maintaining 4Q'08 estimates.** We are maintaining our 4Q'08 estimates, which call for revenue growth of 11% Y/Y, EBITDA of $63.4M, and pro forma EPS of $1.09.

Our current and newly introduced 2010 estimates are in the table below:

Table 156: Priceline Financial Snapshot

$ in millions, except per share data

PCLN	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	372.0	1,850.8	1,836.9	2,081.4	33.1%	-0.7%	13.3%
EBITDA	63.4	364.8	336.4	438.6	60.0%	-7.8%	30.4%
Pro Forma EPS	1.09	5.79	5.64	7.40	43.4%	-2.7%	31.3%
Consensus							
Revenue	378.1	1,856.5	1,933.1	2,166.2	33.5%	4.1%	12.1%
EBITDA	60.7	363.3	352.9	406.0	59.3%	-2.9%	15.0%
Pro Forma EPS	1.06	5.76	5.81	6.58	42.6%	0.9%	13.3%

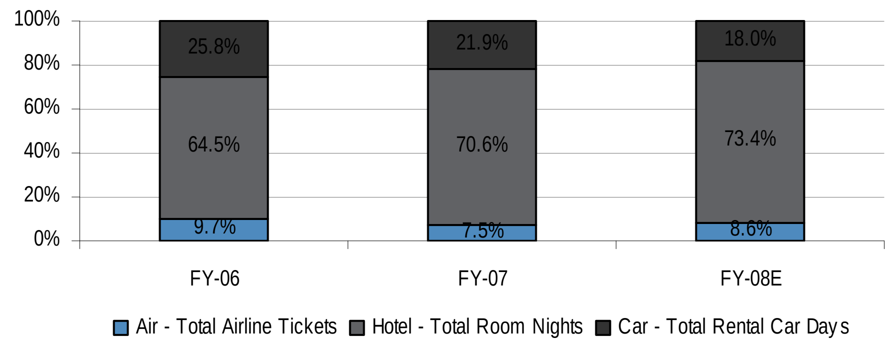
Source: J.P. Morgan estimates, Company data, and Bloomberg

Our Estimates and Outlook for 2009

We are modeling F'09 revenue of $1.84B, EBITDA of $336M, and pro forma EPS of $5.64, representing Y/Y revenue, EBITDA and EPS declines of 1%, 8%, and 3%, respectively. We expect most of the revenue declines to be driven by the international market, where we see weak consumer spend on travel, lower ADRs, and an unfavorable foreign currency exchange rate causing gross bookings declines of 7% Y/Y. Offsetting these declines, we think Priceline will be successful in continuing to gain domestic market share with its lowest price positioning and are modeling domestic gross bookings growth of 6% Y/Y, ahead of our domestic online travel market growth estimate of 2%.

In 2008, we saw Priceline's domestic gross bookings growth rate accelerate to ~41% Y/Y from 9% growth in 2007, in part due to waiving its air booking fees. As a result of this, we saw Priceline gain market share in the air ticket category. We think this is a differentiating factor that will continue to benefit Priceline going forward.

Figure 97: Priceline Units Sold by Product Category



Source: Company reports and J.P. Morgan estimates.

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and pro forma EPS estimates of $2.08B, $439M, and $7.40, which represent 13%, 30%, and 31% Y/Y growth, respectively. Growth should be mostly supported by the international market, where we see gross bookings increases of 36% Y/Y, resulting from an expected improvement in the economic environment and flat foreign currency exchange rates. We expect the company to strategically support the international market by concentrating on developing its presence in Eastern Europe, the US, and Asia as the Western European market matures.

We Are Introducing a Price Target of $86

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and (b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for Priceline of a ~16% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 16x EV/EBIT multiple to our F'09 EBIT estimate (reflecting better forward visibility than the current valuation of 13x our F'09 estimate) and thus arrive at our December 2009 price target of $86.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 157: Growth Outlook

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	1,836.9	2,081.4	2,268.7	2,427.6	2,597.5	2,727.4
Y/Y change		*13.3%*	9%	7%	7%	5%
Less: Operating Expenses	1,604.0	1,745.8	1,883.1	2,002.7	2,142.9	2,236.4
As % of total revenues	*87.3%*	*83.9%*	*83.0%*	*82.5%*	*82.5%*	*82.0%*
Operating Income (Loss)	232.9	335.6	385.7	424.8	454.6	490.9
Operating margin	*12.7%*	*16.1%*	17.0%	17.5%	17.5%	18.0%

Source: Company reports and J.P. Morgan estimates.

Table 158: EV/EBIT Multiple Analysis

$ in millions

EV/EBIT Multiple Analysis	
5 yr forward EBIT CAGR	16%
1x EBIT Growth	16
2009 EBIT	232.9
Implied Enterprise Value	3,725.9
+ Cash	455.1
- Debt	-
Market Value	4,181.0
Share count	48.9
2009 Price Target	85.57

Source: Company reports and J.P. Morgan estimates.

Valuation and Rating Analysis

On an EV/EBITDA basis, PCLN is trading at 8.9x its F'09E EBITDA vs. the peer group average of 6.5x. Given the company's market leadership, we believe the stock deserves a premium. As such, we rate this stock Overweight.

Risks to Our Rating

Priceline shares could underperform other companies in our coverage universe if its domestic growth is pressured by competition from other OTAs or suppliers, if it has difficulty obtaining merchant inventory, if macroeconomic weakness hinders top-line growth, if it experiences increased competition in the international market, or if sales and marketing and technology expenses increase significantly.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 159: PCLN Annual Income Statement

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
Merchant Revenues	1,002.8	1,201.4	1,209.7	1,258.3
Agency Revenues	398.2	632.8	611.2	791.2
Other Revenues	8.3	16.6	16.0	32.0
Total Revenue	1,409.4	1,850.8	1,836.9	2,081.4
Pro Forma Revenue	1,390.8	1,850.8	1,836.9	2,081.4
Cost of Revenue (Reported)	770.0	914.4	941.1	979.0
Gross Profit (Reported)	639.4	936.4	895.8	1,102.4
Gross Margin Pro Forma)	44.6%	50.6%	48.8%	53.0%
Advertising	208.6	305.8	302.2	353.3
Sales & Marketing	47.2	74.8	76.7	91.0
Personnel	86.7	121.0	121.0	139.1
General and Administrative	91.5	52.5	50.1	57.7
Information Technology	13.8	19.0	20.0	22.6
Depreciation & Amortization	37.1	43.5	45.0	49.0
FAS123R	16.6	40.4	48.0	54.0
Adjustments to Operating Expenses	(79.9)	(29.8)	(30.0)	(32.0)
Total Operating Exp (Reported)	501.5	657.0	663.0	766.8
Total Operating Exp (Pro Forma)	405.0	586.9	585.0	680.8
	-	-	-	-
Operating Profit (Reported)	137.9	279.3	232.9	335.6
Operating Profit (Pro Forma)	215.8	349.5	310.9	421.6
Operating Margin (Reported)	9.8%	15.1%	12.7%	16.1%
Operating Margin (Pro Forma)	15.5%	18.9%	16.9%	20.3%
EBITDA	173.0	363.2	325.9	438.6
Adjusted EBITDA	228.1	364.8	336.4	438.6
		19.7%	18.3%	21.1%
Interest (Inc & Exp)	15.4	3.4	-	4.0
Other	(3.3)	0.9	10.5	-
Adjustments to Other Income				
Total Other (Reported)	12.1	4.3	10.5	4.0
Total Other (Pro Forma)	9.0	4.3	10.5	4.0
EBT (Reported)	150.0	283.6	243.4	339.6
EBT (Pro Forma)	224.7	353.8	321.4	425.6
Income Tax, Reported	12.1	(90.9)	(80.3)	(112.1)
Income Tax Pro forma	(36.7)	(68.0)	(64.3)	(85.1)
Equity in income (loss) of minority interest	(5.0)	(3.6)	-	-
Equity in income of minority int. (Pro Forma)	(5.6)	(4.5)	-	-
Net Income (Reported)	157.1	189.1	163.1	227.6
Net Income w/ FAS 123R Adjustment	157.1	189.1	163.1	227.6
Net Income (Pro Forma)	182.5	281.3	257.1	340.5
Preferred Stock Dividend	(1.6)	-	-	-
EPS (Reported)	$3.42	$3.91	$3.57	$4.95
EPS (Pro Forma)	$4.04	$5.79	$5.64	$7.40
Shares Outstanding (Basic)	37.7	39.1	41.7	45.2
Shares Outstanding (Diluted GAAP)	45.5	48.1	45.5	46.0
Shares Outstanding (Diluted Pro Forma)	45.2	48.3	45.5	46.0

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 160: PCLN Quarterly Income Statement

$ in millions

	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Merchant Revenues	246.0	254.9	275.2	226.7	289.2	336.2	324.0	252.1	291.0	323.6	328.1	267.0
Agency Revenues	54.5	98.3	139.6	105.8	109.9	173.2	232.6	117.0	104.1	161.2	217.6	128.3
Other Revenues	0.9	2.6	2.5	2.4	4.1	4.5	5.0	3.0	4.0	4.0	4.0	4.0
Total Revenue	301.4	355.9	417.3	334.9	403.2	514.0	561.6	372.0	399.1	488.8	549.7	399.4
Pro Forma Revenue	285.5	353.6	416.9	334.9	403.2	514.0	561.6	372.0	399.1	488.8	549.7	399.4
Cost of Revenue (Reported)	181.7	198.7	215.0	174.7	222.1	260.3	245.5	186.5	229.9	255.6	252.6	203.0
Gross Profit (Reported)	119.7	157.2	202.3	160.2	181.1	253.7	316.1	185.5	169.2	233.2	297.0	196.4
Gross Margin Pro Forma)	36.4%	43.8%	48.4%	47.8%	44.9%	49.4%	56.3%	49.9%	42.4%	47.7%	54.0%	49.2%
Advertising	43.3	52.8	62.3	50.4	69.8	82.8	92.6	60.6	68.6	78.7	90.1	64.7
Sales & Marketing	11.4	11.5	13.1	11.1	16.3	19.9	21.5	17.1	16.8	19.6	22.0	18.4
Personnel	18.3	20.0	23.1	25.4	26.9	30.6	35.2	28.3	26.7	29.3	34.6	30.4
General and Administrative	63.9	9.7	9.0	8.9	11.8	14.0	13.5	13.2	11.2	12.7	12.6	13.6
Information Technology	2.9	3.2	3.3	4.4	4.1	5.1	4.4	5.4	4.0	4.9	5.5	5.6
Depreciation & Amortization	8.5	9.0	9.1	10.4	10.4	11.1	10.9	11.1	11.0	11.0	11.5	11.5
FAS123R	3.2	3.6	4.4	5.5	9.9	9.3	10.1	11.1	12.0	12.0	12.0	12.0
Adjustments to Operating Expenses	*(61.2)*	*(6.2)*	*(6.2)*	*(6.2)*	*(7.5)*	*(7.5)*	*(7.4)*	*(7.5)*	*(7.5)*	*(7.5)*	*(7.5)*	*(7.5)*
Total Operating Exp (Reported)	151.5	109.6	124.2	116.1	149.3	172.8	188.2	146.8	150.3	168.2	188.4	156.1
Total Operating Exp (Pro Forma)	87.1	99.9	113.6	104.4	131.9	156.1	170.7	128.2	130.8	148.7	168.9	136.6
Operating Profit (Reported)	(31.7)	47.6	78.1	44.0	31.8	81.0	127.9	38.7	18.9	65.0	108.6	40.3
Operating Profit (Pro Forma)	16.8	55.0	88.3	55.7	49.2	97.7	145.3	57.3	38.4	84.5	128.1	59.8
Operating Margin (Reported)	-10.5%	13.4%	18.7%	13.1%	7.9%	15.8%	22.8%	10.4%	4.7%	13.3%	19.8%	10.1%
Operating Margin (Pro Forma)	5.6%	15.5%	21.2%	16.6%	12.2%	19.0%	25.9%	15.4%	9.6%	17.3%	23.3%	15.0%
EBITDA	-35.9	57.8	91.2	59.9	52.1	101.3	148.9	60.9	41.9	88.0	132.1	63.8
Adjustments to EBITDA	*55.1*				*(4.3)*	*(0.0)*	*3.5*	*2.5*	*2.5*	*3.5*	*3.5*	*1.0*
Adjusted EBITDA	19.1	57.8	91.2	59.9	47.7	101.3	152.4	63.4	44.4	91.5	135.6	64.8
Interest (Inc & Exp)	5.73	3.63	3.46	2.55	1.50	0.55	1.30	0.00	0.00	0.00	0.00	0.00
Other	-0.21	-0.33	-1.32	-1.41	-5.08	0.03	3.50	2.50	2.50	3.50	3.50	1.00
Adjustments to Other Income	*-2.79*	*-0.26*	*-0.08*				*0.04*					
Total Other (Reported)	5.52	3.30	2.14	1.13	-3.58	0.58	4.80	2.50	2.50	3.50	3.50	1.00
EBT (Reported)	(26.22)	50.87	80.22	45.15	28.18	81.54	132.72	41.20	21.42	68.50	112.13	41.31
EBT (Pro Forma)	19.49	58.04	90.35	56.86	45.63	98.26	150.16	59.80	40.92	88.00	131.63	60.81
Income Tax, Reported	11.59	(14.96)	26.66	(11.23)	(9.52)	(26.21)	(42.85)	(12.36)	(7.07)	(22.61)	(37.00)	(13.63)
Income Tax Pro forma	(1.71)	(9.36)	(16.09)	(9.51)	(7.44)	(18.30)	(31.23)	(11.06)	(8.18)	(17.60)	(26.33)	(12.16)
Equity in income (loss) of minority interest	(0.09)	(1.33)	(2.52)	(1.06)	(0.51)	(1.23)	(1.90)					
Equity in income of minority int. (Pro Forma)	(0.40)	(1.33)	(2.72)	(1.16)	(0.83)	(1.48)	(2.14)					
Net Income (Reported)	(14.7)	34.6	104.4	32.9	18.2	54.1	88.0	28.8	14.4	45.9	75.1	27.7
Net Income (Pro Forma)	17.4	47.3	71.5	46.2	37.3	78.5	116.8	48.7	32.7	70.4	105.3	48.7

Table 160: PCLN Quarterly Income Statement (cont.)

Preferred Stock Dividend	(1.56)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
EPS (Reported)	-$0.44	$0.79	$2.27	$0.68	$0.37	$1.08	$1.81	$0.65	$0.32	$1.02	$1.63	$0.60
EPS (Pro Forma)	$0.43	$1.11	$1.58	$0.96	$0.76	$1.55	$2.39	$1.09	$0.73	$1.56	$2.29	$1.06
Shares Outstanding (Basic)	37.2	37.6	37.8	38.1	38.2	38.8	39.7	39.7	40.5	41.3	42.1	43.0
Shares Outstanding (Diluted GAAP)	37.2	43.7	45.9	48.4	49.1	49.9	48.7	44.6	45.0	45.0	46.0	46.0
Shares Outstanding (Diluted Pro Forma)	40.2	42.7	45.4	48.3	49.4	50.5	48.9	44.6	45.0	45.0	46.0	46.0

Source: Company reports and J.P. Morgan estimates

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 161: PCLN Annual Balance Sheet

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
Cash and cash equivalents	385.4	386.5	593.1	910.9
Restricted cash	1.4	2.8	2.8	2.8
Short-term investments	122.5	38.9	38.9	38.9
Accounts receivable	70.7	128.9	162.0	197.0
Prepaid expenses and other current assets	33.1	45.2	47.9	38.9
Total current assets	613.0	602.3	844.7	1,188.5
Property and equipment, net	27.1	29.7	33.7	37.7
Intangible assets, net	182.7	213.4	213.4	213.4
Goodwill	287.2	353.4	353.4	353.4
Deferred Taxes	218.5	189.5	189.5	189.5
Other assets	22.3	32.2	32.2	32.2
Total assets	1,350.9	1,420.4	1,666.8	2,014.6
Accounts payable	47.7	70.8	90.8	147.8
Accrued expenses	59.6	92.7	92.7	92.7
Deferred merchant bookings	17.8	30.5	30.5	30.5
Other current liabilities	569.8	467.5	467.5	467.5
Total current liabilities	694.8	661.5	681.5	738.5
Deferred Taxes	46.5	54.4	54.4	54.4
Other long-term liabilities	13.4	16.9	16.9	16.9
Minority Interest	17.0	0.0	0.0	0.0
Long-term debt	0.0	0.0	0.0	0.0
Total liabilities	771.7	732.7	752.7	809.7
Series B Mandatorily Redeemable Preferred Stock	0.0	0.0	0.0	0.0
	0.0	0.0	0.0	0.0
Common stock, $0.008 par value per share,	0.3	0.4	0.4	0.4
Treasury stock, 2,496,326 shares and 2,496,326	(489.1)	(493.4)	(493.4)	(493.4)
Additional paid-in capital	2,124.0	2,123.3	2,349.7	2,640.5
Deferred compensation	0.0	0.0	0.0	0.0
Accumulated deficit	(1,106.5)	(946.3)	(946.3)	(946.3)
Accumulated other comprehensive income	50.3	3.8	3.8	3.8
Total stockholders equity	579.1	687.7	914.1	1,204.9
Total liabilities and stockholders equity	1,350.9	1,420.4	1,666.8	2,014.6

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 162: PCLN Annual Cash Flow Statement

$ in millions

	FY - 07	FY - 08E	FY - 09E	FY - 10E
Net income (loss)	157.1	189.1	163.1	227.6
Depreciation	11.8	13.8	16.0	20.0
Amortization	25.7	28.3	29.0	29.0
Provision for uncollectible accounts	4.9	8.3	11.6	11.6
Deferred Income Tax	(48.0)	22.5	-	-
Restructuring charge, net	-	-	-	-
Warrant costs	-	-	-	-
Equity in loss of investees, net	5.0	3.6	-	-
Impairments of investments in licensees	-	0.8	-	-
Net gain on disposal of property and equipment	-	-	-	-
Compensation expense arising from restricted stock awards	16.3	34.1	17.0	20.0
Amortization of debt issuance costs	3.2	3.0	2.7	2.7
Changes in assets and liabilities:	(19.9)	(6.3)	(15.8)	31.0
Accounts receivable	(24.2)	(71.0)	(33.1)	(35.0)
Prepaid expenses and other current assets	(9.2)	(2.7)	(2.7)	9.0
Accounts payable and accrued expenses	9.8	63.5	20.0	57.0
Other	3.7	3.8	-	-
Cash Flow from Operations	156.0	297.1	223.5	341.8
FCF	140.1	280.0	203.5	317.8
Additions to property and equipment	(15.9)	(17.1)	(20.0)	(24.0)
Purchase of short-term investments and shares held by minority interest	(173.9)	(403.9)	-	-
Maturing of Investments (investing)	57.9	235.2	-	-
(Funding)Return of restricted cash and bank certificate of deposit	1.1	(1.5)	-	-
Equity investment and other acquisitions	(90.6)	(0.7)	-	-
Cash flow from Investing Activities	(221.5)	(187.9)	(20.0)	(24.0)
Proceeds from sale of common stock	-	0.0	0.0	0.0
Proceeds from issuance of convertible senior notes	-	(102.4)	0.0	0.0
Proceeds from exercise of stock options/warrants	19.82	5.2	3.1	0.0
Proceeds from sale of minority interest in subsidiary	-	0.0	0.0	0.0
Purchase of conversion spread hedges	-	0.0	0.0	0.0
Additional debt issuance costs	(1.33)	0.0	0.0	0.0
Excess tax benefit from stock based comp	3.60	6.5	0.0	0.0
Repurchase of stock	(2.64)	(4.3)	0.0	0.0
Cash flow from Financing Activites	19.45	(94.96)	3.07	-
	0	0.0	0.0	0.0
Effect of exchange rate changes on cash	7.821	(13.1)	0.0	0.0
Net Change in Cash	(38.2)	1.1	206.6	317.8
Cash at the Beginning of period	423.6	385.4	386.5	593.1
Cash at the End of Period	385.4	386.5	593.1	910.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

RealNetworks, Inc, Neutral, ($3.55)

We see a tough year ahead for RealNetworks as macroeconomic conditions, particularly weak advertising environment and unfavorable foreign currency exchange rate fluctuations, take a toll on revenue streams. We expect the competitive landscape for online music distribution to remain under Apple's control and think the Rhapsody subscriber acquisition effort will face headwinds. We maintain our Neutral rating on the stock.

- We expect the macroeconomic environment to affect '09 results. We think soft demand for online advertising worldwide will limit room for growth in the Games segment. Based on current industry trends, we expect performance-based advertising revenue that RealNetworks generates in Europe to be also affected, along with CPM-based inventory, due to weakening consumer response. We are modeling 2.5% Games revenue growth in '09 with flattish subscription revenue and a slight rise in syndication revenue offset by Y/Y decrease in advertising.
- We think Rhapsody America's subscriber acquisition will be negatively impacted by the launch of MySpace Music. A potential negative impact on subscriber base implies longer path to operating profitability for Rhapsody. Management believes Rhapsody can be profitable if a sufficient scale is achieved. We, however, remain cautious on the longer-term outlook for pure play subscription music offerings: (1) we continue to believe hardware as opposed to software is where positive margins are; (2) the necessary scale will be even harder to achieve now with a new competitor added to already dominant iTunes. As such, we expect the number of music subscribers to decline to 1.862M at year end '09, down 1% from our forecast for '08.
- The company management believes that current scarcity of funding and lower valuations may create attractive acquisition opportunities. We think $2.86 per share in cash & equivalents on the balance sheet (as of Q3 '08) currently provides downside support to the stock price as operating income remains negative. As such we think a transaction resulting in less cash per share without an improvement in operating profitability will be viewed negatively by investors.
- **2009 drivers.** In our view, the following factors will drive shares in 2009: (1) the degree of resilience of the revenue streams in a recessionary environment; and (2) M&A activity, specifically the cash costs of potential acquisitions and the impact on earnings and cash balances.

Our current and newly introduced 2010 estimates are in the table below:

Table 163: RealNetworks Financial Snapshot

$ in millions, except per share data

RNWK	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	154.6	606.8	594.9	609.4	6.9%	(1.9)%	2.4%
EBITDA	(11.7)	(6.2)	4.0	4.7	(130.1)%	(164.1)%	19.5%
EPS GAAP	(0.03)	(0.05)	0.02	0.02	NM	NM	38.9%
Consensus							
Revenue	153.9	606.0	622.4	644.0	6.8%	2.7%	3.5%
EBITDA	9.3	46.8	46.7	36.3	(19.4)%	(0.1)%	(22.2)%
EPS GAAP	(0.02)	(0.05)	(0.06)	NA	NM	NM	NM

Source: J.P. Morgan estimates, Company data, and Bloomberg. Note: NM = Not Measurable, NA = Not Available

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We expect revenue and diluted GAAP EPS of $595M and 2c, respectively. While our revenue forecast didn't change materially, the change in our EPS projection is due to a revised tax rate.

Our Estimates and Outlook for 2010

We are introducing F'10 revenue and EPS estimates of $609M and 2c.

We Maintain Our Neutral Rating

We rate RNWK Neutral, as we believe cyclical and competitive challenges in key markets will limit room for growth in mid term, resulting in underperformance compared to the peer group. At the same time we see current cash balance of $2.86 per share providing downside risk protection from the current stock price levels.

Risks to Our Rating

Risks to the upside:

- Advertising on MTV and affiliated networks following the creation of RNWK/MTV JV may result in higher music subscriber growth than we currently estimate. We believe the relative simplicity of competing customer propositions (iTunes), not lack of consumer awareness, has limited growth rates.
- Penetration of broadband-enabled mobile handsets can grow faster than we expect, creating a larger opportunity for carrier application service (CAS) revenue.
- RealNetworks' newer PC games can prove more popular than the ones released previously, potentially leading to the creation of incremental advertising inventory and revenue upside. Our model currently assumes that games ad revenue growth will primarily come from increased sell-through rates.

Risks to the downside:

- We believe RealNetworks will pursue acquisitions in the near and mid-term. Such acquisitions could be dilutive to RNWK shareholders.
- We see advertising revenue generated through advertising embedded in casual PC games as one of the potential revenue growth drivers. Advertising revenues are usually strongly correlated with the economy and may be below our model given the economic downturn.
- The Technology Products and Solution segment customer base is relatively concentrated, making its revenue streams vulnerable to increased pricing pressure from wireless carriers.
- Concentrated ownership by Robert Glaser, chairman and CEO, creates risk of potential conflict of interest with minority shareholders.

Table 164: RNWK Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenues	$567.6	$606.8	$594.9	$609.4
Costs & Expenses:				
Cost of revenues	213.5	230.1	215.2	219.0
Operating expenses				
Research and development	102.7	117.6	114.8	117.6
Sales and marketing	209.4	222.0	217.2	222.4
Advertising with related party	24.4	49.7	50.0	51.5
General and administrative	67.3	68.6	70.7	72.8
Restructuring Charge	3.7	0.7	0.0	0.0
Loss of excess office facilities	0.0	0.0	0.0	0.0
Antitrust Litigation benefit, net	(60.7)	0.0	0.0	0.0
Total operating expenses	346.8	458.7	452.7	464.4
Total cost & expenses	560.3	688.8	667.8	683.4
Operating Income	$7.3	($82.1)	($72.9)	($74.0)
EBITDA	$20.5	($6.2)	$4.0	$4.7
Adjusted EBITDA (Company definition)	$58.0	$58.4	$70.5	$72.0
Interest income, net	30.9	13.7	10.8	12.1
Equity in net loss of investments	(0.4)	(0.4)	0.0	0.0
Gain on sale of equity investments	0.1	0.2	0.0	0.0
Impairment of equity investments	0.0	0.0	0.0	0.0
Other income, net	1.7	2.1	0.0	0.0
Minority interest in Rhapsody America	19.8	40.1	41.1	41.1
Gain on initial formation of Rhapsody America	3.9	0.0	0.0	0.0
Gain on Sale of interest in Rhapsody	12.5	23.7	25.5	26.3
Other income, net	68.5	79.4	77.4	79.5
Income (Loss) before income taxes	$75.8	($2.7)	$4.5	$5.4
Income Taxes	(27.5)	(4.4)	(2.1)	(2.1)
Net Income (Loss)	$48.3	($7.1)	$2.4	$3.3
GAAP EPS				
Basic	$0.30	($0.05)	$0.02	$0.02
Diluted	0.28	(0.05)	0.02	0.02
Adjusted EPS				
Basic	$0.27	$0.17	$0.22	$0.23
Diluted	0.25	0.16	0.22	0.23
PF EPS				
Basic	$0.20	$0.06	$0.12	$0.13
Diluted	0.18	0.06	0.12	0.13
Weighted average common shares:				
Basic	152.3	142.3	142.0	142.0
Diluted	167.0	145.4	142.0	142.0

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 165: RNWK Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenues	$129.5	$136.2	$145.1	$156.9	$147.6	$152.6	$152.0	$154.6	$147.9	$153.3	$150.0	$143.9
Costs & Expenses:												
Cost of revenues	45.9	49.20	56.6	61.7	55.4	55.6	62.2	56.9	55.8	55.1	55.4	48.8
Operating expenses												
Research and development	23.5	25.0	26.5	27.7	25.0	29.1	31.1	32.5	28.5	29.6	28.9	27.8
Sales and marketing	49.7	50.1	52.8	56.8	53.6	53.1	55.1	60.3	54.0	55.9	54.7	52.5
Advertising with related party			7.7	16.6	7.3	9.2	15.2	18.0	10.0	10.0	15.0	15.0
General and administrative	17.4	17.1	16.8	16.2	17.1	18.3	15.5	17.8	17.6	18.9	15.9	18.3
Restructuring Charge	0.0	0.0	0.0	3.7	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loss of excess office facilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Antitrust Litigation benefit, net	(60.7)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total operating expenses	29.8	92.1	103.8	121.1	103.7	109.7	116.8	128.5	110.1	114.4	114.6	113.6
Total cost & expenses	75.7	141.3	160.5	182.8	159.1	165.3	178.9	185.5	165.9	169.5	170.0	162.4
Operating Income	$53.7	($5.2)	($15.4)	($25.9)	($11.5)	($12.7)	($27.0)	($30.9)	($18.0)	($16.3)	($20.0)	($18.6)
EBITDA	$11.6	$12.2	$3.2	($6.5)	$7.6	$6.3	($8.4)	($11.7)	$1.4	$3.2	($1.1)	$0.5
Adjusted EBITDA (Company definition)	$11.9	$12.7	$17.6	$15.7	$20.1	$17.8	$11.6	$8.9	$16.3	$17.9	$17.2	$19.1
Interest income, net	9.1	8.1	7.3	6.4	5.0	3.4	2.9	2.5	2.6	2.7	2.7	2.8
Equity in net loss of investments	(0.1)		0.0	(0.3)	(0.1)	(0.1)	(0.2)	0.0	0.0	0.0	0.0	0.0
Gain on sale of equity investments	0.0	0.1	0.0	(0.0)	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Impairment of equity investments	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other income, net	0.5	0.5	0.0	0.8	0.8	0.1	0.8	0.5	0.0	0.0	0.0	0.0
Minority interest in Rhapsody America			6.5	13.3	8.6	8.2	12.3	10.9	9.8	9.6	10.7	11.0
Gain on initial formation of Rhapsody America			3.9		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gain on Sale of interest in Rhapsody			4.1	8.5	3.7	3.4	7.4	9.2	5.1	5.1	7.7	7.7
Other income, net	9.4	8.7	21.7	28.6	17.976	15.1	23.2	23.1	17.526	17.4	21.1	21.4
Income (Loss) before income taxes	$63.2	$3.5	$6.4	$2.7	$6.4	$2.4	($3.772)	($7.7)	($0.5)	$1.1	$1.0	$2.9
Income Taxes	(23.2)	(2.2)	(2.0)	(0.0)	(4.0)	(3.7)	(0.7)	4.0	0.0	(0.5)	(0.4)	(1.2)
Net Income (Loss)	$40.0	$1.3	$4.3	$2.7	$2.4	($1.305)	($4.500)	($3.7)	($0.5)	$0.6	$0.6	$1.7
GAAP EPS												
Basic	$0.25	$0.01	$0.03	$0.02	$0.02	($0.01)	($0.03)	($0.03)	($0.00)	$0.00	$0.00	$0.01
Diluted	0.22	0.01	0.03	0.02	0.02	(0.01)	(0.03)	(0.03)	(0.00)	0.00	0.00	0.01
Adjusted EPS												
Basic	$0.06	$0.06	$0.06	$0.09	$0.07	$0.04	$0.02	$0.03	$0.05	$0.06	$0.05	$0.06
Diluted	0.06	0.05	0.06	0.08	0.07	0.04	0.02	0.03	0.05	0.06	0.05	0.06
PF EPS												
Basic	$0.05	$0.03	$0.05	$0.05	$0.04	$0.02	($0.00)	$0.00	$0.02	$0.03	$0.03	$0.04
Diluted	0.05	0.03	0.05	0.05	0.04	0.02	(0.00)	0.00	0.02	0.03	0.03	0.04
Weighted average common shares:												
Basic	161.4	153.9	149.7	144.4	142.5	142.9	142.0	142.0	142.0	142.0	142.0	142.0
Diluted	178.1	169.0	163.1	157.6	154.7	142.9	142.0	142.0	142.0	142.0	142.0	142.0

Source: J.P. Morgan estimates and company reports

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 166: RNWK Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
ASSETS				
Current Assets:				
Cash and cash equivalents	$476.7	$317.2	$361.1	$407.5
Short-term investments	79.9	101.2	101.2	101.2
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	84.7	71.7	66.7	91.4
Deferred costs, current portion	6.4	8.5	7.5	8.5
Deferred tax assets, net, current portion	0.0	0.0	0.0	0.0
Prepaid expenses and other current assets	26.5	44.4	38.8	44.0
Total current assets	$674.2	$542.9	$575.3	$652.6
Equipment, software, and leasehold improvements:				
Equipment and software	109.6	136.7	160.3	184.5
Leashold improvements	30.6	33.1	43.2	53.6
Total equipment, software, and leasehold improvements, at cost	140.3	169.9	203.5	238.1
Less accumulated depreciation and amortization	83.8	104.0	124.9	146.4
Net equipment, software, and leasehold improvements	56.5	65.9	78.6	91.7
Restricted cash equivalents	15.5	14.7	14.7	14.7
Notes receivable from related parties	0.0	0.0	0.0	0.0
Equity investments	10.0	9.3	9.3	9.3
Other assets	10.2	17.8	17.8	17.8
Deferred tax assets, net, non-current portion	40.9	35.6	35.6	35.6
Other intangible assets, net	107.7	78.7	78.7	78.7
Goodwill	353.2	315.5	315.5	315.5
Total Assets	$1,268.1	$1,080.4	$1,125.4	$1,215.8
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current Liabilities:				
Accounts payable	$56.2	$35.6	$31.2	$35.4
Accrued and other liabilities	106.8	115.6	101.2	114.7
Deferred revenue, current portion	39.6	43.1	40.1	43.3
Related party payable	17.2	18.0	15.0	51.5
Convertible Debt, Current Portion	100.0	0.0	0.0	
Accrued loss on excess office facilities, current portion	3.4	4.3	4.3	4.3
Total Current Liabilities	$323.1	$216.6	$191.9	$249.1
Deferred revenue, non-current portion	2.7	1.1	1.1	1.1
Accrued loss on excess office facilities, non-current portion	7.3	3.9	3.9	3.9
Deferred rent	4.5	4.7	4.7	4.7
Deferred tax liabilities, net, non-current portion	22.1	15.2	15.2	15.2
Convertible debt	0.0	0.0	0.0	0.0
Minority Interest			0.0	
Other long-term liabilities	13.7	32.0	129.3	189.0
Total liabilities	$373.4	$273.5	$346.0	$463.0
Minority Interest	$19.6	($4.6)	($45.7)	($86.7)
Shareholders' equity:				
Preferred stock, $0.001 par value, no shares issued and outstanding	0.0	0.0	0.0	0.0
Series A: authorized 200 shares	0.0	0.0	0.0	0.0
Undesignated series: authorized 59,800 shares	0.0	0.0	0.0	0.0
Common stock, $0.001 par value authorized 1,000,000 shares; issued and outstanding 154,108 shares in 2007 and 163,278 shares in 2006	0.2	0.2	0.2	0.2
Additional paid-in capital	646.1	634.7	645.8	657.0
Deferred stock-based compensation	0.0	0.0	0.0	0.0
Accumulated other comprehensive income	16.1	16.1	16.1	16.1
Retained earnings	212.7	160.6	163.0	166.4
Accumulated deficit	0.0	0.0	0.0	0.0
Total shareholders' equity	$894.7	$806.9	$779.4	$752.9
Total liabilities & stockholders' equity	$1,268.1	$1,080.4	$1,125.4	$1,215.8

Source: Company reports and J.P. Morgan estimates.

Table 167: RNWK Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Cash flows from operating activities				
Net income (loss)	$48.3	($7.1)	$2.4	$3.3
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Depreciation and amortization	45.23	50.8	52.3	53.9
Stock-based compensation	23.9	23.9	24.6	24.9
Equity in net loss of investments	0.4	0.2	0.0	0.0
Loss on disposal of equipment, software, and leasehold improvements	0.3	0.2	0.0	0.0
Gain on sale of equity investments	(0.1)	(0.2)	0.0	0.0
Gain on sale of interest in Rhapsody America	(16.4)	(23.7)	(25.5)	(26.3)
Minority interest in Rhapsody America	(19.8)	(40.1)	(41.1)	(41.1)
Excess tax benefit from stock option exercises	(0.6)	(0.1)	0.0	0.0
Accrued loss on excess office facilities	(3.8)	(3.5)	(3.8)	(3.8)
Unrealized gain on securities	0.0	0.0	0.0	0.0
Increase of net deferred tax asset valuation allowance	0.0	0.0	0.0	0.0
Deferred income taxes	(15.1)	7.4	7.4	7.4
Impairment of equity investments	0.0	0.0	0.0	0.0
Accrued loss on content agreement	0.0	0.0	0.0	0.0
Other	0.1	0.1	0.0	0.0
Net change in certain operating assets and liabilities, net of acquisitions	1.2	(29.8)	0.0	0.0
Net cash provided by (used in) operating activities	$63.8	($21.9)	$16.3	$18.4
Cash flows from investing activities:				
Purchases of equipment, software, and leasehold improvements	($26.7)	($32.6)	($33.6)	($34.6)
Purchases of short-term investments	(133.4)	(207.1)	(222.8)	(222.8)
Proceeds from sales and maturities of short-term investments	207.2	185.8	222.8	222.8
Purchases of other intangible assets	(2.8)	(1.8)	0.0	0.0
Proceeds from sale of equity investments	1.6	1.2	0.0	0.0
Decrease in restricted cash equivalents	1.8	0.8	0.0	0.0
Purchases of cost based investments	(1.7)	(4.5)	0.0	0.0
Cash used in acquisitions, net of cash acquired	(45.6)	(10.2)	0.0	0.0
Net cash used in investing activities	$0.5	($68.4)	($33.6)	($34.6)
Cash flows from financing activities				
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	$15.9	$11.6	$11.2	$11.2
Net proceeds from sale of interest in Rhapsody America	48.7	49.6	$50.0	51.5
Excess tax benefit from stock options exercises	0.6	0.1	0.0	0.0
Repayment of debt	0.0	(100.0)	0.0	0.0
Repurchase of common stock	(178.8)	(23.1)	0.0	0.0
Net cash (used in) provided by financing activities	($113.6)	($61.7)	$61.2	$62.7
Effect of exchange rate changes on cash and cash equivalents	$0.9	(7.5)	0.0	0.0
Net decrease in cash and cash equivalents	($48.5)	($159.5)	$43.9	$46.4
Cash and cash equivalents, beginning of period	$525.2	476.7	317.2	$361.1
Cash and equivalents, end of period	$476.7	$317.2	$361.1	$407.5

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Shutterfly, Inc., Overweight ($6.75)

We believe macroeconomic weakness will continue to negatively impact consumer spending in 2009 and, as such, are forecasting revenue growth of 7.6% in F'09 compared to our F'08 estimate of 11.7% growth. However, despite economic pressure, we believe Shutterfly will remain profitable in 2009 due to improved efforts to reduce costs. Shutterfly trades at 2.6x our F'09 EBITDA estimate of $49.3M, versus peers at 6.5x, hence our Overweight rating. We are introducing a $12 December 2009 price target.

- **We think customer growth and order volume will decelerate in 2009**. We expect F'09 customer growth of 11.5% and order volume growth of 4.1% Y/Y, compared to our respective F'08 growth forecasts of 12.9% and 6.0%. Although we believe the weak consumer sentiment will continue to put pressure on top-line growth, we do not feel Shutterfly is at risk for losing market share.
- **We expect reduced costs will help Shutterfly gain leverage.** We think the upcoming Phoenix facility set to open in 2Q'09 will help Shutterfly reduce its operating expenses as a percentage of revenue. Additionally, we believe the company will continue to benefit from its new shipping relationship with UPS. As such, we are modeling a gross margin of 54.7% in F'09, vs. our 53.0% F'08 estimate, and a F'09 EBITDA margin of 22.0%, up ~610 bps Y/Y.
- **We think outsourcing initiatives and manufacturing efficiencies will improve FCF.** We believe planned outsourcing initiatives as well as reduced storage and hardware costs in 2009 will drive to lower CapEx as a percentage of revenue. As such, we expect Shutterfly to improve FCF next year and are modeling F'09 FCF of $18.4M, compared with our $15.6M estimate in F'08.
- **2009 drivers.** In our view, the following factors will drive SFLY shares in 2009: (1) continued mix shift trend from print to non-print products, (2) reduced expenses resulting from the upcoming Phoenix facility, and (3) planned outsourcing and manufacturing initiatives.
- **Maintaining 4Q'08 estimates.** We are maintaining our 4Q'08 revenue, EBITDA, and GAAP EPS estimates of $102.8M, $33.3M, and $0.41, respectively.

Our current and newly introduced 2010 estimates are in the table below:

Table 168: Shutterfly Financial Snapshot

$ in millions, except per share data

SFLY	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	102.8	208.5	224.4	266.1	40%	8%	19%
EBITDA	33.3	33.2	49.3	62.0	1%	49%	26%
EPS	$0.41	$0.03	$0.15	$0.31	-93%	456%	91%
Consensus							
Revenue	102.5	203.1	225.1	NA	-91%	11%	NA
EBITDA	33.2	32.2	39.7	NA	-96%	23%	NA
EPS	$0.43	$0.13	$0.19	NA	-68%	40%	NA

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Key Financial Metrics and Forecasts

The following table summarizes our Y/Y growth assumptions by business segment through 2009. A detailed description of our forecast is in the following two sections.

Table 169: Shutterfly Operating Metrics

	2007A	2008E	2009E	2010E
Customers	2,411,311	2,721,852	3,036,190	3,533,169
Y/Y Growth	*39.0%*	*12.9%*	*11.5%*	*16.4%*
Orders	7,061,604	7,482,893	7,787,077	8,856,255
Y/Y Growth	*38.3%*	*6.0%*	*4.1%*	*13.7%*
Average orders per customer	1.93	1.82	1.70	1.73
Y/Y Growth	*-0.9%*	*-6.0%*	*-6.5%*	*2.0%*
Average Order Size	$26.44	$27.87	$28.81	$30.04
Y/Y Growth	*9.4%*	*5.4%*	*3.4%*	*4.3%*
As % of total revenues				
Print Revenue	44%	41%	38%	37%
Personalized Products Revenue	56%	59%	62%	63%

Source: Company reports and J.P. Morgan estimates.

Our Estimates and Outlook for 2009

We are modeling F'09 revenue, EBITDA, and GAAP EPS of $224.4M, $49.3M, and $0.15, vs. our F'08 estimates of $208.5M, $33.2M, and $0.03, respectively. We are modeling F'09 Y/Y growth in customers, orders, and AOV of 11.5%, 4.1%, and 3.4%, respectively.

We think macroeconomic weakness will continue to negatively impact consumer spending in 2009, causing Y/Y revenue growth to decelerate. However, we are encouraged by Shutterfly's initiatives to reduce costs and are thus forecasting a gross margin of 54.7% in F'09, compared with our F'08 estimate of 53.0%. In addition, we think manufacturing efficiencies will reduce CapEx as a percentage of revenue in 2009 and are modeling FCF of $18.4M in F'09, vs. our $15.6M estimate in F'08. .

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and GAAP EPS estimates of $266.1M, $62.0M, and $0.31, representing growth rates of 18.6%, 25.8%, and 102.3%, respectively. We are modeling F'10 growth in customers, orders, and AOV of 16.4%, 13.7%, and 4.3%, respectively.

We are basing our estimates with the assumption that the U.S. macro economy will begin to recover in 2010, thus improving consumer sentiment. As such, we think customer and order volume growth as well as a continued mix shift from Print to Personalized Products and Services will drive revenue growth in 2010.

We Are Introducing a Price Target of $12

In introducing price targets for our coverage, we have derived multiples based on 5-year forward EBIT CAGRs. We believe the historical record does not provide a meaningful guide to valuation as (a) the majority of the companies in our coverage did not have a track record as public companies through the previous recession and

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

(b) even the public companies were still in their early-growth (and, for some, rapid growth) stage during the last economic downturn.

As such, given our projection for eBay of a ~54% F'09 - F'14 EBIT CAGR, and our view of the beginning of a possible economic turnaround in 2H'09, we believe the stock can achieve a 54x EV/EBIT multiple to our F'09 EBIT estimate (reflecting better forward visibility than the current valuation of 22x our F'09 estimate) and thus arrive at our December 2009 price target of $12.

The parameters of our EV/EBIT multiple analysis are in the table below:

Table 170: Key Valuation Assumptions

5 yr forward EBIT CAGR	54%
1x EBIT Growth	54
2009 EBIT	$4
Implied Enterprise Value	$201
+ Cash	$88
- Debt	$-
Market Value	$289
Share count	25
2009 Price Target	$12

Source: Company reports and J.P. Morgan estimates.

Our EV/EBIT valuation is based on the following projections for revenue and operating income growth

Table 171: Growth Profile

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	224.4	266.1	309.8	354.6	398.7	440.4
Y/Y change		*18.6%*	16%	14%	12%	10%
Less: Operating Expenses	220.6	256.2	295.9	335.4	373.6	408.3
As % of total revenues	*98.3%*	*96.3%*	*95.5%*	*94.6%*	*93.7%*	*92.7%*
Operating Income (Loss)	3.7	9.8	13.9	19.1	25.1	32.1
Operating margin	*1.7%*	*3.7%*	4.5%	5.4%	6.3%	7.3%

Source: J.P. Morgan estimates.

Valuation and Rating Analysis

Shutterfly trades at a discount to its peers. On an EV/EBITDA basis, SFLY trades at 2.6x our F'09 EBITDA estimate of $49.3M vs. its peer group at 6.5x. Given SFLY's strong growth prospects, we believe there is opportunity for multiple expansion and thus rate the stock Overweight.

Risks to Our Rating

We believe there are three primary risks to our Overweight rating on Shutterfly:

- **Seasonality:** Currently, Shutterfly's business is very seasonal, with approximately 50% of revenues earned in the fourth quarter. If the company were unable to deliver customer orders during the holiday season, there would be downside risk to our rating.

- **Product pricing:** Pricing on 4X6 prints has come down over the last few years, causing the company to look for growth in other product segments.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Should other product segments experience similar pricing pressure, our Overweight rating could be at risk.

- **Consumer spending:** If consumer spending slows more rapidly than we are currently expecting, the company may have difficulty meeting our revenue estimates, and, as such, there could be downside risk to the stock.

Table 172: SFLY Annual Income Statement

$ in millions, except per share

	2007A	2008E	2009E	2010E
Revenues	186.7	208.5	224.4	266.1
Product Revenue (80%)	149.4	166.8	179.5	212.8
Shipping Revenue (20%)	37.3	41.7	44.9	53.2
Cost of revenues	84.1	97.9	101.6	118.2
Pro forma adj for SBC	0.2	0.4	-	-
Gross Profit	102.6	110.6	122.8	147.8
Pro forma Gross Profit	102.8	111.0	122.8	147.8
Gross Margins	*55.0%*	*53.0%*	*54.7%*	*55.6%*
Technology and Development	28.6	38.4	40.8	48.9
Sales and Marketing	33.4	41.8	44.2	52.6
General and Administrative	29.6	32.0	34.1	36.5
Total Operating Expenses	91.6	112.2	119.1	138.0
Total SBC adjustments	3.8	8.5	11.0	11.9
Amortization	0.4	1.9	2.0	2.0
Total pro forma operating expenses	87.3	101.9	106.1	124.1
Income from Operations	11.1	(1.6)	3.7	9.8
PF Income from Operations	15.5	9.1	16.7	23.7
Operating Margins	5.9%	-0.8%	1.7%	3.7%
EBITDA	32.9	33.2	49.3	62.0
EBITDA Margins	17.6%	15.9%	22.0%	23.3%
Interest Expense	(0.2)	(0.3)	(0.4)	(0.4)
Interest Income	5.5	3.2	4.0	4.0
EBT and accounting change	16.4	1.3	7.3	13.4
Tax benefit (provision)	(6.3)	(0.5)	(2.9)	(5.4)
Assumed Tax Rate	*38%*	*37%*	*40%*	*40%*
EAT and before accounting change	10.1	0.8	4.4	8.1
Cumulative effect of change in acct principle	-	-	-	-
Net income	10.1	0.8	4.4	8.1
EPS - basic	0.41	0.03	0.15	0.29
EPS - diluted	0.37	0.03	0.15	0.31
Pro forma EPS (dluted)	0.49	0.30	0.43	0.64
Pro Forma Dilluted Sharecount	28.8	(734.4)	41.8	56.8
Shares outstanding - basic	24.3	25.1	25.4	26.6
Shares outstanding - diluted	26.9	27.2	28.8	26.1
Customers	2,411,311	2,721,852	3,036,190	3,533,169
Y/Y Growth	*39.0%*	*12.9%*	*11.5%*	*16.4%*
Orders	7,061,604	7,482,893	7,787,077	8,856,255
Y/Y Growth	*38.3%*	*6.0%*	*4.1%*	*13.7%*
Average order per customer	1.93	1.82	1.70	1.73
Y/Y Growth	*-0.9%*	*-6.0%*	*-6.5%*	*2.0%*
Average Order Size	$26.44	$27.87	$28.81	$30.04
Y/Y Growth	*9.4%*	*5.4%*	*3.4%*	*4.3%*

Source: Company reports and J.P. Morgan estimates.

Table 173: SFLY Quarterly Income Statement

$ in millions, except per share data

	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Revenues	26.7	29.9	32.6	97.5	34.3	35.4	36.0	102.8	34.8	36.7	39.0	114.0
Product Revenue (80%)	21.4	23.9	26.1	78.0	27.5	28.4	28.8	82.2	27.8	29.3	31.2	91.2
Shipping Revenue (20%)	5.3	6.0	6.5	19.5	6.9	7.1	7.2	20.6	7.0	7.3	7.8	22.8
Cost of revenues	13.0	14.8	17.2	39.0	17.9	17.4	18.4	44.2	18.3	18.0	20.0	45.2
Pro forma adj for SBC	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1				
Gross Profit	13.7	15.0	15.4	58.5	16.4	18.1	17.5	58.6	16.5	18.7	18.9	68.7
Pro forma Gross Profit	13.7	15.1	15.4	58.6	16.5	18.2	17.6	58.7	16.5	18.7	18.9	68.7
Gross Margins	*51.2%*	*50.4%*	*47.1%*	*60.0%*	*47.8%*	*51.0%*	*48.7%*	*57.0%*	*47.4%*	*50.9%*	*48.6%*	*60.3%*
Technology and Development	5.8	6.6	7.6	8.6	9.2	9.8	9.6	9.8	9.4	9.9	10.9	10.6
Sales and Marketing	5.2	7.2	7.0	13.9	8.1	8.6	10.1	15.0	8.2	8.8	10.9	16.3
General and Administrative	6.0	6.7	7.4	9.5	7.6	7.6	6.8	10.1	7.7	7.7	8.6	10.0
Total Operating Expenses	17.0	20.6	22.0	32.0	24.8	26.0	26.5	34.8	25.3	26.4	30.4	36.9
Total SBC adjustments	0.8	0.9	1.0	1.1	1.7	2.0	2.3	2.4	2.7	2.7	2.8	2.8
Amortization	0.0	0.0	0.1	0.2	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total pro forma operating expenses	16.1	19.7	20.9	30.7	22.6	23.6	23.7	31.9	22.1	23.2	27.1	33.6
Income from Operations	(3.3)	(5.5)	(6.6)	26.5	(8.4)	(7.9)	(9.0)	23.7	(8.8)	(7.7)	(11.5)	31.8
PF Income from Operations	(2.4)	(4.6)	(5.4)	27.9	(6.2)	(5.4)	(6.1)	26.7	(5.6)	(4.5)	(8.2)	35.1
Operating Margins	-12.3%	-18.5%	-20.3%	27.2%	-24.6%	-22.4%	-25.0%	23.1%	-25.4%	-21.1%	-29.5%	27.9%
EBITDA	1.1	(0.6)	(0.7)	33.1	(0.7)	0.4	0.1	33.3	1.5	3.3	0.5	44.1
EBITDA Margins	4.1%	-2.0%	-2.1%	33.9%	-2.1%	1.2%	0.4%	32.4%	4.2%	9.0%	1.3%	38.7%
Interest Expense	(0.1)	(0.0)	(0.1)	(0.1)	(0.0)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Interest Income	1.5	1.4	1.4	1.3	1.3	0.7	0.5	0.7	1.0	1.0	1.0	1.0
EBT and accounting change	(1.9)	(4.2)	(5.3)	27.7	(7.1)	(7.3)	(8.6)	24.3	(7.9)	(6.8)	(10.6)	32.7
Tax benefit (provision)	0.8	1.7	2.0	(10.8)	3.5	3.3	5.9	(13.1)	3.2	2.7	4.2	(13.1)
Assumed Tax Rate		*41%*	*38%*	*39%*	*49%*	*45%*	*69%*	*54%*	*40%*	*40%*	*40%*	*40%*
EAT and before accounting change	(1.1)	(2.4)	(3.3)	16.9	(3.6)	(4.0)	(2.7)	11.2	(4.8)	(4.1)	(6.4)	19.6
Cumulative effect of change in acct principle												
Net income	(1.1)	(2.4)	(3.3)	16.9	(3.6)	(4.0)	(2.7)	11.2	(4.8)	(4.1)	(6.4)	19.6
EPS - basic	(0.04)	(0.10)	(0.14)	0.69	(0.15)	(0.16)	(0.11)	0.44	(0.18)	(0.16)	(0.24)	0.73
EPS - diluted	(0.04)	(0.10)	(0.14)	0.63	(0.15)	(0.16)	(0.11)	0.41	(0.18)	(0.16)	(0.24)	0.68
Pro forma EPS (dluted)	(0.03)	(0.08)	(0.11)	0.69	(0.12)	(0.12)	(0.11)	0.63	(0.11)	(0.08)	(0.17)	0.76
Pro Forma Dilluted Sharecount	23.9	24.1	24.5	26.8	24.9	25.0	25.1	27.1	26.1	26.4	26.7	27.5
Shares outstanding - basic	23.9	24.1	24.5	24.5	24.9	25.0	25.1	25.4	26.1	26.4	26.7	27.0
Shares outstanding - diluted	23.9	24.1	24.5	26.8	24.9	25.0	25.1	27.1	26.1	26.4	26.7	28.8

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 173: SFLY Quarterly Income Statement (cont.)

	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Customers	693,092	731,384	844,400	1,384,625	895,257	833,786	916,195	1,478,780	950,763	917,165	1,016,976	1,715,384
Y/Y Growth	*32.3%*	*41.3%*	*35.5%*	*45.0%*	*29.2%*	*14.0%*	*8.5%*	*6.8%*	*6.2%*	*10.0%*	*11.0%*	*16.0%*
Orders	1,288,471	1,461,804	1,660,840	2,650,489	1,617,127	1,561,877	1,656,050	2,647,839	1,620,361	1,594,676	1,738,853	2,833,187
Y/Y Growth	*31.4%*	*40.4%*	*33.5%*	*44.1%*	*25.5%*	*6.8%*	*-0.3%*	*-0.1%*	*0.2%*	*2.1%*	*5.0%*	*7.0%*
Average order per customer	1.86	2.00	1.97	1.91	1.81	1.87	1.81	1.79	1.70	1.74	1.71	1.65
Y/Y Growth	*-0.7%*	*-0.7%*	*-1.5%*	*-0.6%*	*-2.8%*	*-6.3%*	*-8.1%*	*-6.5%*	*-5.6%*	*-7.2%*	*-5.4%*	*-7.8%*
Average Order Size	$20.73	$20.44	$19.63	$36.80	$21.23	$22.70	$21.71	$38.82	$21.46	$23.00	$22.40	$40.22
Y/Y Growth	*20.5%*	*8.4%*	*15.5%*	*3.0%*	*2.4%*	*11.1%*	*10.6%*	*5.5%*	*1.1%*	*1.3%*	*3.2%*	*3.6%*
Print Revenue (% of total revenue)	51%	48%	55%	36%	46%	45%	46%	36%	46%	44%	45%	31%
Non-Print Revenue (% of total revenue)	49%	52%	45%	64%	54%	55%	54%	64%	54%	56%	55%	69%
Print Revenue	13.7	14.3	18.0	35.6	15.9	15.8	16.6	37.0	16.0	16.1	17.5	35.3
Non-print revenue	13.0	15.6	14.6	61.9	18.4	19.7	19.4	65.8	18.8	20.5	21.4	78.6
Expenses as % of Revenue												
Cost of revenues	48.8%	49.6%	52.9%	40.0%	52.2%	49.0%	51.3%	43.0%	52.6%	49.1%	51.4%	39.7%
Technology and Development	21.8%	22.2%	23.2%	8.8%	26.7%	27.7%	26.8%	9.5%	27.0%	27.0%	28.0%	9.3%
Sales and Marketing	19.4%	24.1%	21.6%	14.3%	23.5%	24.3%	28.1%	14.6%	23.6%	24.0%	28.0%	14.3%
General and Administrative	22.3%	22.6%	22.6%	9.7%	22.2%	21.3%	18.8%	9.8%	22.2%	21.0%	22.1%	8.8%
Y/Y Change												
Revenue Growth	58%	52%	54%	49%	29%	19%	10%	5%	1%	3%	8%	11%
Print Revenue	31%	25%	33%	36%	17%	11%	-8%	4%	0%	2%	6%	-5%
Non-print revenue	103%	89%	90%	57%	41%	26%	32%	6%	2%	4%	11%	20%
Cost of revenues	49%	52%	59%	50%	38%	17%	7%	13%	2%	4%	9%	2%
Technology and Development	46%	55%	53%	46%	58%	48%	27%	14%	2%	1%	13%	9%
Sales and Marketing	40%	60%	30%	67%	56%	20%	43%	8%	2%	2%	8%	9%
General and Administrative	76%	57%	45%	47%	28%	12%	-8%	6%	1%	2%	27%	0%
Sequential Change												
Revenue Growth	-59.3%	11.9%	9.1%	199.2%	-64.8%	3.2%	1.4%	185.9%	-66.2%	5.4%	6.2%	192.5%
Cost of revenues	-50.0%	13.8%	16.2%	126.2%	-54.0%	-3.1%	6.0%	139.8%	-58.6%	-1.6%	11.2%	125.9%
Technology and Development	-1.0%	14.2%	14.1%	13.5%	6.5%	7.3%	-1.9%	1.3%	-3.8%	5.4%	10.2%	-2.8%
Sales and Marketing	-37.9%	39.0%	-2.2%	98.0%	-42.2%	7.0%	17.0%	48.8%	-45.3%	7.2%	23.9%	49.4%
General and Administrative	-7.7%	13.0%	9.1%	29.2%	-19.8%	-0.9%	-10.4%	48.8%	-23.4%	-0.3%	11.8%	16.5%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 174: SFLY Annual Balance Sheet

$ in millions

	2007A	2008E	2009E	2010E
ASSETS				
Cash and cash equivalents	122.6	76.3	94.5	116.2
Short-term investments	3.0	-	-	-
Accounts receivable	4.5	7.7	8.5	10.0
Net inventory	4.8	9.2	10.3	12.0
Deferred tax asset - current	1.7	0.6	0.6	0.6
Other current	4.5	8.1	8.1	8.1
Total current assets	141.0	101.9	121.9	146.8
				-
Net fixed assets	48.4	52.2	59.6	68.3
Long-term Investments	-	47.4	47.4	47.4
Acquisition cost	-	-	-	-
Intangible assets, net	3.6	14.6	14.6	14.6
Deferred tax asset	13.5	23.8	23.8	23.8
Other assets	2.2	1.8	1.8	1.8
Total assets	208.7	241.8	269.2	302.8
				-
LIABILITIES AND SHAREHOLDERS' EQUITY				-
Accounts payable	8.8	11.4	12.5	14.6
Accrued liabilities	18.9	27.2	31.9	37.2
Litigation settlement	-	-	-	-
Deferred revenue	8.7	21.8	26.2	30.6
Lease obligation - current	0.8	0.5	0.5	0.5
Note payable - current	-	-	-	-
Total Current Liabilities	37.2	60.9	71.2	83.0
				-
Lease obligations	1.1	1.1	1.1	1.1
Other liabilities	0.1	0.0	0.0	0.0
Note payable	-	-	-	-
Litigation settlement	-	-	-	-
Preferred stock warrant liability	-	-	-	-
Total Liabilities	38.4	62.0	72.3	84.1
				-
				-
Series A-F preferred stock	-	-	-	-
Common stock at par	0.0	0.0	0.0	0.0
Additional paid in capital	190.8	199.2	212.0	225.6
Accumulated other comprehensive income			-	-
Deferred stock-based comp	(0.0)	-	-	-
Retained earnings	(20.2)	(19.4)	(15.0)	(7.0)
Total stockholder equity	170.6	179.8	197.0	218.7
	-	-	-	-
Total Liabilities and shareholders' equity	209.0	241.8	269.2	302.8

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 175: SFLY Annual Cash Flow Statement

$ in millions

	2007A	2008E	2009E	2010E
OPERATING ACTIVITIES:				
Net income (loss)	10.1	0.8	4.4	8.1
Depreciation and amortization	17.4	24.1	32.6	38.3
Amortization of intangible assets	0.4	1.9	2.0	2.0
Amortization of stock-based compensation, net of cancellation	4.0	8.7	11.0	11.9
Amortization of warrants	-	-	-	-
Change in carrying value of preferred stock warrant liability			-	-
Gain/loss on disposal of fixed assets	0.3	0.3	-	-
Deferred income taxes	5.7	(9.7)	-	-
Charitable contribution expense for shares issued to charitable foundation				
Changes in operating assets and liabilities:	4.3	13.3	8.4	8.7
Inventories	(2.3)	(4.4)	(1.1)	(1.7)
Accounts receivable	(2.3)	(3.2)	(0.8)	(1.4)
Prepaid expenses & other current assets	(1.8)	(3.6)	-	-
Deferred tax asset	-	-	-	-
Other assets	(1.7)	0.4	-	-
Accounts payable	(0.6)	2.6	1.2	2.1
Accrued liabilities	10.5	8.4	4.7	5.3
Preferred stock warrant liability	-	-	-	-
Deferred revenue	2.4	13.1	4.4	4.4
Deferred rent	-	-	-	-
Net cash provided by operating activities	42.2	39.4	58.4	68.9
				-
FCF (actuals adjusted for Capitalized Tech & Dev costs)	7.2	15.6	18.4	21.9
				-
INVESTING ACTIVITIES:				-
Purchase of property & equipment	(35.0)	(27.0)	(40.0)	(47.0)
Acquisition of business, net of cash	(2.9)	(10.1)	-	-
Purchase of short term investment	(3.0)	3.0	-	-
Purchase of long term investment	-	(52.3)	-	-
Proceeds from sale of property and equipment	0.0	0.0	-	-
Net cash provided by (used in) investing activities	(40.8)	(86.3)	(40.0)	(47.0)
	-	-	-	-
FINANCING ACTIVITIES:	-	-	-	-
Principal payments of capital lease obligation	(2.8)	(0.4)	(0.2)	(0.2)
Proceeds from loan from a related party	-	-	-	-
Repayment of loan from a related party			-	-
Proceeds from loan	-	-	-	-
Repayment of loan	-	-	-	-
Principal payment of note payable obligation	-	-	-	-
Proceeds from issuance of redeemable conv. pref stock, net of issuance cost				
Payment of IPO related costs	-	-	-	-
Proceeds from issuance of common stock	-	1.1	-	-
Proceeds from exercise of unvested options	-	-	-	-
Other			-	-
Repurchase of common stock	-	-	-	-
Net cash provided by (used in) financing activities	2.1	0.7	(0.2)	(0.2)
				-
Net change in cash and cash equivalents	3.5	(46.3)	18.2	21.7
Cash and cash equivalents at beginning of period	119.1	122.6	76.3	94.5
Cash and cash equivalents at end of period	122.6	76.3	94.5	116.2

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

ValueClick, Neutral, ($6.56)

U.S. Advertising & Marketing Services
Townsend Buckles[AC]
(1-212) 622-0461
townsend.buckles@jpmorgan.com
J.P. Morgan Services Inc.

Like the rest of ad-based media and eCommerce, we believe ValueClick has another challenging year ahead with ad budgets and consumer spending likely to be under heavy pressure. We expect further steep revenue declines across the company in 2009, particularly in the more volatile, lower-visibility ad network (media) and comparison shopping businesses. We maintain our Neutral rating with our view of attractive long-term valuation tempered by near-term macro/industry uncertainty and likelihood of continued deterioration of fundamental performance.

- **Display advertising under pressure; spending cuts + growing inventory = further price deflation.** Display advertising has come grinding to a halt industry-wide. CPM-based display, in particular, has suffered as marketers fall back to more accountable, ROI-based channels such as search, or simply stick with 'tried and true' traditional media. Compounding pullbacks is a growing glut of inventory that is driving down pricing. We expect ValueClick's display ad revenues to decline 17% in 4Q08 and 10% in 09.
- **Can comparison shopping stabilize?** Since acquiring MeziMedia in 07, performance has been on a rollercoaster ride, initially growing triple digits organically before plunging into negative growth in 2H08 from weak eCommerce trends and traffic monetization struggles. Performance in the comparison shopping business is probably the biggest question mark for earnings in 2009 – we expect a tough year with revenue down more than 25%.
- **2009 drivers.** In our view, the following factors will drive shares in 2009: (1) the consumer – sentiment and spending should be a major influence on advertiser budgets and eCommerce; (2) margin preservation – management remains confident it can minimize margin compression with two-thirds of costs variable and fixed-cost cuts planned; (3) hitting guidance – after a number of earnings misses and negative guidance revisions over the last two years, we believe several quarters of hitting expectations would instill greater investor confidence.
- **Maintaining 4Q'08 estimates.** We expect a difficult Q4 given very weak ad and consumer spending trends. With little visibility into the media and comparison shopping businesses in particular, we see downside risk to guidance. We are looking for results at the bottom range of guidance, or EPS of $0.15 and adj. EBITDA (ex. stock comp) of $33.5m off a revenue decline of 25%.

Our current and recently introduced 2010 estimates are in the table below:

Table 176: ValueClick Financial Snapshot

$ in millions, except per share data

VCLK	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	138.1	630.8	524.7	544.2	-2.3%	-16.8%	3.7%
Adj. EBITDA	33.5	161.4	128.1	135.4	-3.5%	-20.6%	5.7%
EPS	0.15	0.54	0.51	0.59	-22.4%	-5.8%	14.8%
Consensus							
Revenue	142.7	635.3	559.5	586.0	-1.6%	-11.9%	4.7%
Adj. EBITDA	34.0	162.0	138.5	142.2	-3.2%	-14.5%	2.7%
EPS	0.15	0.54	0.59	0.62	-23.1%	9.3%	5.1%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We recently tweaked down our 2009 estimates as online advertising and eCommerce spending look to further weaken. We project a continuation of Q4 trends into 1H09 and expect easing declines in the back half of the year against easier comps. Our 09 EPS estimate is $0.51 and adj. EBITDA of $128 million.

2009 Revenue Forecasts

	09/08 %chg
Media[1]	-14%
Lead gen	-12%
Display	-10%
Comparison Shopping	-26%
Affiliate Marketing	-8%
Technology[1]	-26%
Total Revenues	**-17%**

Note: 1. Includes impact of Oct. 08 divestitures.
Source: JPM estimates

Look for double-digit revenue declines; focus on margin preservation. We expect management will continue its focus on mitigating margin compression through cost cuts, and possibly at the expense of booking low-margin revenues from lower pricing or boosting third-party publisher payouts. We expect revenues to decline 17%, including the effect of two small divestitures at ~2%.

Media: Display weakness, further lead gen declines expected. We project segment revenue to decline 14% (-11% organically, ex. divestiture impact), with display down 10% and another 12% of declines in lead gen. As mentioned above, CPM-based display (1/3 of ad network revenues) has suffered more substantial weakness in online ad spending, which we expect to continue throughout the year. The remainder of the business, under performance-based pricing such as CPC and CPL (cost-per-click and cost-per-lead), has remained in greater demand, however fewer consumer clicks/actions still mean less revenue.

Our agency contacts also indicate Internet spending could be a victim of its own convenience (short lead times), where larger advertisers stuck in longer-term media commitments (e.g., TV sports sponsorships) may have to turn to their Internet budgets for cuts.

Ad network shakeout?

We see possibility for a changing competitive landscape over the next year, both on the consolidation side and for the smaller players that might have to find a strategic buyer or shut down with VC support drying up. We do believe ValueClick's strong, established position in the ad network space should help the business weather a difficult revenue environment and possibly even pick up market share from recent entrants; however, with Google making a concerted effort in display and Yahoo and AOL possibly headed for ownership changes, we believe the bigger portals pose an increasing threat to this low barrier, low switching cost business.

Comparison Shopping: Cyclical and structural issues set up challenged outlook. eCommerce has undergone a substantial slowdown with little reason for near-term optimism as weak consumer spending will not likely be helped by rising unemployment and continued home value declines. ValueClick is also facing demands for higher quality traffic amidst the industry slump from its biggest customers, the search engines. Consequently, the company has struggled to acquire and monetize traffic, a problem we expect to continue for the foreseeable future. We see this as ValueClick's worst performing business in 2009, with revenue down 26%, and remain cautious of the outlook in such a competitive space.

Affiliate Marketing: Resilient business model, though heavy retail exposure. We continue to see affiliate marketing as ValueClick's most defensive and resilient business to competitive and macro pressures. We expect the business model of an essentially pre-determined ROI to advertisers may come in greater demand as accountability and driving sales become paramount. However, with 70% of revenues coming from retail eCommerce, lower transaction volumes equate to lower

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

commission-based revenues. We expect to see revenue declines in 2009, offset somewhat by new clients and expanded programs.

Technology: Volume-based business likely to decline with display advertising. We expect display ad spending cuts to translate into ad serving declines. We believe market share gains stemming from the fallout of the industry's two biggest ad servers being acquired by portals (DoubleClick/Google, Atlas/MSFT) helped revenue growth over the last two years; however, we expect those benefits to have largely cycled through. Also dampening reported top-line growth in 2009 is the sale of ValueClick's AdVault business, which we estimate to take off around $7-7.5 million in revenue.

Our Estimates and Outlook for 2010

We recently introduced 2010 estimates assuming an improved macro outlook and return to growth, albeit tepid, in online advertising and eCommerce. Our preliminary estimates are for EPS of $0.59 and adj. EBITDA of $135 million off 3.7% revenue growth. Given the highly uncertain macro environment and low visibility into online advertising, we expect these estimates will likely undergo significant revisions as 2009 progresses.

Mezi earnout payment? A silver lining to an expected tough 2009 could be that ValueClick would not have to make its final acquisition earnout payment to MeziMedia in 1Q10, which could be up to $80 million, representing a substantial portion of expected FCF. The earnout is based on Mezi's annual performance, and while a 1Q09 payment of ~$64 million on Mezi's 08 results has already been met despite the recent weak performance, the company has indicated that if the business remains particularly weak in 2009, some or all of the $80 million may not be achieved, saving a good portion of cash.

Valuation and Rating Analysis

At 3.9x our 2009 adj. EBITDA estimate, we see valuation as attractive given our favorable long-term view for online advertising growth once the economy improves. However, we believe the macro environment – with little visibility – continues to pose a risk to earnings into 2009 and potentially beyond. We reiterate our Neutral rating with a year-end 2009 price target of $9, representing moderate multiple expansion to 5x our 2010 adj. EBITDA estimate due to an improved, more stable macro and company outlook that we expect to see across many of its peers. We further expect that in the current highly volatile equity markets, VCLK shares will fluctuate broadly near to mid-term.

Risks to Our Rating

Potential risks to the downside include:

- Prolonged and/or deepening slowdown in online ad spending or eCommerce.
- Intensified competition from the larger online ad properties, pressuring growth and profitability.

Potential risks to the upside include:

- Company takeout or other strategic maneuver.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 177: VCLK Annual Income Statement

$ in millions

	2007	2008E	2009E	2010E
Revenue				
Media	$386.7	$309.4	$266.0	$279.3
% change	1.0%	-20.0%	-14.0%	5.0%
Comparison Shopping & Search	112.7	169.3	124.7	127.8
% change	183.4%	50.2%	-26.4%	2.5%
Affiliate Marketing	116.0	119.4	109.6	112.4
% change	17.7%	2.9%	-8.1%	2.5%
Technology	32.5	35.8	26.4	27.7
% change	26.5%	10.0%	-26.2%	5.0%
Total Revenue	645.6	630.8	524.7	544.2
% change	18.3%	-2.3%	-16.8%	3.7%
Cost of revenue	204.6	207.6	180.9	186.1
Gross profit	441.0	423.2	343.9	358.1
% of revenue	68.3%	67.1%	65.5%	65.8%
Sales and marketing	190.7	175.5	145.0	149.7
% of revenue	29.5%	27.8%	27.6%	27.5%
General and administrative	75.3	78.4	65.2	66.9
% of revenue	11.7%	12.4%	12.4%	12.3%
Technology	36.0	37.1	31.4	32.7
% of revenue	5.6%	5.9%	6.0%	6.0%
Total operating expenses	302.0	290.9	241.6	249.3
% of revenue	46.8%	46.1%	46.0%	45.8%
% change	18.1%	-3.7%	-17.0%	3.2%
EBITA	139.0	132.3	102.3	108.8
% of revenue	21.5%	21.0%	19.5%	20.0%
Amortization of intangible assets	25.9	29.4	26.4	26.5
Operating income	113.1	102.9	75.9	82.3
% of revenue	17.5%	16.3%	14.5%	15.1%
% change	12.8%	-9.0%	-26.2%	8.5%
Interest income and other, net	12.1	4.6	2.5	4.5
Income before taxes	125.1	107.5	78.4	86.8
Provision for income taxes	51.6	45.7	33.3	36.9
Effective tax rate	41.3%	42.5%	42.5%	42.5%
Net income, recurring	73.5	61.8	45.1	49.9
Shares outstanding, diluted	100.5	93.2	88.0	84.9
EPS, recurring	$0.73	$0.66	$0.51	$0.59
% change	21.3%	-9.2%	-22.8%	14.8%
Non-recurring (costs) benefits, net of tax	(2.9)	(11.2)	-	-
GAAP Net Income	70.6	50.7	45.1	49.9
GAAP EPS	$0.70	$0.54	$0.51	$0.59
EBITDA	148.8	141.8	112.1	118.5
% of revenue	23.0%	22.5%	21.4%	21.8%
% change	13.3%	-4.7%	-20.9%	5.7%
Adj. EBITDA (ex-stock comp)	167.3	161.4	128.1	135.4
% of revenue	25.9%	25.6%	24.4%	24.9%
% change	16.8%	-3.5%	-20.6%	5.7%

Notes:

2008 Non-recurring cost represents 1) $33.8 million non-cash portion of employee stock option buyout; 2) $9.1 million tax benefit.

2007 Non-recurring cost represents FTC settlement over promotional lead generation marketing practices.

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 178: VCLK Quarterly Income Statement

$ in millions

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08E	1Q09E	2Q09E	3Q09E	4Q09E
Revenue												
Media	$108.4	$100.9	$85.6	$91.8	$79.4	$79.3	$78.7	$72.0	$64.3	$66.2	$68.5	$67.0
% change	36.6%	7.9%	-13.0%	-17.8%	-26.8%	-21.4%	-8.0%	-21.5%	-19.0%	-16.5%	-13.0%	-7.0%
Comparison Shopping & Search	13.2	13.4	35.7	50.4	57.1	45.4	36.6	30.2	31.4	34.1	32.0	27.2
% change	69.4%	52.6%	269.3%	272.7%	331.7%	239.5%	2.5%	-40.0%	-45.0%	-25.0%	-12.5%	-10.0%
Affiliate Marketing	28.2	27.0	27.8	32.9	31.2	29.8	29.3	29.0	26.5	26.2	27.8	29.0
% change	14.6%	21.1%	18.0%	17.4%	10.7%	10.3%	5.3%	-11.8%	-15.0%	-12.0%	-5.0%	0.0%
Technology	7.5	7.8	8.2	9.1	9.3	10.1	9.0	7.4	6.0	6.5	6.7	7.1
% change	29.4%	35.6%	25.9%	18.2%	24.2%	29.6%	9.5%	-18.0%	-35.0%	-35.0%	-25.0%	-5.0%
Total Revenue	156.9	148.7	156.9	183.1	176.0	163.8	152.9	138.1	127.7	132.6	134.6	129.8
% change	33.8%	14.3%	13.8%	14.1%	12.2%	10.2%	-2.5%	-24.6%	-27.4%	-19.1%	-12.0%	-6.0%
Cost of revenue	47.0	49.1	50.5	58.0	55.1	51.7	53.7	47.1	43.0	44.9	48.1	44.8
Gross profit	109.9	99.6	106.4	125.1	120.9	112.1	99.2	91.0	84.7	87.7	86.5	85.1
% of revenue	70.0%	67.0%	67.8%	68.3%	68.7%	68.4%	64.9%	65.9%	66.3%	66.1%	64.2%	65.5%
Sales and marketing	48.5	42.2	46.4	53.6	51.7	46.1	40.1	37.6	37.3	37.0	35.3	35.4
General and administrative	17.5	17.2	18.3	22.3	21.7	20.2	19.7	16.8	15.8	16.2	17.0	16.2
Technology	8.9	8.7	8.7	9.6	10.0	10.2	9.4	7.5	7.7	8.0	8.2	7.5
Total operating expenses	74.9	68.1	73.4	85.5	83.3	76.5	69.2	61.9	60.8	61.1	60.4	59.2
% of revenue	47.7%	45.8%	46.8%	46.7%	47.3%	46.7%	45.2%	44.9%	47.6%	46.1%	44.9%	45.6%
% change	33.2%	15.1%	6.5%	19.8%	11.2%	12.3%	-5.7%	-27.6%	-27.0%	-20.1%	-12.6%	-4.4%
EBITA	35.0	31.5	33.1	39.5	37.6	35.6	30.0	29.1	23.9	26.5	26.0	25.9
% of revenue	22.3%	21.2%	21.1%	21.6%	21.4%	21.8%	19.6%	21.1%	18.7%	20.0%	19.3%	19.9%
Amortization of intangible assets	5.8	5.5	6.7	8.0	7.8	7.8	7.1	6.7	6.7	6.7	6.5	6.5
Operating income	29.2	26.0	26.3	31.6	29.8	27.9	22.9	22.4	17.2	19.8	19.5	19.4
% of revenue	18.6%	17.5%	16.8%	17.2%	17.0%	17.0%	15.0%	16.2%	13.5%	15.0%	14.5%	14.9%
% change	80.8%	11.8%	6.2%	-12.4%	2.3%	7.1%	-13.1%	-29.1%	-42.4%	-28.8%	-14.5%	-13.5%
Interest income and other, net	2.9	3.4	2.9	2.8	3.1	1.4	(0.4)	0.5	-	0.5	1.0	1.0
Income before taxes	32.1	29.4	29.3	34.4	32.9	29.3	22.5	22.9	17.2	20.3	20.5	20.4
Provision for income taxes	13.5	11.8	12.4	13.9	13.7	12.8	9.3	9.8	7.3	8.6	8.7	8.7
Effective tax rate	42.0%	40.0%	42.5%	40.6%	41.7%	43.7%	41.5%	43.0%	42.5%	42.5%	42.5%	42.5%
Net income, recurring	18.6	17.6	16.8	20.4	19.2	16.5	13.2	13.0	9.9	11.7	11.8	11.7
Shares outstanding, diluted	101.0	101.6	100.2	99.2	98.6	96.1	90.0	88.0	88.0	88.0	88.0	88.0
EPS, recurring	$0.18	$0.17	$0.17	$0.21	$0.19	$0.17	$0.15	$0.15	$0.11	$0.13	$0.13	$0.13
% change	97.4%	35.9%	-1.4%	-4.4%	5.4%	-1.1%	-12.9%	-28.0%	-42.2%	-22.5%	-8.2%	-10.2%
Non-recurring (costs) benefits, net of tax		-	-	(2.9)	-	-	(11.2)	-	-	-	-	-
GAAP Net Income	18.6	17.6	16.8	17.5	19.2	16.5	2.0	13.0	9.9	11.7	11.8	11.7
GAAP EPS	$0.18	$0.17	$0.17	$0.18	$0.19	$0.17	$0.02	$0.15	$0.11	$0.13	$0.13	$0.13
EBITDA	37.4	33.8	35.5	42.1	40.2	38.2	32.6	30.9	26.4	29.0	28.4	28.3
% change	55.5%	9.4%	8.7%	-3.6%	7.5%	12.9%	-8.2%	-26.7%	-34.3%	-24.0%	-12.7%	-8.5%
Adj. EBITDA (ex-stock comp)	41.0	38.8	40.1	47.4	46.0	43.5	38.4	33.5	30.4	33.0	32.4	32.3
% of revenue	26.1%	26.1%	25.5%	25.9%	26.1%	26.6%	25.1%	24.3%	23.8%	24.9%	24.1%	24.8%
% change	49.9%	13.5%	12.5%	2.9%	12.0%	12.3%	-4.1%	-29.3%	-33.9%	-24.1%	-15.5%	-3.8%

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 179: VCLK Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Current Assets				
Cash & equivalents	82.8	121.5	124.0	114.8
Marketable securities, at fair value	170.7	2.2	2.2	2.2
Accounts receivable, net of allowance for doubtful accounts	126.6	92.0	92.3	94.5
Inventories	1.6	1.7	1.7	1.7
Prepaid expenses, other current assets	4.7	3.9	5.2	6.8
Deferred tax asset	8.1	8.8	8.8	8.8
Income taxes receivable	4.4	10.2	10.2	10.2
Total Current Assets	398.8	240.3	244.5	239.0
Property & equipment, net	19.4	19.8	24.0	28.3
Goodwill	439.5	425.1	489.1	570.1
Other intangible assets, net	113.0	82.7	56.3	29.8
Long-term investments and other assets	1.9	1.9	1.9	1.9
Deferred tax assets, net	4.3	3.8	3.8	3.8
TOTAL ASSETS	1,011.0	804.0	849.9	903.2
Current Liabilities				
Accounts payable and accrued expenses	215.5	94.2	89.5	111.6
Income taxes payable	1.9	-	-	-
Deferred revenue	1.8	1.4	1.4	1.4
Total Current Liabilities	219.2	95.6	91.0	113.0
Income taxes payable, less current portion	74.9	68.2	68.2	68.2
Deferred tax liabilities	3.8	4.4	4.4	4.4
Other non-current liabilities	3.2	0.5	0.5	0.5
Total Liabilities	301.1	168.7	164.0	186.1
Common stock	0.1	0.1	0.1	0.1
Add'l paid-in capital	653.4	606.9	612.4	618.7
Accumulated other comprehensive income	9.3	(0.5)	(0.5)	(0.5)
Retained earnings (accumulated deficit)	47.1	28.8	73.9	98.8
Shareholders' Equity	709.9	635.3	685.9	717.1
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	1,011.0	804.0	849.9	903.2

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 180: VCLK Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Cash Flows from Operating Activities				
Net income, recurring	73.5	61.8	45.1	49.9
Adjustments	(2.9)	(11.2)	-	-
Reported Net Income	70.6	50.7	45.1	49.9
Adjustments to reconcile:				
Depreciation & amortization	35.7	38.9	36.2	36.2
Provision for doubtful accounts and sales credits	7.8	4.9	-	-
Non-cash, stock-based comp expense	18.3	53.4	16.0	16.9
Deferred income taxes	(16.0)	(4.7)	-	-
Tax benefit from stock option exercises	4.3	0.3	-	-
Excess tax benefit from stock option exercises	(4.5)	(0.4)	-	-
Changes in operating assets & liabilities:	26.3	(16.7)	(6.2)	18.3
Net Cash Provided by (Used in) Operating Activities	142.5	126.2	91.1	121.3
Cash Flows from Investing Activities				
Purchase of property and equipment	(9.3)	(10.1)	(14.0)	(14.0)
Purchases of marketable securities	(323.7)	(39.9)	-	-
Proceeds from maturity and sale of marketable securities	324.7	208.0	-	-
Acquisitions/sales of businesses, less cash acquired	(102.1)	(92.4)	(64.0)	(81.0)
Net Cash Used in Investing Activities	(110.5)	65.6	(78.0)	(95.0)
Cash Flows from Financing Activities				
Purchase of common stock	(44.0)	(150.2)	-	(25.0)
Proceeds from exercises of stock option exercies and warants	13.2	(0.4)	(10.5)	(10.5)
Excess tax benefit from stock-based comp	4.5	0.4	-	-
Net Cash Provided by (used in) Financing Activities	(26.3)	(150.1)	(10.5)	(35.5)
Effect of exchange rates on cash	0.3	(2.9)	0.0	0.0
Net Increase (decrease) in Cash and Cash Equivalents	6.0	38.7	2.5	(9.3)
Cash and cash equivalents, beginning of period	76.8	82.8	121.5	124.0
Cash and cash equivalents, end of period	82.8	121.5	124.0	114.8

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Yahoo!, Overweight, ($11.97)

We think the potential for a search deal with Microsoft is reasonably high and that this risk/arb speculation will overpower difficult fundamentals in driving stock performance. As a result, we are maintaining our Overweight rating. However, on an operational basis, we think Yahoo! will continue to struggle with search market share losses, a weak display ad environment, and key employee retention issues. Yahoo! trades at 4.3x our F'09 EBITDA estimate of $1.85B. We are introducing a $19 December 2009 price target.

- **Fully outsourcing search operations makes strategic sense, in our view.** We think Yahoo!'s increased investment in search has come at the expense of display investment and has given competitors the opportunity to eat away some of Yahoo!'s leading display ad market share. We believe niche sites are a particular threat. By our estimates, outsourcing search to Microsoft could lead to ~$1.4B in cost savings.
- **As we think the display ad market will underperform in 2009, we think Yahoo!'s top-line growth will be challenged**. In 2008, we began to see a shift in advertising spend to performance-based models, and we expect this trend to accelerate in 2009 as advertisers carefully manage their marketing ROI. We are modeling 2009 Yahoo! display ad revenue growth of only 4% Y/Y.
- **We expect continued market share losses in search.** In 2009, we are forecasting only 11% Y/Y growth in search (below our 12% global search market growth estimate), as we have not seen any new products or strategies likely to drive increased search usage. Thus, we think continued market share losses are likely.
- **2009 drivers.** In our view, the following factors will drive YHOO shares in 2009: (1) selection of the new CEO, (2) possible deals with Microsoft and AOL, and (3) rollout of the APT platform.
- **Maintaining 4Q'08 estimates.** We are maintaining our 4Q'08 revenue, EBITDA, and GAAP EPS estimates of $1.4B, $509M, and $0.13.

Our current and newly introduced 2010 estimates are in the table below:

Table 181: Yahoo! Financial Snapshot

$ in millions, except per share data

YHOO	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	1,398.3	5,421.6	5,400.1	5,876.8	6.0%	-0.4%	8.8%
EBITDA	508.8	1,779.4	1,846.5	1,900.9	-7.7%	3.8%	2.9%
GAAP EPS	0.13	0.63	0.33	0.32	34.4%	-47.9%	-3.5%
Consensus							
Revenue	1379.5	5,403.90	5,466.10	5,853.50	5.7%	1.2%	7.1%
EBITDA	523.9	1846.2	2044.8	2197.8	-4.2%	10.8%	7.5%
GAAP EPS	0.12	0.63	0.45	0.53	33.8%	-28.6%	17.8%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We are slightly adjusting our F'09 revenue, EBITDA, and GAAP EPS estimates. We are now modeling F'09 revenue, EBITDA, and EPS of $5.40B, $1.85B, and $0.33 vs. our prior estimates of $5.43B, $1.85, and $0.33, respectively. This represents Y/Y growth of (0.4)%, 4%, and (48)%, respectively. Broken out by segment, we expect O&O display advertising to grow 4% Y/Y, O&O search advertising to grow 11% Y/Y, and fee revenue to decline 15% Y/Y. Within search and display, we expect affiliate revenue losses to continue due to weaker ad spend and continued culling of low quality affiliates. Therefore, we are modeling a 4% Y/Y decline in affiliate revenue.

Search Outsourcing to Microsoft Could Add ~$725M in OCF

In addition to receiving an estimated 1x cash payment for the search technology from Microsoft, we believe the sale would generate significant cost saves for Yahoo!, as it will outsource the business to Microsoft. We estimate that Yahoo! could receive an additional ~$725M in a Microsoft arrangement due to cost savings

Yahoo! would lose some of its revenue stream…
We think the outsourcing of search monetization to Microsoft would result in a $694M annual revenue loss using the following assumptions:

- No change in volume or monetization of search traffic due to a Microsoft sale vs. Yahoo! Ownership;
- Microsoft would absorb a 90% TAC rate on Yahoo! search traffic; and
- Yahoo! receives ~$500M in net affiliate search revenue, none of which would be retained if search assets were sold to Microsoft (Please note that Ask.com has affiliates, but we are taking a conservative view).

Table 182: Yahoo! Revenue Could Decline by $694M through a MSFT Deal

$ in millions

	Current	Sold to Microsoft
F'09 O&O Search Revenue	*1,942*	*1,942*
Microsoft TAC Rate	*100%*	*90%*
F'09 Net O&O Search Revenue	1942	1748
F'09 Net Affiliate Revenue	500	0
Total F'09 Revenue	2,442	1,748
Loss from MSFT Agreement		694

Source: Company reports and J.P. Morgan estimates.

However, the cost savings make this deal accretive to OCF
In order to estimate the OpEx associated with search, we have assumed that 90% of Google's operating expenses are associated with search operations. Using comScore global search volume data, we translated this into a cost per search value. Assuming that Yahoo! has the same cost per search expense, the elimination of in-house search would save the company $1.4B on our F'09 projected search volume. Thus, Yahoo! could increase its annual OCF by ~$725M, after netting the estimated revenue loss and cost savings.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 183: However, Yahoo! Operating Expenses Could Decline $1.4B in a MSFT Deal

millions

Google TTM Global Search Volume	546,778
TTM Google Opex (ex SBC)	7,640
% of Opex associated with search	90%
Opex/Search	0.013
Yahoo! F'09E Search Volume	112,705
Opex/Search	0.013
Est. Yahoo! Search Opex	1,417.3

Source: Company reports, comScore qSearch data, and J.P. Morgan estimates

Our Estimates and Outlook for 2010

We are introducing F'10 revenue, EBITDA, and GAAP EPS estimates of $5.88B, $1.90B, and $0.32, which represent Y/Y growth of 9%, 3%, and (4)%, respectively. Our estimates assume the beginning of an economic recovery and flat foreign currency exchange rates. Thus, we see revenue growing 15% Y/Y in the O&O search segment, as we think increases in ad spend will be slightly offset by search market share losses. We see display advertising revenue growing 10%Y/Y, as we expect the business to benefit from an economic recovery.

We Are Introducing a Price Target of $19

We completed a DCF analysis to establish a December 2009 price target of $19. We have used a DCF analysis to account for the off-balance sheet adjustments. The assumptions for our analysis are laid out in the following two tables.

Table 184: Key DCF assumptions

Equity beta	1.13
Risk free rate (10yr yield)	4.3%
Risk premium	7.0%
Cost of Equity	12.2%
Cost of debt	0.0%
Final debt ratio	0.0%
Equity as a % Cap	100.0%

Source: J.P. Morgan estimates

Table 185: Growth Outlook

$ in millions

	2009E	2010E	2011E	2012E	2013E	2014E
Revenues	5,400.1	5,876.8	6,523.2	7,175.5	7,749.6	8,369.6
Y/Y change		*8.8%*	11%	10%	8%	8%
Less: Operating Expenses	5,153.6	5,695.8	6,197.1	6,816.8	7,362.1	7,951.1
As % of total revenues	*95.4%*	*96.9%*	*95.0%*	*95.0%*	*95.0%*	*95.0%*
Operating Income (Loss)	246.5	180.9	326.2	358.8	387.5	418.5
Operating margin	*4.6%*	*3.1%*	5.0%	5.0%	5.0%	5.0%
Less: taxes	160.9	141.2	143.5	157.9	170.5	184.1
tax rate	*43.3%*	*44.0%*	*44.0%*	*44.0%*	*44.0%*	*44.0%*
Unlevered Net Income	85.6	39.7	182.7	200.9	217.0	234.3
Add Back: Depreciation and SBC	1600.0	1720.0	1978.0	2215.4	2436.9	2631.8
Less: Capital Expenditure	(750.0)	(790.0)	(908.5)	(1,017.5)	(1,119.3)	(1,208.8)
As % of total revenues	*13.9%*	*13.4%*	*13.9%*	*14.2%*	*14.4%*	*14.4%*
Plus/(Minus): Working Capital Changes	(4.9)	(14.7)	(14.7)	(14.7)	(14.7)	(14.7)
As % of total revenues	*-0.1%*	*-0.3%*	*-0.2%*	*-0.2%*	*-0.2%*	*-0.2%*
Free Cash Flow	930.7	955.0	1,237.4	1,384.0	1,519.9	1,642.6
Growth Rate		3%	30%	12%	10%	8%

Source: Company reports and J.P. Morgan estimates.

With a 5% terminal growth rate assumption, we arrive at our $19.00 price target.

Valuation and Rating Analysis

Given our belief that a MSFT deal is possible and asset value limits downside, we rate the stock Overweight. On an EV/EBITDA basis, Yahoo! trades at 4.3x our F'09 EBITDA estimate of $1.85B vs. its peers at 7.8x F'09 estimates.

Risks to Our Rating

Yahoo! is heavily dependent on the performance of the online advertising industry. Yahoo! generates the majority of its net revenues from its Marketing Services revenue unit. The advertising industry is susceptible to overarching economic conditions, making a large portion of Yahoo!'s revenues vulnerable to general economic risk. Changes in competition (e.g., mergers/acquisitions) and new regulations could also impact Yahoo!'s main revenue stream.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 186: YHOO Annual Income Statement

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
Marketing Services	4,231.5	4,528.7	4,641.1	5,110.2
Fees	881.0	893.0	759.0	766.6
Total Revenue	5,112.6	5,421.6	5,400.1	5,876.8
Cost of Revenue	971.4	1,225.0	1,261.8	1,410.4
Gross Profit	4,141.1	4,196.6	4,138.3	4,466.4
Gross Margin	81.0%	77.4%	76.6%	76.0%
Sales and Marketing	1,363.9	1,410.1	1,406.6	1,542.5
Product Development	866.0	1,027.1	994.2	1,094.7
G&A	536.3	690.3	648.0	705.2
Amortization & stock comp	107.1	103.2	123.0	123.0
FAS123 Adjustment	572.4	480.8	720.0	820.0
Other Adjustment	-	-	-	-
Total Expenses	3,445.7	3,711.5	3,891.8	4,285.4
Total Expenses (ex-FAS123R)	2,873.3	3,230.8	3,171.8	3,465.4
Operating Profit	695.4	485.1	246.5	180.9
Operating Margin (Reported)	13.6%	8.9%	4.6%	3.1%
EBITDA	1,927.0	1,779.4	1,846.5	1,900.9
EBITDA Margin	37.7%	32.8%	34.2%	32.3%
Other income, net	154.0	82.2	125.0	140.0
IBT & Minority Interest	849.4	567.3	371.5	320.9
Margins	17%	10%	7%	5%
Income Taxes	337.3	247.1	160.9	141.2
Tax Rate	40%	44%	43%	44%
IAT	512.2	320.2	210.6	179.7
Earnings in Equity Interest	150.7	592.5	250.0	265.0
Minority Interest	(2.9)	(3.0)	(3.1)	-
IAT & Minority Interest	660.0	909.6	460.6	444.7
Accounting Changes	-	-	-	-
Reported Net Income	660.0	909.6	460.6	444.7
Reported EPS GAAP (inc. FAS 123R)	0.47	0.63	0.33	0.32
Adjusted Net Income	655.9	651.6	867.7	903.9
Pro Forma EPS	0.47	0.47	0.62	0.65
Diluted Shares	1,403	1,397	1,398	1,398

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 187: YHOO Quarterly Income Statement

$ in millions

	Q1-07	Q2-07	Q3-07	Q4-07	Q1-08	Q2-08	Q3-08	Q4-08E	Q1-09E	Q2-09E	Q3-09E	Q4-09E
Marketing Services	979.8	1,031.9	1,058.7	1,161.1	1,106.9	1,134.8	1,101.6	1,185.3	1,087.2	1,146.1	1,141.5	1,266.3
Fees	203.2	211.9	223.9	242.0	245.2	211.1	223.7	213.0	208.4	179.5	190.1	181.0
Total Revenue	1,183.1	1,243.8	1,282.6	1,403.1	1,352.1	1,346.0	1,325.3	1,398.3	1,295.6	1,325.5	1,331.6	1,447.4
Cost of Revenue	222.9	226.5	252.7	269.3	286.3	310.2	306.9	321.6	304.5	311.5	312.9	332.9
Gross Profit	960.2	1017.3	1029.9	1133.8	1065.8	1035.7	1018.4	1076.7	991.2	1014.0	1018.7	1114.5
Gross Margin	81.2%	81.8%	80.3%	80.8%	78.8%	76.9%	76.8%	77.0%	76.5%	76.5%	76.5%	77.0%
Sales and Marketing	317.2	338.3	340.6	367.8	359.1	348.6	345.9	356.6	339.5	344.6	346.2	376.3
Product Development	191.2	216.6	223.1	235.1	257.5	268.3	267.8	233.5	246.2	251.9	253.0	243.2
G&A	115.7	123.4	140.5	156.7	179.9	171.9	177.7	160.8	155.5	159.1	159.8	173.7
Amortization & stock comp	27.1	25.2	30.0	24.8	23.7	23.2	24.2	32.0	30.0	30.0	31.0	32.0
FAS123 Adjustment	140.0	128.8	145.5	158.1	125.0	123.2	132.6	100.0	165.0	175.0	185.0	195.0
Other Adjustment												
Total Expenses	791.2	832.3	879.7	942.6	945.2	935.2	948.3	882.9	936.1	960.6	975.0	1020.2
Total Expenses (ex-FAS123R)	651.2	703.5	734.1	784.5	820.2	812.0	815.7	782.9	771.1	785.6	790.0	825.2
Operating Profit	169.0	185.0	150.2	191.2	120.6	100.5	70.2	193.8	55.1	53.5	43.7	94.3
Operating Margin (Reported)	14.3%	14.9%	11.7%	13.6%	8.9%	7.5%	5.3%	13.9%	4.2%	4.0%	3.3%	6.5%
EBITDA	460.0	473.6	466.3	527.1	433.1	427.0	410.4	508.8	440.1	448.5	448.7	509.3
EBITDA Margin	38.9%	38.1%	36.4%	37.6%	32.0%	31.7%	31.0%	36.4%	34.0%	33.8%	33.7%	35.2%
Other income, net	35.5	30.7	43.7	44.1	23.7	24.7	8.9	25.0	30.0	30.0	30.0	35.0
IBT & Minority Interest	204.5	215.7	193.9	235.3	144.3	125.2	79.1	218.8	85.1	83.5	73.7	129.3
Margins	17%	17%	15%	17%	11%	9%	6%	16%	7%	6%	6%	9%
Income Taxes	92.4	87.7	78.7	78.5	57.0	47.7	50.6	91.9	37.4	36.7	32.4	54.3
Tax Rate	45%	41%	41%	33%	39%	38%	64%	42%	44%	44%	44%	42%
IAT	112.1	128.0	115.3	156.8	87.3	77.5	28.5	126.9	47.6	46.7	41.3	75.0
Earnings in Equity Interest	29.1	32.1	36.5	52.9	454.8	54.9	27.8	55.0	55.0	60.0	65.0	70.0
Minority Interest	1.2	0.5	(0.5)	(4.0)	0.1	(1.2)	(1.9)	-	-	-	-	-
IAT & Minority Interest	142.4	160.6	151.3	205.7	542.2	131.2	54.3	181.9	102.6	106.7	106.3	145.0
Reported Net Income	142.4	160.6	151.3	205.7	542.2	131.2	54.3	181.9	102.6	106.7	106.3	145.0
Reported EPS GAAP (inc. FAS 123R)	0.10	0.11	0.11	0.15	0.37	0.09	0.04	0.13	0.07	0.08	0.08	0.10
Adjusted Net Income	153.6	162.7	152.9	186.7	150.0	138.5	123.1	239.9	195.0	204.7	209.9	258.1
Pro Forma EPS	0.11	0.12	0.11	0.13	0.11	0.10	0.09	0.17	0.14	0.15	0.15	0.18
Diluted Shares	1,418	1,404	1,395	1,395	1,395	1,399	1,398	1,398	1,398	1,398	1,398	1,398

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 188: YHOO Annual Balance Sheet

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
Assets				
Cash and cash equivalents	1,513.9	2,787.7	3,843.4	4,938.4
Restricted cash	-	-	-	-
ST investments in marketable securities	487.5	1,070.4	1,070.4	1,070.4
Restricted short-term investments	-	-	-	-
Accounts receivable, net	1,055.5	1,048.7	1,085.5	1,196.1
Prepaid expenses and other current assets	180.7	405.5	419.7	462.5
Total current assets	3,237.7	5,312.2	6,419.0	7,667.3
				-
LT investments in marketable securities	362.0	85.1	85.1	85.1
Restricted long-term investments	-	-	-	-
Property and equipment, net	1,331.6	1,525.7	1,395.7	1,285.7
Goodwill	4,002.0	4,038.4	4,038.4	4,038.4
Intangible assets, net	611.5	556.5	556.5	556.5
Other assets, net	503.9	226.1	226.1	226.1
Investments in equity interests	2,180.9	3,114.9	3,114.9	3,114.9
Total assets	12,229.7	14,858.9	15,835.6	16,974.0
Liabilities and stockholders' equity				
Accounts payable	176.2	167.8	173.7	191.4
Accrued expenses and other current liabilities	1,006.2	1,048.7	1,085.5	1,196.1
Deferred revenue	368.5	377.5	390.8	430.6
Short term debt	749.6	-	-	-
Total current liabilities	2,300.4	1,594.1	1,650.0	1,818.1
			-	-
Long Term Deferred Revenue	95.1	246.3	246.3	246.3
Long Term Debt		-	-	-
Other liabilities	289.1	370.6	370.6	370.6
Minority interests in consolidated subsidiaries	12.3	15.3	15.3	15.3
Convertible debt	-	-	-	-
Total liabilities	2,696.9	2,226.2	2,282.1	2,450.2
Total stockholders' equity	9,532.8	12,632.7	13,553.5	14,523.8
Total Liabilities and Shareholders' Equity	12,229.7	14,858.9	15,835.6	16,974.0

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 189: YHOO Annual Cash Flow Statement

$ in millions

	FY-07	FY-08E	FY-09E	FY-10E
Net Income	660.0	909.6	460.6	444.7
D&A	659.2	813.5	880.0	900.0
Tax Benefit	(21.2)	52.2	-	-
Excess Tax Benefit from SBC			-	-
Equity	(150.7)	(592.5)	(250.0)	(265.0)
Minority Interests	18.0	3.0	-	-
Stock Based Compensation	572.4	480.8	720.0	820.0
Other Non-Cash Items	(149.8)	658.2	-	-
Changes in Working Capital	366.5	658.2	(4.9)	(14.7)
Accounts Receivable	-	56	36.8	110.6
Prepaid Expenses	-	216	14.2	42.8
Accounts Payable	-	17	5.9	17.7
Accrued Charges	-	(28)	36.8	110.6
Deferred Revenue	-	(69)	13.3	39.8
Other Operating	-	-	-	-
Cash From Operations	1,960.9	2,353.1	1,805.7	1,885.0
FCF	1,352.1	1,699.1	1,055.7	1,095.0
INVESTING CASH FLOWS				
Capital Expenditures	(602.3)	(732.9)	(750.0)	(790.0)
Net Investment	216.4	(380.4)	-	-
ST Investment Purch.	(112.0)	-	-	-
ST Investments Mat.	899.0	-	-	-
Acquisitions	(973.6)	(209.2)	-	-
Cash From Investing	(572.5)	(1,322.5)	(750.0)	(790.0)
FINANCING CASH FLOWS				
Common Stock Issued	375.1	331.4	-	-
Shares Repurchased	(1,583.9)	(79.2)	-	-
Structured stock repurchase	(250.0)	-	-	-
Excess Tax Benefit from SBC	(6.5)	78.9	-	-
Other financing activities, net	(18.6)	(8.5)	-	-
Long Term Debt	-	-	-	-
Cash From Financing	(1,484.0)	322.5	-	-
Foreign Exch Effects	39.7	(79.4)	-	-
Net Change In Cash	(55.9)	1,273.7	1,055.7	1,095.0
Cash at Beginning	1,569.9	1,513.9	2,787.7	3,843.4
Cash at End	1,514.0	2,787.7	3,843.4	4,938.4

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

International Company Outlooks

Baidu, Overweight, ($126.93)

We maintain our Overweight rating on Baidu, the dominant market leader in China's online search market, which is still in an early high-growth stage. Our Dec-09 price target is US$300, which implies 67.6x FY08E, 50.7x FY09E and 35.3x FY10E diluted GAAP EPS, or 62.7x FY08E, 48.0x FY09E and 34.0x FY10E adjusted diluted EPS.

- We believe online search advertising is still in an early high-growth stage in China, driven by: (1) rising Internet penetration, (2) significant growth in websites and pages, (3) higher search usage (due to greater mass of web content), and (4) large number of SMEs (with small ad budgets) turning to search advertising (due to the higher ROI). We expect the paid search market in China to grow over 40% Y/Y in 2009 and 2010 each (following ~64% growth for 2008, as per our estimates).
- Baidu remains the dominant player in China's search market with ~65% market share as of 3Q08 (as per iResearch estimates) and also the highest Internet traffic in China (as per Alexa estimates). We expect Baidu to maintain its leadership in China due to: (1) our view that its products are tailored better to local needs (e.g., music search and Baidu Knows - community Q&A site), (2) its strong local brand name, (3) good relationship with the Chinese government, (4) its good Chinese search technology, and (5) it has among the widest distribution networks in China (a key to market development and driving sales), and is well ahead of competitors in search.
- We expect Baidu to see a negative impact in 4Q'08 and 2009 from the medical and pharmaceutical customer removal issue (following a CCTV report in mid-Nov. on unlicensed entities advertising via Baidu), as these customers account for 10-15% of Baidu's total revenue. We believe the stock is likely to trade weakly in the near term until there is more clarity on the impact on 2009. However, we believe this recent "hiccup" is positive for Baidu in the long term, as Baidu is now taking the right steps to address the longer-term user experience and monetization issues, which should put the company on the right path to continue to grow in the early-stage search market. Thus, we remain positive on Baidu.
- With the impact from the medical and pharmaceutical customer issue, we had revised down our '08E/'09E earnings by 4% and 18%, respectively (on 10 Dec 2008). For 4Q'08, we expect total revenue of US$138.1M, up 2% Q/Q and 64% Y/Y, with gross margin of 62.2% (down from 66.4% in 3Q'08) and adj. operating margin of 36.1% (down from 41.9% in 3Q08). We forecast GAAP diluted EPS of US$1.27, down 14% Q/Q but up 37% Y/Y.
- **2009 Drivers:** In our view, the following factors will drive shares in 2009: (1) more clarity on 2009 impact from medical & pharmaceutical customer removal issue, (2) continued strong execution to drive sales and margins, (3) official launch of C2C ecommerce site, and (4) continued solid growth in China's Internet usage and SME search adoption.

Our financial estimates for Baidu are in the table below:

Table 190: Baidu Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	138.1	471.2	667.2	947.2	103%	42%	42%
EBITDA	62.5	218.4	307.1	449.7	114%	41%	46%
GAAP EPS	1.27	4.44	5.92	8.49	85%	33%	43%
Adj. EPS	1.36	4.79	6.25	8.82	87%	31%	41%
Consensus							
Revenue	141.7	463.6	674.7	945.7	100%	46%	40%
EBITDA	66.2	217.2	310.7	414.1	113%	43%	33%
GAAP EPS	1.40	4.57	6.40	9.16	90%	40%	43%
Adj. EPS	1.53	4.76	6.70	9.36	86%	41%	40%

Source: J.P. Morgan estimates and Bloomberg. *Note: Adj. EPS excludes share-based compensation expense.

Our Estimates and Outlook for 2009

We forecast net revenue of US$667.2M in 2009, up 42% Y/Y, and GAAP diluted EPS of US$5.92, up 33% Y/Y, or adjusted EPS (ex-share-based expense) of US$6.25, up 31% Y/Y. We expect continued growth in both active online marketing customers and revenue per customer, though with relatively higher growth in number of customers (as SME penetration remains very low – Baidu’s active customer base was 194k in 3Q’08, vs. China SME base of ~40M).

On margins, we forecast gross margin at 60.4% for 2009 (conservative forecast as Baidu could potentially increase investment in bandwidth / servers for the long-term opportunities in China), down from 63.8% for 2008. We forecast TAC at slightly over 14% of revenue in 2009, up from ~13% in 2008 (as Baidu continues to sign deals that are positive to net revenue growth). We expect adjusted operating margin (ex-share-based expense) of 35.0% for 2009, down from 36.9% for 2008, and adjusted net margin of 33.0% for 2009, down from 35.4% for 2008.

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$947.2M, up 42% Y/Y, and GAAP diluted EPS of US$8.49, up 43% Y/Y, or adjusted EPS of US$8.82, up 41% Y/Y. We forecast gross margin at 59.5% (slightly lower Y/Y); adjusted operating margin of 35.0% (stable Y/Y) and adjusted net margin of 33.3% (also stable Y/Y).

Price Target, Valuation and Rating Analysis

We maintain our Overweight on Baidu, as it remains the market leader in China’s online search market, which we believe is still in an early high-growth stage. Our Dec-2009 price target is US$300, which implies PEG of 1.3x, which we believe is reasonable given the strong China Internet usage growth and early stage of search advertising. Our price target implies 67.6x FY’08E, 50.7x FY’09E and 35.3x FY’10E diluted GAAP EPS, or 62.7x FY08E, 48.0x FY’09E and 34.0x FY’10E adjusted diluted EPS.

In addition, we believe earnings upside in 2009 could come from banner advertising, C2C ecommerce services and potential margin leverage.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Risks to Our Rating

Risks to our rating and price target include: (1) lower-than-expected online search spending in China, (2) large infrastructure-related (servers and bandwidth) spending, (3) near-term distributor transition in a couple of cities (FuShan and Dongguan in 2Q08), (4) unsuccessful ecommerce and Japan search initiatives, and (5) potential margin decline (from TAC increase, bandwidth cost increase, tax rate increase or significant labor cost increase).

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 191: BIDU Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Total Revenue	231.6	471.2	667.2	947.2
Online marketing services	231.2	470.6	666.6	946.7
Other services	0.5	0.6	0.5	0.5
COGS	-85.5	-170.5	-264.3	-383.4
Gross Profit	146.2	300.7	402.9	563.8
Operating Expense	-73.5	-138.9	-181.0	-243.8
SG&A expenses	*-52.3*	*-91.4*	*-117.6*	*-161.0*
R&D expenses	*-15.9*	*-35.4*	*-51.7*	*-71.0*
Share-based comps expenses	*-5.3*	*-12.0*	*-11.8*	*-11.8*
EBIT	72.7	161.8	221.8	320.0
Adj. EBIT (ex-share-based exp.)	77.9	173.8	233.6	331.8
EBITDA	101.8	218.4	307.1	449.7
Net Interest Income	6.4	6.6	11.3	18.7
Net Other Income	2.7	1.4	0.0	0.0
Pre Tax Profit	81.8	169.8	233.1	338.7
Tax Expense/(Credit)	1.7	-15.2	-24.5	-35.0
Net Profit	83.5	154.6	208.6	303.6
Adj. Net Profit (ex-share-based exp)	88.8	166.6	220.4	315.4
Diluted EPS (US$)	2.40	4.44	5.92	8.49
Adj. Diluted EPS (US$, ex-share-based exp.)	2.56	4.79	6.25	8.82
Margins (%)				
Gross Margin	63.1	63.8	60.4	59.5
Adj. OPM	33.7	36.9	35.0	35.0
EBITDA Margin	44.0	46.3	46.0	47.5
Net Margin	36.1	32.8	31.3	32.1
Adj. Net Margin	38.3	35.4	33.0	33.3
Sequential Growth (%)				
Revenue	119.2	103.4	41.6	42.0
Gross Profit	95.2	105.7	34.0	40.0
EBIT	119.2	122.7	37.1	44.3
Net Profit	119.5	85.1	34.9	45.5
Adj. Net Profit	103.9	87.6	32.3	43.1
Diluted EPS	122.0	84.7	33.3	43.4
Adj. Diluted EPS	103.1	87.2	30.7	41.0

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 192: BIDU Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Total Revenue	35.7	52.7	66.3	78.3	81.9	117.0	135.4	138.1	135.3	162.0	178.6	191.2
Online marketing services	35.6	52.6	66.2	78.1	81.7	117.0	135.2	137.9	135.2	161.9	178.4	191.1
Other services	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
COGS	-13.2	-19.2	-24.1	-29.5	-32.5	-40.8	-45.4	-52.2	-53.5	-62.9	-70.7	-77.3
Gross Profit	22.5	33.5	42.2	48.8	49.4	76.2	89.9	85.9	81.8	99.1	107.9	114.0
Operating Expense	-13.0	-16.5	-19.8	-24.6	-28.4	-35.9	-35.7	-39.0	-39.1	-43.8	-47.6	-50.5
SG&A expenses	*-8.6*	*-11.9*	*-14.7*	*-17.4*	*-19.8*	*-23.0*	*-23.0*	*-25.7*	*-25.7*	*-28.3*	*-30.8*	*-32.7*
R&D expenses	*-2.8*	*-3.5*	*-4.3*	*-5.4*	*-6.3*	*-8.7*	*-10.2*	*-10.4*	*-10.5*	*-12.6*	*-13.8*	*-14.8*
Share-based comps expenses	*-1.6*	*-1.2*	*-0.7*	*-1.8*	*-2.3*	*-4.3*	*-2.5*	*-2.9*	*-2.9*	*-2.9*	*-2.9*	*-2.9*
EBIT	9.6	16.9	22.4	24.2	21.0	40.3	54.2	46.9	42.7	55.3	60.3	63.5
Adj. EBIT (ex-share-based exp.)	11.1	18.1	23.2	26.0	23.3	44.6	56.8	49.9	45.7	58.2	63.3	66.4
EBITDA	15.3	23.6	29.8	33.7	32.9	54.9	68.7	62.5	59.7	75.2	83.1	89.1
Net Interest Income	1.5	1.5	1.6	1.8	1.5	1.5	1.7	1.9	2.3	2.7	3.0	3.3
Net Other Income	0.2	0.4	0.5	1.7	-0.1	1.0	0.4	0.0	0.0	0.0	0.0	0.0
Pre Tax Profit	11.3	18.9	24.6	27.6	22.5	42.8	56.4	48.8	45.0	58.0	63.3	66.8
Tax Expense/(Credit)	-0.2	-0.2	-0.3	2.5	-1.5	-4.2	-5.1	-4.4	-4.8	-6.1	-6.6	-7.0
Net Profit	11.1	18.6	24.3	30.1	20.9	38.6	51.2	44.4	40.2	51.9	56.7	59.8
Adj. Net Profit (ex-share-based exp)	12.7	19.8	25.0	32.0	23.2	42.9	53.7	47.4	43.2	54.8	59.6	62.8
Diluted EPS (US$)	0.32	0.54	0.70	0.87	0.60	1.11	1.47	1.27	1.15	1.47	1.61	1.69
Adj. Diluted EPS (US$, ex-share-based exp.)	0.36	0.57	0.72	0.92	0.67	1.23	1.54	1.36	1.23	1.56	1.69	1.77
Margins (%)												
Gross Margin	63.1	63.5	63.7	62.3	60.4	65.1	66.4	62.2	60.5	61.2	60.4	59.6
Adj. OPM	31.2	34.4	35.0	33.2	28.5	38.1	41.9	36.1	33.8	35.9	35.4	34.7
EBITDA Margin	42.9	44.7	44.9	43.1	40.1	47.0	50.8	45.3	44.1	46.4	46.5	46.6
Net Margin	31.0	35.4	36.6	38.5	25.5	33.0	37.8	32.2	29.7	32.0	31.7	31.3
Adj. Net Margin	35.5	37.6	37.7	40.8	28.3	36.7	39.7	34.3	31.9	33.8	33.4	32.8
Sequential Growth (%)												
Revenue	2.6	47.7	25.7	18.1	4.6	42.8	15.7	2.0	-2.0	19.8	10.2	7.1
Gross Profit	-9.3	48.7	26.1	15.6	1.4	54.1	18.0	-4.5	-4.7	21.1	8.9	5.6
EBIT	-26.7	77.2	32.4	7.7	-13.0	91.7	34.6	-13.5	-8.9	29.4	9.1	5.2
Net Profit	-29.6	68.4	30.1	24.3	-30.6	84.8	32.6	-13.3	-9.4	28.9	9.3	5.6
Adj. Net Profit	-24.1	56.6	26.1	27.9	-27.4	84.8	25.3	-11.9	-8.8	26.9	8.8	5.3
Diluted EPS	-29.6	68.2	29.9	24.1	-30.6	84.7	32.6	-13.7	-9.7	28.4	8.9	5.2
Adj. Diluted EPS	-24.0	56.4	25.9	27.8	-27.3	84.7	25.3	-12.2	-9.1	26.5	8.4	4.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 193: BIDU Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash & Cash Equivalents	211	409	588	899
Account Receivables	9	15	21	30
Other Current Assets	9	25	35	50
Total Current Assets	229	449	644	979
Net Fixed Assets	103	147	262	362
LT Investments	2	3	3	3
Other LT Assets	19	27	26	24
Total Long Term Assets	124	177	291	390
Total Assets	353	626	934	1,369
ST Debt	-	-	-	-
Accrued Expenses and Payables	48	86	120	169
Other Current Liabilities	36	78	109	158
Total Current Liabilities	84	164	230	327
LT Debt	-	-	-	-
Other LT Liabilities	0	-	-	-
Total Liabilities	84	164	230	327
Share Capital	0	0	0	0
Additional Paid-in Capital	156	190	222	255
Other Reserves	(11)	(19)	(19)	(19)
Retained Earnings	124	290	502	806
Preferred Stock	-	-	-	-
Total Equity	268	461	705	1,042
Total Liabilities and Equity	353	626	934	1,369

Source: Company reports and J.P. Morgan estimates.

Table 194: BIDU Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	84	155	209	304
Add Non cash Expenses/(income)				
Depreciation and Amortization	24	45	74	118
Extra-ordinaries	-	-	-	-
Other Non-Cash Items	5	12	12	12
Changes in Working Capital:				
(Increase)/Decrease Receivables	(5)	(6)	(6)	(9)
(Increase)/Decrease Inventories	-	-	-	-
(Increase)/Decrease Other Current Assets	(5)	(15)	(10)	(15)
Increase/(Decrease) Payables	27	34	33	49
Increase/(Decrease) Other Current Liabilities	16	38	30	48
Net Cash from Operations	146	263	342	506
Cash Flow from Investing				
Purchase of Property, Plant & Equipment	(88)	(78)	(185)	(217)
Purchase / Sale of Other LT Assets	(6)	(8)	-	-
Purchase / Sale of Investments	(2)	(1)	-	-
Net Cash from Investing Activities	(96)	(86)	(185)	(217)
Cash Flow from Financing				
Issuance/Repayment of Debt	-	-	-	-
Change in other LT liabilities	(1)	(0)	-	-
Change in Common Equity - net	(1)	0	18	22
Payment of Cash Dividends	-	-	-	-
Other Financing Charges, Net	-	-	-	(0)
Net Cash from Financing Activities	(1)	(0)	18	22
Net Change in Cash & Cash Equivalents	57	197	179	311
Cash & Cash Equivalents at end of period	211	409	588	899

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

China Finance Online, Neutral, ($7.05)

We maintain our Neutral rating on China Finance Online (JRJC) due to the greater customer demand uncertainty in the near term and the continuing challenging domestic stock market environment. Our Jun-09 price target is US$8, which implies 10.7x FY08E and 12.3x FY09E GAAP EPS, or 7.4x FY08E and 8.6x FY09E adjusted diluted EPS.

- We had downgraded our rating on JRJC to Neutral (on 15 Dec 2008) due to: (a) greater uncertainties around customer demand in the near term, especially with TopView (~20% of cash revenue in 2H08, as per our estimate) discontinuation from Jan 1, '09, (b) JRJC's individual subscribers (core business segment) turning cautious in their purchase activities since mid-September (on global equity market stress and slowdown in the real economy), (c) continuing tough environment from slowdown in China's stock market activities, and (d) 4Q08 guidance being significantly below prior expectations.
- JRJC's 3Q08 revenue was US$15.2MM, up 4% Q/Q, 109% Y/Y but 8% below our forecast (US$16.5MM) and 6% below consensus (US$16.2MM), and also below the guidance range (US$15.5-16.5MM). GAAP EPS was US$0.21, up 5% Q/Q, 148% Y/Y, in line with our and consensus estimates, though aided by a tax benefit and forex gain. JRJC's 4Q08 guidance was significantly below prior estimates; guided revenue range was US$14.5-15.0MM, implying Q/Q decline of 1% to 5%, or Y/Y growth of 63% to 69%. The midpoint of guidance was ~22% below our prior forecast (US$18.9MM) as well as consensus forecast (US$18.7MM).
- For 4Q08, we expect revenue at US$15.0MM, at the top end of guidance range, sequentially lower due to reduced cash flow and revenue estimates for the core individual subscriptions business. We expect 4Q08 margins to be largely similar to 3Q08 levels. Our revenue estimate for FY08 was reduced to US$56.0MM, at the bottom end of prior FY08 guidance (US$56-61MM). Given the demand uncertainties in the near to medium term, we had reduced our FY09 revenue / adusted. EPS estimates as well, on the back of lower individual subscriber cash inflows and lower margin assumptions. Thus, we expect FY09 revenue / adjusted EPS Y/Y change of -2% / -13%, respectively.
- **2009 drivers:** In our view, the key share price driver (on the upside and the downside) in 2009 will be a meaningful recovery, or further deterioration, in China's domestic stock market activities.

Our financial estimates are in the table below:

Table 195: China Finance Online Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	15.0	56.0	54.8	57.0	116%	-2%	4%
EBITDA	6.2	23.0	23.3	25.0	174%	1%	7%
GAAP EPS	0.18	0.74	0.65	0.67	nm	-12%	2%
Adj. EPS	0.25	1.08	0.94	0.94	135%	-13%	1%
Consensus							
Revenue	14.6	57.3	71.6	58.3	121%	25%	-19%
EBITDA	5.5	20.1	33.1	NA	138%	65%	nm
GAAP EPS	0.16	0.77	1.12	NA	nm	46%	nm
Adj. EPS	0.19	1.07	1.19	0.80	134%	11%	-33%

Source: J.P. Morgan estimates and Bloomberg. *Note: Adj. EPS excludes share-based compensation expense.

Our Estimates and Outlook for 2009

For FY09, due to expectations of customer demand uncertainties for the company in the near to medium term, especially with TopView (~20% of cash revenue in 2H08, as per our estimate) discontinuation from Jan 1, '09, and continuing challenges from the business environment (A share market), we believe a cautious stance is warranted. We forecast net revenue of US$54.8MM in 2009, down 2% Y/Y, and GAAP diluted EPS of US$0.65, down 12% Y/Y, or adjusted EPS (ex-share-based expense) of US$0.94, down 13% Y/Y.

We forecast gross margin at 81.9% for 2009, down from 83.5% for 2008. We expect adjusted operating margin (ex-share-based expense) of 36.9% for 2009, down slightly from 37.4% for 2008, and adjusted net margin of 39.0% for 2009, down from 43.9% for 2008 (partly due to higher tax rate of ~8% in 2009 vs. ~0% in 2008 due to tax benefits from a prior acquisition).

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$57.0MM, up 4% Y/Y, and GAAP diluted EPS of US$0.67, up 2% Y/Y, or adjusted EPS of US$0.94, up 1% Y/Y. On margins, we forecast gross margin at 81.6% (largely stable Y/Y), adjusted operating margin of 36.6% (largely stable Y/Y) and adjusted net margin of 38.3% (slightly lower Y/Y).

Price Target, Valuation and Rating Analysis

We maintain our Neutral rating on JRJC due to the greater customer demand uncertainty in the near term (especially with TopView discontinuation from Jan 1, '09) and the continuing challenging domestic stock market environment. Our price target is US$8 (Jun-09), which implies FY08E / FY09E adjusted PE of 7.4x / 8.6x, or GAAP PE of 10.7x / 12.3x, on the back of FY08E / '09E / '10E adjusted EPS growth of 135%/ -13% / 1%. JRJC also has a net cash balance of US$3.6 / diluted ADS; our price target implies ex-cash FY08E / FY09E adjusted PE of 4.4x / 5.3x. We set our PT below our DCF valuation of ~US$10 (WACC of 13%, terminal growth 0%) due to the near-term uncertainties, which could keep the stock price under pressure.

On the positive side, we note: (a) JRJC has demonstrated solid execution capability over the past couple of years, with seven back-to-back quarters (up to 2Q08) of record cash inflows in the retail subscription business, (b) JRJC's significantly enhanced telemarketing capability (ramped up through the course of 2008 to ~780 telemarketers at present, from 410 at end-2007) and product development capability, which have helped scaling up of revenues and earnings (through conversion of free users to paying subscribers), and (c) JRJC's paying subscriber base of 115k as of 3Q08, up from 56.2k at end-2007, with further room for upside in conversion rate (active paying subscribers as a percentage of free registered users, currently still only ~1.1%).

Risks to Our Rating and Price Target

Key upside risks to our rating and price target include: (1) meaningful recovery in China's A share market activities (positively impacting customer demand for JRJC's products), (2) higher than expected revenue growth in core subscription business, and (3) further strategic partnerships and acquisitions to expand its core business.

Key downside risks include: (1) further deterioration in domestic stock market activities, (2) increase in competition in financial analysis software, and (3) management challenges of managing the larger business scale.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 196: JRJC Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	25.90	55.97	54.84	57.01
Subscriptions	*22.69*	*50.70*	*49.04*	*50.35*
Online Ads	*1.56*	*2.83*	*3.02*	*3.33*
Wireless (Stockstar) / others	*1.66*	*2.43*	*2.77*	*3.33*
COGS	-4.41	-9.26	-9.93	-10.50
Gross Profit	21.49	46.71	44.90	46.51
Operating Expense	-16.99	-33.36	-31.12	-32.10
Sales & Mktg. expenses	*-6.79*	*-13.14*	*-13.16*	*-13.68*
G&A expenses	*-5.12*	*-7.71*	*-7.13*	*-7.41*
R&D expenses	*-2.15*	*-4.96*	*-4.39*	*-4.56*
Other expenses	*0.00*	*0.00*	*0.00*	*0.00*
Share-based compensation expense (123R)	*-2.95*	*-7.56*	*-6.44*	*-6.44*
EBITDA	8.41	23.02	23.34	25.03
EBIT	4.50	13.35	13.78	14.41
Adj. EBIT (ex-123R expense)	7.45	20.91	20.23	20.86
Net Interest Income	1.11	1.66	2.47	3.01
Net Other Income	-10.56	1.63	0.40	0.40
Pre Tax Profit	-4.95	16.64	16.65	17.83
Tax Expense/(Credit)	-0.81	-0.10	1.73	2.43
GAAP Net Profit	-4.13	16.99	14.92	15.40
Adj. Net Profit (ex-123R expense)	9.94	24.55	21.37	21.84
Pre Tax EPS (USD)	-0.26	0.84	0.84	0.89
EPS (USD)	-0.22	0.86	0.75	0.77
Diluted EPS (USD)	-0.22	0.74	0.65	0.67
Adj. Diluted EPS (ex-123R exp., USD)	0.46	1.08	0.94	0.94
Margins (%)				
Gross Margin	83.0	83.5	81.9	81.6
Adj. Operating Margin (ex-123R option expense)	28.7	37.4	36.9	36.6
EBITDA Margin	32.5	41.1	42.6	43.9
Net Margin	-15.9	30.4	27.2	27.0
Adj. Net Margin (ex-123R option expense)	38.4	43.9	39.0	38.3
Sequential Growth (%)				
Revenue	263.4	116.1	-2.0	4.0
Gross Profit	272.4	117.3	-3.9	3.6
Adj. EBIT	1,448.0	180.8	-3.3	3.1
Pre Tax Profit	nm	-435.8	0.1	7.0
Adj. Net Profit	1,599.7	146.9	-13.0	2.2
Adj. Diluted EPS	1,508.4	134.6	-13.1	0.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 197: JRJC Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	4.00	5.72	7.30	8.88	11.06	14.68	15.23	15.01	14.30	13.63	13.46	13.44
Subscriptions	*3.39*	*4.93*	*6.38*	*7.99*	*9.85*	*13.40*	*13.78*	*13.67*	*13.01*	*12.21*	*11.96*	*11.86*
Online Ads	*0.25*	*0.40*	*0.50*	*0.41*	*0.59*	*0.76*	*0.76*	*0.73*	*0.65*	*0.75*	*0.79*	*0.83*
Wireless (Stockstar) / others	*0.36*	*0.40*	*0.42*	*0.49*	*0.62*	*0.52*	*0.68*	*0.61*	*0.63*	*0.67*	*0.71*	*0.75*
COGS	-0.82	-1.08	-1.19	-1.32	-1.72	-2.10	-2.77	-2.67	-2.56	-2.46	-2.45	-2.46
Gross Profit	3.18	4.64	6.11	7.56	9.34	12.58	12.46	12.34	11.74	11.17	11.01	10.98
Operating Expense	-2.81	-3.59	-4.67	-5.93	-7.36	-9.00	-8.56	-8.44	-8.05	-7.75	-7.67	-7.66
Sales & Mktg. expenses	*-1.22*	*-1.33*	*-1.85*	*-2.39*	*-2.39*	*-3.57*	*-3.58*	*-3.60*	*-3.43*	*-3.27*	*-3.23*	*-3.23*
G&A expenses	*-0.87*	*-1.25*	*-1.16*	*-1.83*	*-1.64*	*-2.23*	*-1.88*	*-1.95*	*-1.86*	*-1.77*	*-1.75*	*-1.75*
R&D expenses	*-0.32*	*-0.42*	*-0.58*	*-0.83*	*-0.97*	*-1.23*	*-1.48*	*-1.28*	*-1.14*	*-1.09*	*-1.08*	*-1.08*
Other expenses	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Share-based compensation expense (123R)	*-0.39*	*-0.60*	*-1.08*	*-0.88*	*-2.37*	*-1.97*	*-1.61*	*-1.61*	*-1.61*	*-1.61*	*-1.61*	*-1.61*
EBITDA	0.94	1.87	2.78	2.82	4.77	6.00	6.10	6.16	6.00	5.78	5.76	5.80
EBIT	0.37	1.05	1.44	1.63	1.97	3.58	3.90	3.90	3.70	3.42	3.34	3.32
Adj. EBIT (ex-123R expense)	0.77	1.65	2.52	2.51	4.34	5.54	5.52	5.51	5.31	5.04	4.95	4.93
Net Interest Income	0.25	0.25	0.24	0.36	0.34	0.35	0.52	0.45	0.57	0.60	0.63	0.67
Net Other Income	0.06	0.11	0.04	-10.77	0.87	0.55	0.11	0.10	0.10	0.10	0.10	0.10
Pre Tax Profit	0.69	1.41	1.73	-8.78	3.19	4.47	4.52	4.45	4.37	4.12	4.07	4.09
Tax Expense/(Credit)	-0.09	-0.15	-0.18	-0.40	-0.06	-0.09	-0.25	0.30	0.45	0.43	0.43	0.43
GAAP Net Profit	0.78	1.56	1.90	-8.37	3.51	4.56	4.77	4.15	3.92	3.69	3.65	3.66
Adj. Net Profit (ex-123R expense)	1.17	2.16	2.98	3.63	5.88	6.53	6.38	5.76	5.53	5.31	5.26	5.27
Pre Tax EPS (USD)	0.04	0.07	0.09	-0.45	0.16	0.23	0.23	0.22	0.22	0.21	0.20	0.21
EPS (USD)	0.04	0.08	0.10	-0.43	0.18	0.23	0.24	0.21	0.20	0.19	0.18	0.18
Diluted EPS (USD)	0.04	0.08	0.08	-0.43	0.15	0.20	0.21	0.18	0.17	0.16	0.16	0.16
Adj. Diluted EPS (ex-123R exp., USD)	0.06	0.11	0.13	0.16	0.26	0.28	0.28	0.25	0.24	0.23	0.23	0.23
Margins (%)												
Gross Margin	79.6	81.1	83.7	85.1	84.5	85.7	81.8	82.2	82.1	81.9	81.8	81.7
Operating Margin (ex-123R option expense)	19.2	28.8	34.5	28.2	39.3	37.8	36.2	36.7	37.1	36.9	36.8	36.7
EBITDA Margin	23.6	32.6	38.0	31.8	43.1	40.9	40.0	41.0	41.9	42.4	42.8	43.1
Net Margin	19.4	27.3	26.0	-94.2	31.7	31.1	31.3	27.6	27.4	27.1	27.1	27.2
Net Margin (ex-123R option expense)	29.2	37.7	40.8	40.9	53.1	44.5	41.9	38.4	38.7	38.9	39.1	39.2
Sequential Growth (%)												
Revenue	58.4	43.2	27.6	21.6	24.5	32.8	3.7	-1.4	-4.7	-4.7	-1.3	-0.1
Gross Profit	65.7	46.1	31.6	23.7	23.5	34.7	-0.9	-1.0	-4.8	-4.9	-1.5	-0.3
EBIT ex-123R option expense	-248.6	115.0	52.9	-0.6	73.0	27.7	-0.5	-0.1	-3.6	-5.2	-1.7	-0.4
Pre Tax Profit	-138.9	104.6	22.2	-608.8	-136.3	40.1	1.2	-1.6	-1.8	-5.6	-1.3	0.4
Net Profit ex-123R option expense	n.m.	84.8	38.2	21.8	61.7	11.1	-2.2	-9.8	-3.9	-4.1	-0.9	0.3
Diluted EPS ex-123R expense	n.m.	85.1	25.0	17.3	66.3	10.1	-1.4	-9.7	-4.1	-4.2	-1.1	0.1

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 198: JRJC Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash & Cash Equivalents	74.7	104.0	126.6	157.0
Accounts Receivable	1.5	3.3	2.9	3.4
Inventory	-	-	-	-
Total Other Current Assets	8.6	12.2	10.8	11.5
Total Current Assets	84.8	119.5	140.3	171.9
Gross Fixed Assets	6.7	12.1	16.9	23.1
Accumulated Depreciation	(1.2)	(3.1)	(5.8)	(9.7)
Net Fixed Assets	5.5	9.0	11.1	13.5
Other Long Term Assets	12.1	14.4	14.1	13.8
Long Term Investments and Associates	1.5	1.5	1.5	1.5
Total Long Term Assets	19.1	25.0	26.6	28.7
Total Assets	103.9	144.4	166.9	200.6
ST Debt and Current Portion of LT Debt	-	-	-	-
Accounts Payable (Accrued expenses, etc.)	10.5	11.5	9.2	9.7
Other Current Liabilities	20.5	30.0	26.9	31.0
Total Current Liabilities	31.0	41.5	36.1	40.7
Long Term Debt	-	-	-	-
Other Long Term Liabilities	5.5	6.2	4.4	3.1
Total Long Term Liabilities	5.5	6.2	4.4	3.1
Share Capital	0.0	0.0	0.0	0.0
Share Premium	58.7	62.5	77.4	92.3
Other Reserves	4.5	13.0	13.0	13.0
Retained Earnings	4.1	21.1	36.0	51.4
Preferred Stock	-	-	-	-
Total Equity	67.4	96.6	126.5	156.8
Total Liabilities and Equity	103.9	144.4	166.9	200.6

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 199: JRJC Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	(4.1)	17.0	14.9	15.4
Non cash Expenses/(income)	-	-	-	-
Depreciation and Amortization	1.0	2.1	3.1	4.2
Extraordinaries	(0.0)	(0.3)	-	-
Other Non-Cash Items	13.4	7.6	6.4	6.4
Changes in Working Capital:				
(Increase)/Decrease Receivables	0.0	(1.8)	0.3	(0.5)
(Increase)/Decrease Inventories	-	-	-	-
(Increase)/Decrease Other Current Assets	(4.3)	(3.6)	1.4	(0.7)
Increase/(Decrease) Payables	(0.0)	1.0	(2.3)	0.5
Increase/(Decrease) Other Current Liabilities	22.5	9.5	(3.1)	4.1
Net Cash from Operations	28.4	31.6	20.8	29.5
Cash Flow from Investing				
Purchase of Property, Plant & Equipment	(4.8)	(5.4)	(4.8)	(6.2)
Purchase/Sale of Other LT assets	-	(2.6)	-	-
Purchase/Sale of Investments	-	-	-	-
Net Cash from Investing Activities	(4.8)	(8.0)	(4.8)	(6.2)
Cash Flow from Financing				
Issuance/Repayment of Debt	-	-	-	-
Change in other LT liabilities	-	0.7	(1.9)	(1.3)
Change in Common Equity - net	3.2	4.7	8.5	8.5
Payment of Cash Dividends	-	-	-	-
Other Financing Charges, Net	-	0.3	0.0	-
Net Cash from Financing Activities	3.2	5.7	6.6	7.2
Net Effect of Exchange Rate Changes	3.0	-	-	-
Net Change in Cash and Cash Equivalents	29.8	29.3	22.6	30.4
Cash & CE at End of Period	74.7	104.0	126.6	157.0

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

NetEase, Neutral, ($22.10)

We remain Neutral on NetEase. While we like NetEase in the long run, we believe NetEase lacks near-term drivers; we still don't have confidence that TianXia 2 and other upcoming item-based games will be significant revenue contributors in 2009. Our price target is US$25 (Jun-09), which implies 16.3x FY08E and 11.7x FY09E GAAP EPS, or 15.4x FY08E and 11.1x FY09E adjusted EPS.

- NetEase is one of the leading online game developers and operators in China. However, we believe NetEase still lacks the next big game to drive earnings growth in the near to medium term. While we are impressed by the consistent growth of flagship games FWJ and WWJ2 (even after approximately five years and seven years, respectively, since launch), 2009 growth is still expected to be largely in line with the market growth. In addition, the Blizzard JV and Starcraft will likely not contribute revenue until 2H09.
- Despite the ongoing transition period in its online games, we remain positive on NetEase in the long run. We believe NetEase differentiates itself by: (1) its deep penetration of sales & marketing teams into small cities (where there is less competition), and (2) taking a long-term view in game development (and upgrade) and customer monetization. As one of the leading online game developers (with ~1,200 engineers) in China with proven game operating capability, we believe NetEase is well positioned to capture growth in China's online games industry in the long run. In addition, NetEase has the largest free email user base in China; we believe it can leverage this user base and portal traffic to monetize better over time through online ads and search services.
- **2009 drivers:** In our view, the following factors will drive shares in 2009: (1) the performance of new games such as TX2 and Legend of Westward Journey (item-based version of WWJ3), (2) potential upside from new Blizzard games and in-house games in 2009, (3) performance of existing games (following periodic release of new upgrade packs), and (4) share buyback of up to US$100M over the next few quarters.

Our current and newly introduced 2010 estimates are in the table below:

Table 200: NetEase Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	122.0	433.5	529.7	589.2	47%	22%	11%
EBITDA	82.1	288.7	345.7	378.5	55%	20%	9%
GAAP EPS	0.51	1.54	2.14	2.33	21%	40%	9%
Adj. EPS	0.54	1.63	2.25	2.44	19%	38%	8%
Consensus							
Revenue	117.9	448.7	499.1	551.0	53%	11%	10%
EBITDA	77.2	291.3	310.1	338.8	57%	6%	9%
GAAP EPS	0.41	1.57	1.91	2.09	23%	22%	9%
Adj. EPS	0.42	1.63	1.90	2.11	19%	16%	11%

Source: J.P. Morgan estimates and Bloomberg. *Note: Adj. EPS excludes share-based compensation expense.

Our Estimates and Outlook for 2009

We forecast net revenue of US$529.7M in 2009, up 22% Y/Y, and GAAP diluted EPS of US$2.14, up 40% Y/Y, or adjusted EPS (ex-share-based expense) of US$2.25, up 38% Y/Y. We forecast online game revenue of US$450.4M in 2009 (85% of total revenue), up 22% Y/Y, with FWJ revenue growth of 15% Y/Y, WWJ2 revenue growth of 6% Y/Y, and WWJ3 revenue growth of 17% Y/Y. For online advertising, we forecast revenue of US$67.4M (13% of total revenue), up 21% Y/Y (largely in line with market growth).

We forecast gross margin at 82.5% for 2009, up slightly from 82.0% for 2008, mainly due to margin expansion in the online ad segment (with Olympics content spending going away). We expect adjusted operating margin (ex-share-based expense) of 60.9% for 2009, down from 63.1% for 2008 (due to expected higher SG&A and R&D expenses in 2009), and adjusted net margin of 55.8% for 2009, up from 48.4% for 2008 (due to net forex losses in 2008 and lower income tax rate of ~15% in 2009 vs. ~21% in 2008).

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$589.2M, up 11% Y/Y, and GAAP diluted EPS of US$2.33, up 9% Y/Y, or adjusted EPS of US$2.44, up 8% Y/Y. On margins, we forecast gross margin at 81.1% (down slightly Y/Y due to the online game segment), adjusted operating margin of 59.5% (down slightly Y/Y), and adjusted net margin of 55.6% (stable Y/Y).

Price Target, Valuation and Rating Analysis

We maintain our Neutral on NetEase with a Jun-09 price target of US$25, which implies 16.3x FY08E and 11.7x FY09E GAAP EPS, or 15.4x FY08E and 11.1x FY09E adjusted EPS. Our price target is below our DCF valuation of ~US$37 due to relatively muted growth expectation in the near term, as we believe NetEase still lacks the next big game to drive earnings growth. While we are impressed by the delivery of consistent growth of FWJ and WWJ2 games, 2009 growth is still expected to be in line with the market growth. As such, we remain Neutral. The company currently has total cash balance of ~US$777M (US$5.9/share).

Risks to Our Rating and Price Target

Downside risks to our rating and price target include: (1) greater industry competition, (2) delays in game launches, (3) hacking or pirated server issues limiting user growth, and (4) significant increase in R&D expenses. Upside risks include: (1) better-than-expected acceptance of its new games, (2) extended life cycle of existing games on the back of new upgrade packs, and (3) upside in online advertising revenue.

Table 201: NTES Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	293.9	433.5	529.7	589.2
Wireless & other	*8.7*	*10.7*	*11.9*	*13.0*
Advertising	*37.1*	*55.5*	*67.4*	*83.7*
Online Games	*248.2*	*367.3*	*450.4*	*492.5*
COGS	-53.2	-78.2	-92.6	-111.1
Gross Profit	240.7	355.3	437.0	478.1
Operating Expense	-80.6	-93.5	-128.5	-141.4
Sales & Mktg. expenses	*-29.3*	*-31.1*	*-45.6*	*-50.8*
G&A expenses	*-18.9*	*-23.5*	*-31.8*	*-35.3*
R&D expenses	*-19.7*	*-27.3*	*-37.1*	*-41.2*
Other expenses	*0.0*	*0.0*	*0.0*	*0.0*
Share-based compensation	-12.7	-11.7	-14.0	-14.0
EBIT	160.1	261.8	308.6	336.7
Adjusted EBIT (excl share-based comps)	172.8	273.4	322.6	350.7
EBITDA	185.9	288.7	345.7	378.5
Net Interest Income	15.0	19.9	25.4	34.5
Net Other Income	-6.8	-21.1	0.0	0.0
Pre Tax Profit	168.2	260.5	334.0	371.3
Tax Expense/(Credit)	-0.4	-62.3	-52.2	-57.8
Net Profit	167.8	198.3	281.8	313.5
Net Profit (excl 123R option expense)	180.5	209.9	295.8	327.5
Pre Tax EPS (US$)	1.36	2.11	2.68	2.91
After Tax EPS (US$)	1.36	1.61	2.26	2.46
After Tax EPS Diluted (US$)	1.27	1.54	2.14	2.33
After Tax EPS Diluted (US$ excl 123R option exp.)	1.37	1.63	2.25	2.44
Margins (%)				
Gross Margin	81.9	82.0	82.5	81.1
Operating Margin (excl 123R option expense)	58.8	63.1	60.9	59.5
EBITDA Margin	63.3	66.6	65.3	64.2
Net Margin	57.1	45.7	53.2	53.2
Net Margin excl 123R option expense	61.4	48.4	55.8	55.6
Sequential Growth (%)				
Revenue	9.5	47.5	22.2	11.2
Gross Profit	8.2	47.6	23.0	9.4
Adjusted EBIT	1.8	58.3	18.0	8.7
Pre Tax Profit	-0.4	54.9	28.2	11.2
Net Profit (excl 123R exp)	9.4	16.3	40.9	10.7
After Tax EPS	16.6	20.6	39.7	8.8
After Tax EPS excl 123R option expense	15.7	18.8	38.5	8.3

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 202: NTES Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	69.1	70.4	73.1	81.7	91.9	103.0	117.2	122.0	124.1	130.5	135.6	139.4
Wireless & other	*2.1*	*2.2*	*2.2*	*2.2*	*2.7*	*2.5*	*2.7*	*2.8*	*2.9*	*2.9*	*3.0*	*3.1*
Advertising	*6.7*	*7.9*	*10.4*	*12.3*	*10.1*	*13.9*	*15.2*	*16.4*	*15.0*	*16.3*	*17.6*	*18.5*
Online Games	*60.3*	*60.4*	*60.5*	*67.2*	*79.2*	*86.6*	*99.3*	*102.7*	*106.2*	*111.3*	*115.0*	*117.8*
COGS	-13.0	-12.4	-13.6	-14.4	-15.6	-18.5	-23.7	-20.6	-20.9	-22.4	-24.3	-25.0
Gross Profit	56.1	58.1	59.5	67.4	76.3	84.5	93.5	101.4	103.2	108.2	111.3	114.3
Operating Expense	-15.6	-19.3	-24.4	-21.4	-18.6	-22.3	-24.8	-27.9	-30.8	-31.6	-32.7	-33.5
Sales & Mktg. expenses	*-5.1*	*-5.9*	*-10.6*	*-7.8*	*-5.1*	*-7.4*	*-8.9*	*-9.8*	*-11.2*	*-11.1*	*-11.5*	*-11.8*
G&A expenses	*-3.5*	*-5.1*	*-5.3*	*-5.0*	*-5.1*	*-5.3*	*-6.4*	*-6.7*	*-7.4*	*-7.8*	*-8.1*	*-8.4*
R&D expenses	*-4.4*	*-4.7*	*-5.1*	*-5.6*	*-5.7*	*-6.6*	*-7.2*	*-7.9*	*-8.7*	*-9.1*	*-9.5*	*-9.8*
Other expenses	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Share-based compensation	-2.6	-3.6	-3.5	-3.0	-2.7	-3.0	-2.4	-3.5	-3.5	-3.5	-3.5	-3.5
EBIT	40.5	38.8	35.1	45.9	57.7	62.1	68.7	73.5	72.4	76.6	78.7	80.9
Adjusted EBIT (excl share-based comps)	43.1	42.3	38.6	49.0	60.4	65.2	71.1	77.0	75.9	80.1	82.2	84.4
EBITDA	46.2	45.5	41.8	52.6	63.9	68.6	74.4	82.1	81.1	85.7	88.3	90.6
Net Interest Income	3.0	3.7	3.9	4.4	4.4	4.6	5.8	5.1	5.5	6.1	6.6	7.2
Net Other Income	-0.1	-1.2	-1.6	-4.1	-7.3	-3.8	-9.9	0.0	0.0	0.0	0.0	0.0
Pre Tax Profit	43.4	41.3	37.4	46.2	54.8	62.9	64.7	78.6	77.9	82.6	85.3	88.1
Tax Expense/(Credit)	4.4	0.3	2.7	-7.2	16.4	15.1	18.5	12.3	12.2	12.9	13.3	13.7
Net Profit	39.0	41.1	34.7	53.4	38.4	47.8	46.1	66.3	65.7	69.7	72.0	74.3
Net Profit (excl 123R option expense)	41.7	44.6	38.2	56.5	41.2	50.9	48.5	69.8	69.2	73.2	75.5	77.8
Pre Tax EPS (US$)	0.34	0.33	0.31	0.38	0.45	0.52	0.51	0.64	0.63	0.66	0.68	0.70
After Tax EPS (US$)	0.31	0.33	0.28	0.44	0.32	0.39	0.36	0.54	0.53	0.56	0.58	0.59
After Tax EPS Diluted (US$)	0.29	0.31	0.27	0.41	0.30	0.37	0.36	0.51	0.50	0.53	0.55	0.56
After Tax EPS Diluted (US$ excl 123R option exp.)	0.31	0.34	0.29	0.44	0.32	0.39	0.38	0.54	0.53	0.56	0.57	0.59
Margins (%)												
Gross Margin	81.2	82.5	81.4	82.4	83.0	82.0	79.8	83.1	83.2	82.9	82.1	82.0
Operating Margin (excl 123R option expense)	62.4	60.1	52.8	59.9	65.7	63.3	60.6	63.1	61.2	61.4	60.6	60.5
EBITDA Margin	66.9	64.6	57.2	64.4	69.5	66.6	63.5	67.4	65.4	65.6	65.1	65.0
Net Margin	56.5	58.3	47.5	65.4	41.8	46.5	39.4	54.3	53.0	53.4	53.1	53.3
Net Margin excl 123R option expense	60.3	63.4	52.3	69.1	44.8	49.4	41.4	57.2	55.8	56.1	55.7	55.8
Sequential Growth (%)												
Revenue	3.9	2.0	3.8	11.8	12.4	12.0	13.9	4.0	1.7	5.2	3.9	2.8
Gross Profit	3.0	3.5	2.5	13.2	13.3	10.7	10.7	8.4	1.8	4.8	2.9	2.7
Adjusted EBIT	4.9	-1.8	-8.8	27.0	23.4	7.9	9.1	8.3	-1.5	5.5	2.6	2.7
Pre Tax Profit	5.4	-4.7	-9.5	23.5	18.6	14.8	2.8	21.5	-0.8	6.0	3.2	3.2
Net Profit (excl 123R exp)	5.6	7.1	-14.4	47.8	-27.1	23.6	-4.6	43.8	-0.8	5.8	3.1	3.1
After Tax EPS	7.4	8.1	-13.9	54.7	-28.2	24.5	-3.4	43.2	-1.4	5.5	2.7	2.7
After Tax EPS excl 123R option expense	6.1	10.1	-12.8	48.6	-26.9	23.5	-4.8	43.4	-1.4	5.2	2.5	2.6

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 203: NTES Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash and Cash Equivalents	552.2	844.6	1,194.5	1,571.5
Account Receivables	22.1	23.8	27.5	31.0
Inventory	-	-	-	-
Total Other Current Assets	14.7	18.6	21.7	24.1
Total Current Assets	589.1	887.0	1,243.7	1,626.7
Gross Fixed Assets	61.5	90.1	126.0	165.2
Accumulated Depreciation	(37.1)	(60.4)	(84.2)	(112.0)
Net Fixed Assets	24.4	29.7	41.8	53.3
Other Long Term Assets	8.8	15.8	16.0	16.0
Long Term Investments and Associates	-	-	-	-
Total Long Term Assets	33.1	45.5	57.8	69.2
Total Assets	622.2	932.5	1,301.5	1,695.9
ST Debt and Current Portion of LT Debt	85.2	-	-	-
Accounts Payable	33.2	41.8	51.4	61.8
Other Current Liabilities	51.1	80.4	92.9	104.8
Total Current Liabilities	169.6	122.2	144.3	166.6
Long Term Debt	-	-	-	-
Other Long Term Liabilities	1.4	0.1	0.1	0.1
Total Long Term Liabilities	1.4	0.1	0.1	0.1
Share Capital	0.3	0.4	0.4	0.4
Share Premium	-	15.9	72.6	131.2
Other Reserves	22.6	109.6	110.7	110.7
Retained Earnings	428.4	684.4	973.5	1,286.9
Preferred Stock	-	-	-	-
Total Equity	451.3	810.2	1,157.1	1,529.3
Total Liabilities and Equity	622.2	932.5	1,301.5	1,695.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 204: NTES Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	167.9	198.3	281.8	313.5
Add Non cash Expenses/(income)	-	-	-	-
Depreciation and Amortization	13.2	15.2	23.2	27.8
Extraordinaries	(0.0)	(0.0)	-	-
Other Non-Cash Items	12.7	11.7	14.0	14.0
Changes in Working Capital:	-	-	-	-
(Increase)/Decrease Receivables	(4.6)	0.5	(3.4)	(3.5)
(Increase)/Decrease Inventories	-	-	-	-
(Increase)/Decrease Other Current Assets	(6.8)	(2.4)	(2.9)	(2.4)
Increase/(Decrease) Payables	(0.8)	5.3	9.2	10.4
Increase/(Decrease) Other Current Liabilities	(4.7)	24.4	11.6	11.9
Net Cash from Operations	176.7	253.0	333.3	371.5
Cash Flow from Investing	-	-	-	-
Purchase of Property, Plant & Equipment	(7.8)	(18.2)	(35.0)	(39.2)
Purchase/Sale of Other LT assets	(6.1)	(6.2)	-	-
Purchase/Sale of Investments	-	-	-	-
Net Cash from Investing Activities	(13.8)	(24.4)	(35.0)	(39.2)
Cash Flow from Financing	-	-	-	-
Issuance/Repayment of Debt	(18.4)	(93.5)	-	-
Change in other LT liabilities	(0.1)	(1.5)	-	-
Change in Common Equity - net	(65.1)	89.0	42.5	44.6
Payment of Cash Dividends	-	-	-	-
Other Financing Charges, Net	(50.0)	16.0	0.0	0.0
Net Cash from Financing Activities	(133.6)	10.1	42.5	44.6
Net Effect of Exchange Rate Changes/Others	-	-	-	-
Net Change in Cash and Cash Equivalents	29.3	238.7	340.9	377.0
Cash at End of Period	552.2	844.6	1,194.5	1,571.5

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Ninetowns, Neutral, ($0.83)

We remain Neutral on Ninetowns as the company's core B2G (business-to-government) segment and its new B2B (business-to-business) segment continue to face a tough business environment due to the continuing slowdown in the global trade sector. Our Dec-09 price target is US$2.0 (down recently from Dec-08 price target of US$2.8), which is at a discount to our DCF valuation and current net cash per share due to market concerns about potentially higher losses going forward, which are likely to keep the stock price under pressure.

- Ninetowns' e-filings software sales have faced a tough business environment over the last couple of years due to a free alternative distributed by the government. In recent months, the ongoing export slowdown and quality issues in some of China's sectors (e.g., food and toys) have further adversely impacted Ninetowns' SME client base for both B2G and B2B offerings.
- Ninetowns has also continued to see operating losses as it works on developing its new B2B segment. While Ninetowns has responded to the tougher business environment by expanding its pay-per-transaction model for enterprise software to several regions (to continue to gain new trade enterprises and retain existing clients) and taking cost cutting measures such as workforce reduction (from 400 employees to a current headcount of 300), we expect earnings to stay under pressure in the foreseeable future due to muted B2G revenues and early stage of B2B monetization.
- **Potential 2009 drivers:** In our view, the following factors could drive shares in 2009: (1) return to profitability (upside risk) or larger operating losses (downside risk), and (2) if Ninetowns were to become a potential acquisition or partnership prospect (due to customer list of over 130k exporters and importers, and cheap valuation).

Our current and newly introduced 2010 estimates are in the table below:

Table 205: Ninetowns Financial Snapshot

$ in millions, except per share data

	2H'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	7.0	14.4	12.5	13.9	4%	-13%	12%
EBITDA	-2.4	-6.6	-0.2	1.5	NM	NM	NM
GAAP EPS	-0.11	-0.23	-0.09	-0.04	NM	NM	NM
Adj. EPS	-0.11	-0.22	-0.08	-0.03	NM	NM	NM
Consensus							
Revenue	NA	NA	NA	NA	NM	NM	NM
EBITDA	NA	NA	NA	NA	NM	NM	NM
GAAP EPS	NA	NA	NA	NA	NM	NM	NM
Adj. EPS	NA	NA	NA	NA	NM	NM	NM

Source: J.P. Morgan estimates. *Note: Adj. EPS excludes share-based compensation expense.

Our Estimates and Outlook for 2009

We forecast net revenue of US$12.5MM, down 13% Y/Y, and a GAAP loss of US$0.09 per share (vs. GAAP loss of US$0.23 per share for 2008), or adjusted (ex-share-based expense) loss of US$0.08 per share (vs. loss of US$0.22 per share for 2008). We forecast enterprise software revenue of US$9.0MM (72% of total revenue), down 19% Y/Y, software development service revenue of US$3.1MM (25% of total revenue), up 4% Y/Y, and B2B revenue of US$0.4MM (3% of total revenue), up 6% Y/Y.

With respect to margins, we forecast gross margin at 75.1% for 2009, up from 72.4% for 2008 (due to expected lower gross loss in B2B segment). We expect adjusted operating margin (ex-share-based expense) of -34.9% (operating loss) for 2009, narrowing from -74.4% for 2008, and adjusted net margin (ex-share-based expense) of -22.1% (loss) for 2009, narrowing from -52.9% for 2008.

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$13.9MM, up 12% Y/Y, and GAAP loss of US$0.04 per share, or adjusted loss of US$0.03 per share. We forecast 2010 enterprise software revenue of US$9.7MM (69% of total revenue), up 7% Y/Y, software development service revenue of US$3.8MM (27% of total revenue), up 22% Y/Y, and B2B revenue of US$0.5MM (4% of total revenue), up 40% Y/Y.

On margins, we forecast gross margin at 76.5% (up slightly Y/Y), adjusted operating margin of -18.5% (narrowing Y/Y), and adjusted net margin of -8.3% (narrowing Y/Y).

Price Target, Valuation and Rating Analysis

We remain Neutral on Ninetowns. The stock is trading at over 50% discount to FY08E net cash of US$2.66/share. We believe such a significant discount to net cash is unjustified; however, we remain Neutral due to the very low business visibility for the company and likelihood of continued operating losses. We recently revised down our price target to US$2.0 (Dec-09) from the prior US$2.8 (Dec-08) due to the weaker-than-expected results in 1H08. We set our price target at a discount to our DCF valuation of US$2.2 (also discount to current net cash per share of US$2.6) due to continued market concerns about potentially higher losses going forward, which are likely to keep the stock price under pressure.

Risks to Our Rating and Price Target

Upside risks to our rating and price target include: 1) possibility of Ninetowns becoming a target for acquisition or strategic partnership; 2) higher-than-expected monetization from the new B2B segment; and 3) significant conversions of free e-filing software users to paid service customers. Downside risks include: 1) further decline in existing core revenue base; 2) larger-than-expected investments in the B2B business; and 3) disruption in good working relationship with the PRC Inspections Administration.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 206: NINE Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	13.8	14.4	12.5	13.9
Enterprise software	*10.3*	*11.1*	*9.0*	*9.7*
Software development service	*3.4*	*3.0*	*3.1*	*3.8*
Other	*0.1*	*0.3*	*0.4*	*0.5*
COGS	-3.1	-4.0	-3.1	-3.3
Gross profit	10.8	10.4	9.4	10.7
Operating expense	-24.3	-21.6	-14.0	-13.5
Sales & mktg. expenses	*-5.5*	*-5.6*	*-3.7*	*-3.5*
G&A expenses	*-11.5*	*-11.5*	*-7.8*	*-8.0*
R&D expenses	-4.3	-4.4	-2.5	-2.1
Other expenses	-3.0	0.0	0.0	0.0
Share-based compensation	-0.3	-0.4	-0.3	-0.3
EBIT	-13.5	-11.2	-4.6	-2.9
Adj. EBIT (ex-123R expense)	-13.3	-10.7	-4.4	-2.6
EBITDA	-10.0	-6.6	-0.2	1.5
Net interest income	1.9	1.2	1.4	1.3
Net other income	-19.9	1.1	0.0	0.0
Pre-tax profit	-31.6	-8.9	-3.3	-1.6
Tax expense/(credit)	0.0	0.2	0.2	0.1
Net profit	-30.8	-8.1	-3.0	-1.5
Adj. Net profit (ex-123R exp.)	-4.7	-7.6	-2.8	-1.2
Pre-tax EPS (US$)	-0.90	-0.25	-0.09	-0.04
After-tax EPS (US$)	-0.88	-0.23	-0.09	-0.04
Diluted EPS (US$)	-0.88	-0.23	-0.09	-0.04
Adj. Diluted EPS (ex-123R exp., US$)	-0.13	-0.22	-0.08	-0.03
Margins (%)				
GPM	77.9	72.4	75.1	76.5
OPM (ex-123R exp.)	-96.0	-74.4	-34.9	-18.5
EBITDA margin	-72.5	-45.5	-1.9	10.9
Net margin	-222.8	-56.0	-24.4	-10.4
Adj. Net margin (ex-123R exp.)	-33.9	-52.9	-22.1	-8.3
Sequential growth (%)				
Revenue	-28.4	4.3	-13.4	11.7
Gross profit	-37.3	-3.1	-10.2	13.7
Adj. EBIT	n.m.	n.m.	n.m.	n.m.
Pre-tax profit	n.m.	n.m.	n.m.	n.m.
Net profit (ex-123R exp.)	n.m.	n.m.	n.m.	n.m.
Diluted EPS	n.m.	n.m.	n.m.	n.m.
Adj. Diluted EPS (ex-123R exp.)	n.m.	n.m.	n.m.	n.m.

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 207: NINE Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash, cash equivalents and term deposits	91.9	92.9	88.0	87.7
Account receivables	5.0	4.4	4.1	4.7
Inventory	0.9	0.6	0.5	0.6
Total other current assets	2.5	2.1	1.8	2.0
Total current assets	100.3	100.0	94.5	95.0
Gross fixed assets	27.8	33.6	36.3	39.2
Accumulated depreciation	(2.5)	(5.6)	(8.2)	(11.0)
Net fixed assets	25.4	27.9	28.1	28.2
Other long term assets	30.9	31.8	31.8	31.8
Long term investments and associates	-	-	-	-
Total long term assets	56.2	59.7	59.9	60.0
Total assets	156.6	159.7	154.4	155.0
ST debt and current portion of LT debt				
Accounts payable	5.9	3.4	1.1	1.1
Other current liabilities	4.3	3.8	3.6	4.1
Total current liabilities	10.2	7.3	4.7	5.2
Long term debt	-	-	-	-
Other long term liabilities	2.9	2.3	2.3	2.3
Total long term liabilities	2.9	2.3	2.3	2.3
Share capital	0.1	0.1	0.1	0.1
Share premium	116.8	127.5	127.8	129.4
Other reserves	-	-	-	-
Retained earnings	26.5	22.5	19.4	18.0
Preferred stock	-	-	-	-
Total equity	143.4	150.1	147.4	147.5
Total liabilities and equity	156.6	159.7	154.4	155.0

Source: Company reports and J.P. Morgan estimates.

Table 208: NINE Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net income	(30.8)	(8.1)	(3.0)	(1.5)
Add non cash expenses/(income)	-	-	-	-
Depreciation and amortization	3.3	4.2	4.1	4.1
Extraordinaries	25.1	(0.6)	-	-
Other non-cash items	3.4	0.4	0.3	0.3
Changes in working capital:	-	-	-	-
(Increase)/decrease receivables	(1.7)	1.0	0.3	(0.6)
(Increase)/decrease inventories	(0.0)	0.5	0.0	(0.1)
(Increase)/decrease other current assets	1.6	0.6	0.3	(0.2)
Increase/(decrease) payables	(2.3)	(3.0)	(2.3)	0.0
Increase/(decrease) other current liabilities	1.2	(0.9)	(0.3)	0.5
Net cash from operations	(0.4)	(5.9)	(0.6)	2.6
Cash flow from investing				
Purchase of property, plant & equipment	(27.9)	(2.6)	(2.8)	(2.9)
Purchase/sale of other LT assets	-	0.1	(1.5)	(1.3)
Purchase/sale of investments	35.5	-	-	-
Net cash from investing activities	7.6	(2.6)	(4.3)	(4.2)
Cash flow from financing	-	-	-	-
Issuance/repayment of debt				
Change in other LT liabilities	-	(0.9)	-	-
Change in common equity - net	0.2	(0.3)	-	1.3
Payment of cash dividends	-	-	-	-
Other financing charges, net	-	2.3	(0.0)	0.0
Net cash from financing activities	0.2	1.1	(0.0)	1.3
Net effect of exchange rate changes	(0.6)	-	-	-
Net change in cash and cash equivalents	6.8	(7.3)	(4.9)	(0.4)
Net change in term deposits	(36.0)	-	-	-
Total cash balance at beginning of period	114.2	91.9	92.9	88.0
Total cash balance at end of period	91.9	92.9	88.0	87.7

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Shanda, Overweight, ($30.75)

We maintain our Overweight rating on Shanda, the largest item-based (free-to-play) online game operator in China and our top pick in the online games sector. Our price target for Shanda is US$35, which implies 14.5x FY08E and 13.0x FY09E diluted GAAP EPS, or 13.9x FY08E and 12.5x FY09E adjusted diluted EPS.

- We expect Shanda's large diversified game portfolio of 23 MMORPGs and 16 casual games (in operations and in pipeline) will continue to deliver consistently solid revenue growth going forward. We also believe Shanda's large active account base (paying and non-paying combined) of ~70 million could be further monetized through cross-selling of new games and sequels (e.g., Legend of Mir2), and in-game advertising. Furthermore, Shanda has demonstrated that it aas the leading on-ground sales team in China to acquire new users – a significant advantage during the current macro slowdown.
- We expect Shanda to emerge stronger in the online game industry post the current financial crisis. With a strong cash position and the largest online game revenue base in China, we believe: (1) Shanda is seeing better employee retention, (2) cash-strapped game start-up teams are more willing to sell to or join Shanda, and (3) Shanda has the financial strength to license additional games at more competitive costs.
- We also maintain our view that: (1) Shanda's strong marketing capability and operating platform will enable it to further monetize its aging, but very well known, games Mir2 and Woool, (2) Shanda's "sequels" strategy of existing games (such as Mir2 WaiZhuag) will deliver stable longer-term growth, (3) Shanda continues to expand its game pipeline and diversify game-specific risks, and (4) Shanda has the most extensive free-to-play model experience among peers, which should continue to benefit the company.
- **2009 drivers:** In our view, the following factors will drive shares in 2009: (1) Shanda consistently delivering good results, (2) new games attracting greater than expected user traction, and (3) share buyback of up to US$200MM over the next few quarters (Shanda ended 3Q08 with cash of US$458MM, short-term investments of US$129MM and convertible debt of US$175MM).

Our current and newly introduced 2010 estimates are in the table below:

Table 209: Shanda Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	144.0	514.0	652.7	736.2	57%	27%	13%
EBITDA	64.5	243.2	298.0	335.6	72%	23%	13%
GAAP EPS	0.63	2.42	2.69	3.05	46%	11%	13%
Adj. EPS	0.65	2.53	2.80	3.16	-5%	11%	13%
Consensus							
Revenue	143.4	510.4	614.1	685.7	56%	20%	12%
EBITDA	64.4	234.9	276.4	280.4	66%	18%	1%
GAAP EPS	0.62	2.38	2.76	3.23	43%	16%	17%
Adj. EPS	0.63	2.41	2.71	3.10	-9%	13%	14%

Source: J.P. Morgan estimates and Bloomberg. *Note: Adj. EPS excludes share-based compensation expense.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We forecast net revenue of US$652.7MM in 2009, up 27% Y/Y, and GAAP diluted EPS of US$2.69, up 11% Y/Y, or adjusted EPS (ex-share-based expense) of US$2.80, up 11% Y/Y. We forecast MMORPG revenue of US$549.8MM in 2009 (84% of total revenue), up 29% Y/Y, and casual game revenue of US$80.6MM (12% of total revenue), up 20% Y/Y.

We forecast gross margin at 70.9% for 2009, slightly lower than 71.8% for 2008, adjusted operating margin (ex-share-based expense) of 39.3% for 2009, slightly lower than 41.1% for 2008, and adjusted net margin of 30.6% for 2009, down from 35.7% for 2008 (on higher effective tax rate of ~24% in 2009, due to Actoz – with higher tax rate in Korea – and Aurora combination).

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$736.2MM, up 13% Y/Y, and GAAP diluted EPS of US$3.05, up 13% Y/Y, or adjusted EPS of US$3.16, up 13% Y/Y. We forecast MMORPG revenue of US$615.8MM in 2010 (84% of total revenue), up 12% Y/Y, and casual game revenue of US$93.8MM (13% of total revenue), up 16% Y/Y. On margins, we forecast gross margin at 70.8% (stable Y/Y); adjusted operating margin of 39.1% (stable Y/Y) and adjusted net margin of 31.0% (also stable Y/Y).

Price Target, Valuation and Rating Analysis

We maintain our Overweight rating on Shanda, which remains our top pick in the online game sector in China. Our price target is US$35 (June-09), which implies 14.5x 2008E and 13.0x 2009E GAAP EPS, or 13.9x 2008E and 12.5x 2009E adjusted EPS. Our price target is below our DCF valuation of ~US$55 (13% WACC, 0% terminal growth), due to the lower sector multiples. Historically, the game sector has traded at a forward P/E of 10x-20x. We believe Shanda can trade towards the mid-end of this range, due to upside potential to our estimates from successes in upcoming new games, and in-game advertising. On the other hand, with general stock market weakness, the stock is not likely to trade at the historical high end of around 20x, in our view.

Risks to Our Rating

Risks to our rating and price target include: (1) existing games seeing a significant decline from lack of new content or promotions, (2) new major titles seeing lower-than-expected gamer interest, and (3) any new business initiatives that would lead to large investments.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 210: SNDA Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	327.2	514.0	652.7	736.2
MMORPG	*270.6*	*427.1*	*549.8*	*615.8*
Casual games	*43.7*	*66.9*	*80.6*	*93.8*
EZ hardware	*1.1*	*0.3*	*0.3*	*0.3*
EZ subscription	*0.0*	*0.0*	*0.0*	*0.0*
Others (Includes Actoz revenue from 3Q07)	*11.7*	*19.7*	*22.1*	*26.3*
COGS	-106.5	-145.0	-189.8	-214.9
Gross Profit	220.6	369.0	462.9	521.3
Operating Expense	-87.3	-165.8	-213.9	-241.2
Sales & Mktg. expenses	*-23.8*	*-45.6*	*-58.7*	*-66.3*
G&A expenses	*-41.8*	*-80.0*	*-102.9*	*-116.0*
R&D expenses	*-21.7*	*-40.1*	*-52.2*	*-58.9*
Other expenses	*0.0*	*0.0*	*0.0*	*0.0*
123R share-based compensation	*-7.8*	*-8.0*	*-7.6*	*-7.6*
EBIT	133.3	203.2	249.0	280.1
Adj. EBIT (ex-share-based comps.)	141.1	211.2	256.6	287.8
EBITDA	167.4	243.2	298.0	335.6
Net Interest Income	7.0	10.7	13.8	19.2
Net Other Income	65.7	2.6	3.3	3.7
Pre Tax Profit	206.0	216.6	266.1	303.0
Tax Expense/(Credit)	-17.7	-38.4	-65.7	-74.6
Net Profit	185.1	175.8	192.4	220.5
Adj. Net Profit (ex-share-based comps.)	136.9	183.7	200.0	228.1
Pre Tax EPS (US$)	2.87	3.02	3.81	4.31
After Tax EPS (US$)	2.58	2.45	2.75	3.13
EPS Diluted (US$)	2.53	2.42	2.69	3.05
Adj. Diluted EPS (US$ ex-share-based comps.)	1.87	2.53	2.80	3.16
Margins (%)				
Gross Margin	67.4	71.8	70.9	70.8
Adj. Operating Margin (ex-share-based comps.)	43.1	41.1	39.3	39.1
EBITDA Margin	51.2	47.3	45.6	45.6
Net Margin	56.6	34.2	29.5	29.9
Adj. Net Margin (ex-share-based comps.)	41.8	35.7	30.6	31.0
Sequential Growth (%)				
Revenue	56.9	57.1	27.0	12.8
Gross Profit	81.4	67.3	25.5	12.6
Adj. EBIT	168.0	49.7	21.5	12.1
Pre Tax Profit	176.4	5.1	22.9	13.9
Net Profit (ex-share-based comps.)	116.2	34.2	8.9	14.0
EPS Diluted	174.3	-4.5	11.3	13.4
Adj. Diluted EPS (ex-share-based comps.)	113.7	35.0	10.7	12.9

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 211: SNDA Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	68.8	74.1	87.4	97.8	111.1	122.1	137.4	144.0	151.7	159.5	167.5	174.0
MMORPG	*53.5*	*62.1*	*73.4*	*82.5*	*91.3*	*101.3*	*113.2*	*121.7*	*127.4*	*134.2*	*141.0*	*147.1*
Casual games	*11.8*	*9.3*	*10.9*	*11.7*	*16.6*	*15.7*	*17.6*	*17.1*	*19.4*	*19.9*	*20.6*	*20.8*
EZ hardware	*0.9*	*0.0*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
EZ subscription	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Others (Includes Actoz revenue from 3Q07)	*2.6*	*2.7*	*3.0*	*3.5*	*3.1*	*5.0*	*6.5*	*5.1*	*4.9*	*5.3*	*5.8*	*6.1*
COGS	-24.0	-24.3	-26.4	-32.2	-33.9	-33.2	-37.1	-40.9	-44.2	-46.3	-48.6	-50.8
Gross Profit	44.9	49.8	61.0	65.6	77.2	88.9	100.2	103.0	107.5	113.2	118.9	123.3
Operating Expense	-15.8	-17.8	-26.6	-27.4	-32.8	-40.0	-44.3	-49.0	-48.6	-52.6	-55.3	-57.4
Sales & Mktg. expenses	*-3.8*	*-5.0*	*-8.1*	*-7.0*	*-8.4*	*-11.5*	*-12.8*	*-13.0*	*-13.7*	*-14.4*	*-15.1*	*-15.7*
G&A expenses	*-8.4*	*-8.7*	*-11.9*	*-12.9*	*-15.1*	*-18.7*	*-21.9*	*-24.5*	*-22.8*	*-25.5*	*-26.8*	*-27.8*
R&D expenses	*-3.6*	*-4.0*	*-6.6*	*-7.5*	*-9.2*	*-9.9*	*-9.5*	*-11.5*	*-12.1*	*-12.8*	*-13.4*	*-13.9*
Other expenses	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
123R share-based compensation	*-1.5*	*-2.0*	*-2.0*	*-2.3*	*-2.2*	*-2.2*	*-1.7*	*-1.9*	*-1.9*	*-1.9*	*-1.9*	*-1.9*
EBIT	29.0	32.1	34.3	38.2	44.5	48.9	56.0	54.1	59.0	60.5	63.6	65.9
Adj. EBIT (ex-share-based comps.)	30.5	34.1	36.3	40.5	46.7	51.1	57.6	56.0	60.9	62.5	65.5	67.8
EBITDA	35.7	39.4	44.1	48.6	53.7	58.6	66.6	64.5	70.4	72.5	76.1	78.9
Net Interest Income	0.9	1.1	2.0	3.0	2.7	2.8	2.6	2.6	2.9	3.3	3.6	4.0
Net Other Income	33.3	26.4	2.7	2.3	-1.5	-1.6	5.1	0.7	0.8	0.8	0.8	0.9
Pre Tax Profit	63.2	59.6	39.1	43.5	45.7	50.1	63.7	57.4	62.7	64.6	68.1	70.7
Tax Expense/(Credit)	3.1	5.0	6.4	3.3	4.1	9.0	13.7	11.9	15.5	16.0	16.8	17.4
Net Profit	58.0	54.6	31.8	40.1	41.1	40.8	49.4	44.5	45.2	46.7	49.3	51.3
Net Profit (ex-share-based comps.)	27.8	33.3	33.8	42.4	43.3	43.0	51.1	46.4	47.1	48.6	51.2	53.2
Pre Tax EPS (US$)	0.88	0.84	0.55	0.60	0.63	0.69	0.88	0.82	0.90	0.93	0.97	1.01
After Tax EPS (US$)	0.81	0.76	0.44	0.55	0.57	0.56	0.69	0.64	0.65	0.67	0.70	0.73
After Tax EPS Diluted (US$)	0.79	0.74	0.44	0.54	0.56	0.56	0.68	0.63	0.63	0.65	0.69	0.71
After Tax EPS Diluted (US$ ex-share-based comps.)	0.38	0.46	0.46	0.58	0.60	0.58	0.70	0.65	0.66	0.68	0.72	0.74
Margins (%)												
Gross Margin	65.2	67.2	69.8	67.1	69.5	72.8	73.0	71.6	70.9	71.0	71.0	70.8
Operating Margin (ex-share-based comps.)	44.3	46.0	41.6	41.4	42.0	41.9	41.9	38.9	40.1	39.2	39.1	38.9
EBITDA Margin	51.8	53.2	50.5	49.7	48.3	48.0	48.5	44.8	46.4	45.5	45.5	45.3
Net Margin	84.3	73.7	36.4	41.0	37.0	33.4	36.0	30.9	29.8	29.3	29.4	29.5
Net Margin (ex-share-based comps.)	40.5	44.9	38.7	43.3	39.0	35.2	37.2	32.2	31.0	30.4	30.6	30.6
Sequential Growth (%)												
Revenue	14.2	7.7	17.9	11.9	13.6	9.9	12.5	4.8	5.4	5.1	5.0	3.9
Gross Profit	18.3	11.1	22.3	7.6	17.7	15.2	12.7	2.8	4.4	5.3	5.1	3.7
Adj. EBIT	43.3	11.7	6.7	11.4	15.2	9.6	12.7	-2.8	8.8	2.6	4.9	3.4
Pre Tax Profit	92.7	-5.7	-34.4	11.2	5.0	9.8	27.1	-10.0	9.3	3.1	5.4	3.8
Net Profit (ex-share-based comps.)	17.9	19.5	1.6	25.3	2.3	-0.8	18.8	-9.2	1.5	3.1	5.4	3.9
After Tax EPS	87.5	-6.9	-40.5	23.8	2.9	-0.1	21.1	-7.7	1.4	3.0	5.4	3.8
After Tax EPS (ex-share-based comps.)	17.2	19.8	1.1	24.8	4.1	-2.6	19.9	-6.9	1.3	2.9	5.2	3.6

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 212: SNDA Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash and Cash Equivalents	263.24	515.40	731.75	961.67
Account Receivables	4.27	4.69	5.72	6.29
Inventory	0.29	0.78	0.95	1.05
Total Other Current Assets	24.74	30.25	37.22	41.74
Total Current Assets	292.55	551.13	775.65	1,010.74
Gross Fixed Assets	73.44	103.80	148.71	199.31
Accumulated Depreciation	(31.51)	(62.54)	(87.34)	(120.87)
Net Fixed Assets	41.93	41.26	61.38	78.44
Other Long Term Assets	189.53	212.99	214.88	214.88
Long Term Investments and Associates	107.54	131.03	132.19	132.19
Total Long Term Assets	339.00	385.27	408.44	425.50
Total Assets	631.55	936.40	1,184.09	1,436.25
ST Debt and Current Portion of LT Debt	-	-	-	-
Accounts Payable	6.44	9.82	12.02	12.81
Other Current Liabilities	110.87	190.28	232.06	254.91
Total Current Liabilities	117.31	200.11	244.08	267.71
Long Term Debt	-	173.46	175.00	175.00
Other Long Term Liabilities	33.76	35.75	25.25	17.67
Total Long Term Liabilities	33.76	209.21	200.25	192.67
Share Capital	1.59	1.67	1.70	1.71
Share Premium	214.08	152.10	169.06	184.68
Other Reserves	16.64	8.34	8.42	8.42
Retained Earnings	248.17	364.96	560.57	781.05
Preferred Stock	-	-	-	-
Total Equity	480.48	527.08	739.76	975.86
Total Liabilities and Equity	631.55	936.40	1,184.09	1,436.25

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 213: SNDA Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	185.14	175.78	192.39	220.48
Add Non cash Expenses/(income)	-	-	-	-
Depreciation and Amortization	26.28	32.01	41.32	47.80
Extraordinaries	3.14	2.37	8.00	8.00
Other Non-Cash Items	(90.37)	7.97	7.63	7.63
Changes in Working Capital:	-	-	-	-
(Increase)/Decrease Receivables	(0.07)	(0.01)	(0.99)	(0.56)
(Increase)/Decrease Inventories	0.90	(0.46)	(0.16)	(0.09)
(Increase)/Decrease Other Current Assets	(11.94)	(3.13)	(6.69)	(4.52)
Increase/(Decrease) Payables	(5.65)	2.76	2.11	0.79
Increase/(Decrease) Other Current Liabilities	46.39	68.74	40.09	22.84
Net Cash from Operations	153.82	286.02	283.69	302.36
Cash Flow from Investing	-	-	-	-
Purchase of Property, Plant & Equipment	(9.70)	(12.75)	(44.00)	(50.60)
Purchase/Sale of Other LT assets	(2.00)	(19.76)	(17.07)	(14.27)
Purchase/Sale of Investments	235.51	(13.13)	-	-
Net Cash from Investing Activities	223.81	(45.63)	(61.07)	(64.87)
Cash Flow from Financing	-	-	-	-
Issuance/Repayment of Debt	(271.16)	173.46	-	-
Change in other LT liabilities	-	(1.26)	(10.82)	(7.57)
Change in Common Equity - net	(1.11)	(100.53)	8.00	8.00
Payment of Cash Dividends	-	-	-	-
Other Financing Charges, Net	-	(85.27)	(8.00)	(8.00)
Net Cash from Financing Activities	(272.27)	(13.60)	(10.82)	(7.57)
Net Effect of Exchange Rate Changes	(13.41)	-	-	-
Net Change in Cash and Cash Equivalents	91.93	226.79	211.79	229.92
Cash at End of Period	263.24	515.40	731.75	961.67

Source: Company reports and J.P. Morgan estimates.

Sina, Overweight, ($22.89)

We maintain our Overweight rating on Sina, the leader in the online branded advertising segment in China. Our Jun-09 price target is US$53, which implies 31.5x FY08E and 25.1x FY09E adjusted EPS, on the back of 51% / 26% earnings growth forecast for '08/'09.

- Sina is the leader in China's online branded advertising market. While there is debate over how China's economy will shape up over the next few years, we are very confident that Internet usage will continue to grow, driven by lower computer prices, lower connection fees, higher influence of online media, and government support. Sina, as the leader in online branded advertising in China, should remain a key beneficiary of China's Internet usage growth. We maintain our 2009 forecast for Sina to see ad revenue growth of 22% Y/Y, and we expect to see Sina taking market share away from low-tier sites.
- We also expect a continuing increase in allocation of ad budgets from offline to online media. While management has observed delays in the 2009 budget planning process by advertisers, there had been no cancellations in 4Q08 as of mid-November. Further, from surveying its own ad customers, the company noted that the majority of clients planned to increase their budget allocation online. We maintain our view that more offline ad budgets will be reallocated to online, driven by: (1) China's increasing Internet user penetration (still ~20% vs. ~70% in the US, Japan, Korea), (2) higher cost effectiveness, and (3) relatively more measurable results for advertisers.
- **2009 drivers:** In our view, the following factors will drive shares in 2009: (1) better visibility on 2009 ad budget growth by early '09, (2) continued solid growth in Internet usage in China, (3) potential upside from Google-Sina search and E-House real estate channel partnership, and (4) formation of further online partnerships (such as with E-House in online real estate segment).

Our current and newly introduced 2010 estimates are in the table below:

Table 214: Sina Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	98.7	366.8	437.6	547.5	49%	19%	25%
EBITDA	31.0	106.1	138.8	173.9	43%	31%	25%
GAAP EPS	0.42	1.46	1.84	2.27	51%	26%	24%
Adj. EPS	0.48	1.68	2.11	2.55	51%	26%	21%
Consensus							
Revenue	99.2	367.7	438.3	513.6	49%	19%	17%
EBITDA	31.9	99.9	133.3	166.4	35%	33%	25%
GAAP EPS	0.41	1.44	1.71	1.98	48%	19%	16%
Adj. EPS	0.45	1.59	1.88	2.28	42%	19%	21%

Source: J.P. Morgan estimates and Bloomberg. *Note: Adj. EPS excludes share-based compensation expense.

Our Estimates and Outlook for 2009

We forecast net revenue of US$437.6MM in 2009, up 19% Y/Y, and GAAP diluted EPS of US$1.84, up 26% Y/Y, or adjusted EPS (ex-share-based expense) of US$2.11, up 26% Y/Y. We forecast 2009 advertising revenue of US$314.3MM (72% of total revenue), up 22% Y/Y, and wireless-related revenue of US$114.4MM (26% of total revenue), up 14% Y/Y. Among other revenue, we currently forecast US$6.2MM in search-related revenue in 2009, up 19% Y/Y.

We forecast gross margin at 61.3% for 2009, up from 60.4% for 2008 (due to lower content-related costs in 2009). Our online ad gross margin forecast is 64.6% in 2009, up from 62.6% for 2008 (due to lower content costs), and our wireless-related gross margin forecast is 50.7%, down from 54.0% for 2008. We expect adjusted operating margin (ex-share-based expense) of 27.0% for 2009, up from 24.7% for 2008, and adjusted net margin of 29.5% for 2009, up from 27.8% for 2008.

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$547.5MM, up 25% Y/Y, and GAAP diluted EPS of US$2.27, up 24% Y/Y, or adjusted EPS of US$2.55, up 21% Y/Y. We forecast 2010 advertising revenue of US$414.1MM, up 32% Y/Y, and wireless-related revenue of US$123.5MM, up 8% Y/Y. On margins, we forecast gross margin at 61.1% (stable Y/Y), adjusted operating margin of 26.9% (stable Y/Y) and adjusted net margin of 28.6% (slightly lower Y/Y).

Price Target, Valuation and Rating Analysis

We remain Overweight on Sina, on the back of low valuation and our relatively high conviction for 2009 and longer-term growth. We maintain our Jun-09 price target at US$53, which implies 36.2x 2008E and 28.9x 2009E GAAP PE, or 31.5x 2008E and 25.1x 2009E adjusted PE; on the back of our 50.6% and 25.6% earnings growth forecast for 2008 and 2009. This is above our DCF valuation of ~US$44 (12% WACC, 0% terminal growth); we believe Sina can trade at this valuation, given its estimated longer-term earnings growth of ~30%. Our sum-of-the-parts valuation indicates a range of US$49.4-56.3. Sina currently holds over US$550MM of cash and short-term investments (or over US$450MM of net cash, net of ~US$100M convertible debt); with significant net cash on hand, we believe Sina can weather the more challenging environment in the near to medium term.

Risks to Our Rating and Price Target

Risks to our rating and price target include greater-than-expected slowdown in advertising spending in China, decline in online ad gross margin, and competition from other Internet portals. In addition, changes in regulations in the wireless value-added space and further decline in wireless-related revenue also add to downside risks.

Table 215: SINA Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	246.1	366.8	437.6	547.5
Mobile related	*70.5*	*100.6*	*114.4*	*123.5*
Advertising	*168.9*	*258.3*	*314.3*	*414.1*
Others	*6.7*	*7.8*	*8.9*	*9.9*
COGS	-92.9	-145.2	-169.5	-213.1
Gross Profit	153.2	221.6	268.0	334.4
Operating Expense	-102.2	-145.6	-165.9	-203.2
Sales & Mktg. expenses	*-49.3*	*-75.5*	*-82.3*	*-102.9*
G&A expenses	*-22.6*	*-26.1*	*-33.3*	*-41.6*
R&D expenses	*-20.3*	*-28.3*	*-33.3*	*-41.6*
Other expenses	*-1.2*	*-1.2*	*-1.0*	*-1.0*
Share-based compensation	*-8.7*	*-14.5*	*-16.0*	*-16.0*
EBIT	51.0	76.0	102.2	131.2
Adjusted EBIT (ex- 123R exp.)	59.7	90.5	118.2	147.2
EBITDA	74.3	106.1	138.8	173.9
Net Interest Income	12.4	27.4	32.2	36.9
Net Other Income	0.8	2.4	0.0	0.0
Pre Tax Profit	64.2	105.7	134.4	168.1
Tax Expense/(Credit)	-6.5	-17.0	-21.1	-25.8
Reported Net Profit	57.7	88.6	111.9	139.3
Adj. Net Profit *	67.1	102.1	129.0	156.4
Reported Diluted EPS (US$)	0.97	1.46	1.84	2.27
Adj. Diluted EPS (US$) *	1.12	1.68	2.11	2.55
Margins (%)				
Gross Margin	62.2	60.4	61.3	61.1
Adj. Operating Margin *	24.3	24.7	27.0	26.9
EBITDA Margin	30.2	28.9	31.7	31.8
Net Margin	23.5	24.2	25.6	25.4
Adj. Net Margin *	27.3	27.8	29.5	28.6
Sequential Growth (%)				
Revenue	15.6	49.0	19.3	25.1
Gross Profit	13.3	44.6	21.0	24.8
Adj. EBIT (ex-123R)	34.6	51.6	30.6	24.6
EBITDA	32.4	42.8	30.9	25.3
Reported Diluted EPS	39.8	50.9	25.5	23.8
Adj. Diluted EPS *	26.8	50.6	25.6	20.6

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 216: SINA Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	51.3	59.8	64.3	70.7	71.3	91.3	105.4	98.7	92.3	105.4	118.7	121.1
Mobile related	*18.2*	*17.0*	*16.6*	*18.6*	*21.7*	*24.5*	*27.1*	*27.3*	*27.8*	*28.3*	*28.9*	*29.4*
Advertising	*31.8*	*41.2*	*45.8*	*50.1*	*47.8*	*64.9*	*76.2*	*69.3*	*62.4*	*74.9*	*87.6*	*89.4*
Others	*1.3*	*1.6*	*1.9*	*1.9*	*1.8*	*1.9*	*2.1*	*2.1*	*2.1*	*2.2*	*2.2*	*2.3*
COGS	-20.4	-22.2	-24.1	-26.2	-28.5	-34.3	-44.4	-37.9	-37.1	-40.6	-45.4	-46.4
Gross Profit	30.9	37.6	40.2	44.5	42.8	57.0	61.0	60.8	55.2	64.8	73.3	74.7
Operating Expense	23.4	24.9	25.1	28.8	29.4	37.4	40.9	37.9	37.5	40.1	44.0	44.2
Sales & Mktg. expenses	*-10.7*	*-11.7*	*-12.1*	*-14.8*	*-14.5*	*-20.5*	*-21.8*	*-18.8*	*-18.5*	*-20.0*	*-22.0*	*-21.8*
G&A expenses	*-5.8*	*-6.0*	*-5.5*	*-5.4*	*-5.8*	*-6.1*	*-6.8*	*-7.4*	*-7.4*	*-7.9*	*-8.9*	*-9.1*
R&D expenses	*-4.3*	*-4.9*	*-5.5*	*-5.6*	*-5.6*	*-6.8*	*-8.3*	*-7.6*	*-7.4*	*-7.9*	*-8.9*	*-9.1*
Other expenses	*-0.4*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.4*	*-0.3*	*-0.3*	*-0.3*	*-0.3*	*-0.3*
Share-based compensation	*-2.2*	*-2.1*	*-1.7*	*-2.8*	*-3.3*	*-3.8*	*-3.6*	*-3.8*	*-4.0*	*-4.0*	*-4.0*	*-4.0*
EBIT	7.5	12.7	15.2	15.7	13.4	19.6	20.1	22.9	17.7	24.7	29.3	30.5
Adjusted EBIT (ex- 123R exp.)	9.7	14.7	16.9	18.4	16.7	23.4	23.7	26.7	21.7	28.7	33.3	34.5
EBITDA	13.4	18.3	20.5	22.0	20.1	27.1	27.9	31.0	26.4	33.7	38.6	40.1
Net Interest Income	2.5	2.4	3.7	3.7	6.2	6.7	7.1	7.3	7.7	7.9	8.2	8.4
Net Other Income	0.0	0.8	0.0	0.0	0.0	3.1	-0.8	0.0	0.0	0.0	0.0	0.0
Pre Tax Profit	10.0	15.9	18.9	19.4	19.6	29.4	26.4	30.2	25.4	32.6	37.4	38.9
Tax Expense/(Credit)	1.4	1.5	1.7	1.9	3.6	4.2	4.4	4.8	4.1	5.1	5.8	6.0
Reported Net Profit	8.6	14.5	17.2	17.5	16.1	25.2	22.0	25.4	21.1	27.2	31.2	32.4
Adj. Net Profit *	11.4	16.1	19.1	20.5	19.6	26.2	26.8	29.4	25.4	31.5	35.5	36.7
Reported Diluted EPS (US$)	0.15	0.25	0.28	0.29	0.27	0.42	0.36	0.42	0.35	0.45	0.51	0.53
Adj. Diluted EPS (US$) *	0.19	0.27	0.32	0.34	0.33	0.43	0.44	0.48	0.42	0.52	0.58	0.60
Margins (%)												
Gross Margin	60.2	62.9	62.5	62.9	60.1	62.4	57.9	61.6	59.8	61.5	61.7	61.7
Adj. Operating Margin *	18.9	24.6	26.2	26.1	23.5	25.6	22.5	27.0	23.5	27.2	28.0	28.4
EBITDA Margin	26.2	30.7	31.8	31.2	28.2	29.7	26.4	31.4	28.6	32.0	32.5	33.2
Net Margin	16.8	24.2	26.7	24.8	22.5	27.6	20.8	25.7	22.9	25.8	26.3	26.8
Adj. Net Margin *	22.1	26.9	29.7	29.0	27.5	28.7	25.5	29.8	27.5	29.9	29.9	30.3
Sequential Growth (%)												
Revenue	-9.1	16.6	7.6	9.9	0.9	28.1	15.4	-6.4	-6.4	14.2	12.6	2.0
Gross Profit	-3.7	21.8	6.9	10.6	8.7	33.1	7.0	-0.4	-2.2	17.3	13.1	1.9
Adj. EBIT (ex-123R)	-12.3	52.3	14.5	9.2	-3.7	39.9	1.4	12.6	-9.1	32.1	15.9	3.5
EBITDA	-13.6	36.6	11.7	7.6	-8.7	34.7	2.9	11.3	-15.0	27.8	14.6	4.0
Reported Diluted EPS	-26.8	65.5	16.2	1.5	-7.8	55.7	-12.8	15.3	-16.9	28.7	14.7	3.6
Adj. Diluted EPS *	-25.7	40.9	17.7	6.7	-3.9	32.4	2.6	9.4	-13.9	23.9	12.7	3.1

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 217: SINA Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash and Cash Equivalents	272	363	487	639
Account Receivables	57	76	93	117
Short-term investments	206	206	206	206
Total Other Current Assets	9	26	32	41
Total Current Assets	544	672	819	1003
Gross Fixed Assets	66	92	122	156
Accumulated Depreciation	-39	-67	-87	-112
Net Fixed Assets	27	25	35	44
Other Long Term Assets	92	91	90	89
Long Term Investments and Associates	0	0	0	0
Total Long Term Assets	119	115	125	133
Total Assets	662	787	944	1135
ST Debt and Current Portion of LT Debt	0	0	0	0
Accounts Payable	1	6	7	8
Other Current Liabilities	66	74	91	115
Total Current Liabilities	67	80	98	123
Long Term Debt	99	99	99	99
Other Long Term Liabilities	1	0	0	0
Total Long Term Liabilities	100	99	99	99
Share Capital	7	7	7	8
Share Premium	332	357	383	411
Other Reserves	0	0	0	0
Retained Earnings	155	244	356	495
Preferred Stock	0	0	0	0
Total Equity	495	608	747	913
Total Liabilities and Equity	662	787	944	1135

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 218: SINA Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	58	89	112	139
Add Non cash Expenses/(income)				
Depreciation and Amortization	15	16	21	27
Extraordinaries	0	0	1	3
Other Non-Cash Items/Share base comps	9	15	16	16
Changes in Working Capital:				
(Increase)/Decrease Receivables	-12	-19	-17	-24
(Increase)/Decrease Inventories	0	0	0	0
(Increase)/Decrease Other Current Assets	1	-17	-6	-8
Increase/(Decrease) Payables	-1	5	1	2
Increase/(Decrease) Other Current Liabilities	17	8	17	23
Net Cash from Operations	87	95	145	178
Cash Flow from Investing				
Purchase of Property, Plant & Equipment	-13	-12	-30	-35
Purchase/Sale of Other LT assets (Goodwill)	-1	0	0	0
Others (incl Chg in short-term investment)	-6	0	0	0
Net Cash from Investing Activities	-19	-12	-30	-35
Cash Flow from Financing				
Issuance/Repayment of Debt	-1	0	0	0
Change in other LT liabilities	1	-1	0	0
Change in Common Equity - net	20	10	11	11
Payment of Cash Dividends	0	0	0	0
Other Financing Charges, Net	21	0	-1	-3
Net Cash from Financing Activities	41	8	9	8
Net Change in Cash and Cash Equivalents	108	92	124	152
Cash at End of Period	272	363	487	639

Source: Company reports and J.P. Morgan estimates.

Sohu, Overweight, ($46.22)

We maintain our Overweight rating on Sohu, which also remains our top pick in the online advertising sector in China. Our Jun-09 price target is US$100, which implies 26.6x FY08E and 20.9x FY09E GAAP EPS, or 24.8x FY08E and 19.8x FY09E adjusted diluted EPS.

- Sohu remains among the leading Internet portals in China, and is likely to remain among the key beneficiaries of the continued uptrend in online advertising in China. Although China GDP growth is likely to slow to 8-9% in 2009, we expect Internet penetration (currently ~20%) to grow to ~24% in 2009, and drive online ad revenue growth by at least 20%. We believe with improving execution and better brand awareness (having been the official Beijing Olympics Internet content sponsor), Sohu can continue to deliver solid online ad growth going forward. In addition, the company continues to expand its original content, such as exclusive interviews (video and text), video content, and deeper content verticals coverage.
- The continuing success of Sohu's online game TLBB remains an additional growth driver for the company (with beneficial impact on revenues and margins). TLBB registered users were at 39.4 million in 3Q08, with active paying accounts of 1.86 million. We expect continued strong long-term growth for TLBB, and expect 3Q08 and future upgrade packs to be drivers for 4Q08 and 2009. TLBB's strong brand name in China will help the game to further penetrate into lower-tier cities. Sohu also plans to launch three new games in 2H09, besides an upgrade pack for existing game Blade Online in 2Q09, which should further boost online gaming revenue. International game licensing fees (currently from HK, Taiwan and Vietnam) are also expected to contribute incremental revenue.
- **2009 drivers:** In our view, the following factors will drive shares in 2009: (1) slightly better visibility on 2009 ad budget growth by early '09, (2) continued solid execution in both online ad and online gaming, (3) potential upside from new games in 2H09, and (4) share buyback program of up to US$150MM until the end of 2009 (Sohu has US$279MM in net cash as of 3Q08).

Our current and newly introduced 2010 estimates are in the table below:

Table 219: Sohu Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	120.9	428.4	527.6	625.0	127%	23%	18%
EBITDA	56.3	189.6	240.6	282.9	262%	27%	18%
GAAP EPS	1.16	3.76	4.78	5.60	314%	27%	17%
Adj. EPS	1.23	4.04	5.05	5.87	256%	25%	16%
Consensus							
Revenue	120.4	427.5	529.2	613.9	126%	24%	16%
EBITDA	53.8	187.2	234.0	281.5	257%	25%	20%
GAAP EPS	1.14	3.73	4.50	5.13	311%	21%	14%
Adj. EPS	1.25	3.92	4.70	5.22	246%	20%	11%

Source: J.P. Morgan estimates and Bloomberg. *Note: Adj. EPS excludes share-based compensation expense.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We forecast net revenue of US$527.6MM in 2009, up 23% Y/Y, and GAAP diluted EPS of US$4.78, up 27% Y/Y, or adjusted EPS (ex-share-based expense) of US$5.05, up 25% Y/Y. We forecast 2009 brand advertising revenue of US$207.3MM (39% of total revenue), up 22% Y/Y, and online game revenue of US$249.1MM (47% of total revenue), up 24% Y/Y. For the wireless related segment, we forecast revenue of US$63.7MM (12% of total revenue), up 34% Y/Y.

On margins, we forecast gross margin at 74.7% for 2009, slightly below 75.3% for 2008. Our online game gross margin forecast is 89.1% in 2009, slightly lower than 92.0% for 2008, and our advertising gross margin forecast is 65.7%, up from 63.6% for 2008 (due to lower content costs in 2009). We expect adjusted operating margin (ex-share-based expense) of 42.2% for 2009, up from 40.8% for 2008, and adjusted net margin of 38.1% for 2009, up from 37.0% for 2008.

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$625.0MM, up 18% Y/Y, and GAAP diluted EPS of US$5.60, up 17% Y/Y, or adjusted EPS of US$5.87, up 16% Y/Y. We forecast 2010 brand advertising revenue of US$272.0MM, up 31% Y/Y, and online game revenue of US$277.3MM, up 11% Y/Y. On margins, we forecast gross margin at 74.0% (slightly lower Y/Y); adjusted operating margin of 41.8% (stable Y/Y) and adjusted net margin of 38.1% (also stable Y/Y).

Price Target, Valuation and Rating Analysis

We maintain our Overweight stance on Sohu, which also remains our top pick in the online ad sector in China. Our price target for Sohu is US$100 (Jun-09), which implies 26.6x FY08E and 20.9x FY09E GAAP EPS, or 24.8x FY08E and 19.8x FY09E adjusted diluted EPS; the price target is based on the midpoint of our sum-of-the-parts valuation of US$87.8-US$111.2. Our Jun-09 DCF valuation for Sohu is US$97, based on a 10-year DCF forecast, WACC of 12%, and terminal growth rate of 0%.

Risks to Our Rating and Price Target

Risks to our rating and price target include a greater slowdown in the Chinese economy that could result in lower online advertising revenue growth, significant market share loss in online advertising to other websites, uncertainty in wireless revenue due to policy change at mobile operators, any significant delays in upgrade launches for existing online games, and unsuccessful new games.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 2: SOHU Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	188.9	428.4	527.6	625.0
Advertising	*119.2*	*176.2*	*212.9*	*277.2*
Brand advertising	*112.1*	*169.7*	*207.3*	*272.0*
Paid search	*7.1*	*6.5*	*5.6*	*5.2*
Mobile related	*26.3*	*47.5*	*63.7*	*68.6*
Online games (breakout from 1Q07)	*42.1*	*201.7*	*249.1*	*277.3*
Others	*1.3*	*3.0*	*1.9*	*2.0*
COGS	-63.1	-105.9	-133.7	-162.6
Gross Profit	125.8	322.5	393.9	462.5
Operating Expense	-93.1	-158.7	-182.0	-211.9
Sales & Mktg. expenses	*-46.0*	*-84.4*	*-88.3*	*-106.3*
G&A expenses	*-14.7*	*-19.2*	*-23.7*	*-28.1*
R&D expenses	*-22.6*	*-43.4*	*-58.6*	*-66.3*
Other expenses	*-1.1*	*-0.7*	*-0.3*	*-0.2*
Share-based compensation	*-8.8*	*-11.0*	*-11.0*	*-11.0*
EBIT	32.7	163.8	211.9	250.6
Adj. EBIT (ex- 123R expense)	*41.5*	*174.7*	*222.9*	*261.6*
EBITDA	52.4	189.6	240.6	282.9
Net Interest Income	2.8	4.3	6.7	10.9
Net Other Income	0.9	-0.5	0.0	0.0
Pre Tax Profit	36.4	167.5	218.6	261.4
Tax Expense/(Credit)	-1.5	-20.1	-28.7	-34.1
Net Profit (after MI)	34.9	147.5	189.9	227.4
Adj. Net Profit (ex- 123R exp.)	43.7	158.4	200.9	238.4
Diluted EPS (US$)	0.91	3.76	4.78	5.60
Adj. Diluted EPS (US$, ex- 123R exp.)	1.13	4.04	5.05	5.87
Margins (%)				
Gross Margin	66.6	75.3	74.7	74.0
Operating Margin (ex- 123R exp.)	22.0	40.8	42.2	41.8
EBITDA Margin	27.7	44.3	45.6	45.3
Net Margin	18.5	34.4	36.0	36.4
Adj. Net Margin (ex- 123R exp.)	23.1	37.0	38.1	38.1
Sequential Growth (%)				
Revenue	39.9	126.7	23.2	18.5
Gross Profit	42.5	156.2	22.1	17.4
EBIT	32.2	321.1	27.6	17.3
EBITDA	33.2	261.8	26.9	17.6
Diluted EPS	33.8	314.1	27.2	17.2
Adj. Diluted EPS	32.5	256.3	25.2	16.2

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 220: SOHU Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	33.1	39.0	51.5	65.3	84.8	102.0	120.7	120.9	121.7	129.4	135.9	140.6
Advertising	*25.6*	*28.4*	*31.5*	*33.7*	*34.8*	*43.4*	*51.1*	*46.9*	*46.0*	*51.7*	*56.2*	*59.0*
Brand advertising	*23.5*	*26.6*	*29.8*	*32.2*	*33.2*	*41.7*	*49.4*	*45.4*	*44.5*	*50.3*	*54.9*	*57.6*
Paid search	*2.1*	*1.7*	*1.7*	*1.5*	*1.6*	*1.7*	*1.7*	*1.5*	*1.4*	*1.4*	*1.4*	*1.4*
Mobile related	*5.6*	*6.6*	*6.8*	*7.3*	*8.6*	*9.2*	*14.5*	*15.2*	*15.4*	*15.7*	*16.1*	*16.4*
Online games (from 1Q07)	*1.6*	*3.8*	*12.7*	*24.0*	*41.0*	*47.9*	*54.6*	*58.3*	*59.8*	*61.4*	*63.1*	*64.8*
Others	*0.3*	*0.2*	*0.5*	*0.3*	*0.5*	*1.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*
COGS	-12.8	-14.9	-16.8	-18.6	-20.0	-24.6	-31.6	-29.8	-30.7	-32.7	-34.5	-35.8
Gross Profit	20.2	24.1	34.8	46.8	64.9	77.4	89.1	91.1	91.0	96.7	101.3	104.9
Operating Expense	-16.2	-19.1	-25.9	-31.9	-34.3	-37.5	-45.3	-41.5	-43.0	-44.9	-46.3	-47.8
Sales & Mktg. expenses	*-6.8*	*-9.0*	*-13.2*	*-16.9*	*-15.9*	*-21.2*	*-27.4*	*-19.9*	*-20.7*	*-22.0*	*-22.4*	*-23.2*
G&A expenses	*-2.6*	*-2.7*	*-4.3*	*-5.2*	*-5.5*	*-4.4*	*-3.8*	*-5.4*	*-5.5*	*-5.8*	*-6.1*	*-6.3*
R&D expenses	*-3.9*	*-4.8*	*-6.2*	*-7.8*	*-9.2*	*-9.6*	*-11.3*	*-13.3*	*-14.0*	*-14.2*	*-14.9*	*-15.5*
Other expenses	*-0.4*	*-0.3*	*-0.2*	*-0.2*	*-0.2*	*-0.2*	*-0.2*	*-0.1*	*-0.1*	*-0.1*	*0.0*	*0.0*
Share-based compensation	*-2.5*	*-2.4*	*-2.0*	*-1.9*	*-3.5*	*-2.2*	*-2.6*	*-2.8*	*-2.8*	*-2.8*	*-2.8*	*-2.8*
EBIT	4.1	4.9	8.8	14.9	30.5	39.9	43.8	49.6	48.0	51.8	55.1	57.1
Adjusted EBIT (excl share base comps)	*6.6*	*7.3*	*10.8*	*16.8*	*34.0*	*42.0*	*46.3*	*52.3*	*50.7*	*54.5*	*57.8*	*59.8*
EBITDA	9.1	10.0	13.6	19.7	37.2	45.5	50.6	56.3	54.8	58.9	62.4	64.5
Net Interest Income	0.8	1.1	0.6	0.4	0.2	1.5	1.4	1.2	1.3	1.5	1.8	2.0
Net Other Income	-0.1	-0.1	0.6	0.6	0.0	-0.6	0.1	0.0	0.0	0.0	0.0	0.0
Pre Tax Profit	4.7	5.9	10.0	15.8	30.7	40.8	45.2	50.8	49.3	53.3	56.9	59.1
Tax Expense/(Credit)	0.3	0.2	0.3	0.7	9.2	0.6	5.0	5.4	6.5	7.0	7.5	7.7
Net Profit (after MI)	4.5	5.7	9.7	15.1	21.6	40.2	40.261	45.4	42.8	46.3	49.4	51.4
Net Profit (excl 123R option expense)	7.0	8.1	11.7	17.0	25.1	42.3	42.822	48.2	45.5	49.1	52.2	54.1
EPS Diluted (US$)	0.12	0.15	0.25	0.39	0.55	1.02	1.02	1.16	1.09	1.17	1.24	1.28
EPS Diluted (US$ excl 123R option expense)	0.18	0.21	0.31	0.43	0.64	1.07	1.08	1.23	1.16	1.24	1.31	1.35
Margins (%)												
Gross Margin	61.2	61.7	67.5	71.6	76.5	75.9	73.8	75.4	74.8	74.7	74.6	74.6
Operating Margin (excl 123R option expense)	19.8	18.8	21.0	25.7	40.1	41.2	38.4	43.3	41.7	42.2	42.6	42.5
EBITDA Margin	27.6	25.6	26.4	30.1	43.8	44.6	42.0	46.6	45.0	45.5	45.9	45.9
Net Margin	13.5	14.6	18.8	23.1	25.4	39.4	33.4	37.6	35.2	35.8	36.4	36.5
Net Margin (excl 123R option expense)	21.0	20.8	22.7	26.0	29.6	41.5	35.5	39.9	37.4	37.9	38.4	38.5
Sequential Growth (%)												
Revenue	-3.7	17.8	32.1	26.8	29.8	20.2	18.3	0.2	0.7	6.3	5.0	3.5
Gross Profit	-8.9	18.9	44.5	34.6	38.6	19.4	15.0	2.3	-0.2	6.3	4.8	3.5
Adj. EBIT (ex- share base comps)	-15.3	11.7	47.9	54.7	103.1	23.5	10.2	13.0	-3.1	7.5	6.0	3.4
EBITDA	-9.1	9.5	36.4	44.4	88.9	22.4	11.4	11.2	-2.7	7.4	5.9	3.4
Diluted EPS	-27.1	26.6	70.9	51.6	43.0	84.5	0.5	13.2	-6.4	7.7	6.1	3.4
Diluted EPS (excl 123R option expense)	-14.8	15.9	46.1	41.4	47.8	67.2	0.6	13.7	-6.0	7.2	5.7	3.2

Source: Company reports and J.P. Morgan estimates.

Table 221: SOHU Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash and Cash Equivalents	123	263	461	693
Account Receivables	27	73	85	100
Inventory	0	0	0	0
Total Other Current Assets	8	48	56	66
Total Current Assets	157	384	602	860
Gross Fixed Assets	93	122	160	205
Accumulated Depreciation	-28	-42	-59	-80
Net Fixed Assets	65	80	101	125
Other Long Term Assets	68	69	68	68
Long Term Investments and Associates	0	0	0	0
Total Long Term Assets	133	149	169	193
Total Assets	291	533	771	1053
ST Debt and Current Portion of LT Debt	0	0	0	0
Accounts Payable	3	3	4	5
Other Current Liabilities	69	121	141	166
Total Current Liabilities	72	124	145	171
Long Term Debt	0	0	0	0
Other Long Term Liabilities	0	3	3	3
Total Long Term Liabilities	0	3	3	3
Share Capital	0	0	0	0
Share Premium	139	179	206	235
Other Reserves	0	0	0	0
Retained Earnings	79	227	417	644
Preferred Stock	0	0	0	0
Total Equity	219	406	623	879
Total Liabilities and Equity	291	533	771	1053

Source: Company reports and J.P. Morgan estimates.

Table 222: SOHU Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	35	147	190	227
Add Non cash Expenses/(income)				
Depreciation and Amortization	11	15	18	21
Extraordinaries	0	0	0	0
Other Non-Cash Items	9	11	11	11
Changes in Working Capital:	0	0	0	0
(Increase)/Decrease Receivables	-3	-46	-12	-15
(Increase)/Decrease Inventories	0	0	0	0
(Increase)/Decrease Other Current Assets	3	-41	-8	-10
Increase/(Decrease) Payables	1	1	1	1
Increase/(Decrease) Other Current Liabilities	32	52	20	25
Net Cash from Operations	88	139	219	260
Cash Flow from Investing				
Purchase of Property, Plant & Equipment	-53	-29	-38	-46
Purchase/Sale of Other LT assets /intanbgible assets	2	-1	0	0
Purchase/Sale of Investments	1	0	0	0
Net Cash from Investing Activities	-50	-30	-38	-46
Cash Flow from Financing				
Issuance/Repayment of Debt	-60	0	0	0
Change in other LT liabilities	0	3	0	0
Change in Common Equity - net	19	28	16	18
Payment of Cash Dividends	0	0	0	0
Other Financing Charges, Net	0	0	0	0
Net Cash from Financing Activities	-41	31	16	18
Net Effect of Exchange Rate Changes	0	0	0	0
Net Change in Cash and Cash Equivalents	-2	140	198	233
Cash at end of the Period	123	263	461	693

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

The9, Overweight, ($13.68)

We maintain our Overweight rating on The9 on what we view as cheap valuation, as the stock is trading around cash (on the back of market concerns about game license renewal and delays in new game launches) and we expect the company to continue with positive cash flow generation. Our Jun-09 price target is US$18, which implies 9.2x FY08E and 11.4x FY09E GAAP EPS, or 8.1x FY08E and 9.3x FY09E adj. EPS.

- The9's flagship game World of Warcraft (WoW, ~92% of total revenue) disappointed in 3Q08 with a revenue decline of 10% Q/Q (with average concurrent users at 416k, down from 489k in 2Q08) on the back of greater than expected negative impact from the Olympics and negative Q3 seasonality. The9's two main item-based games, Sun and GE, also continued to deliver largely disappointing results. Further, The9's growth outlook remains relatively uncertain, due to: (1) The9 is still in the process of negotiating with Blizzard (developer of WoW) on the license renewal for WoW; (2) FIFA Online 2 has yet to obtain government approval (already delayed a few quarters); (3) WoW's next upgrade, Wrath of Lich King, is still in the process of obtaining government approval; and (4) other games such as Hellgate: London and Huxley now seem to be delayed to late 2009 or beyond.
- On the positive side, The9 still possesses a diversified game pipeline of casual games (FIFA Online 2 and Audition 2), licensed MMORPGs (Hellgate: London, Huxley, Atlantica, RO2, etc.) and in-house games (MJSG and FM Online). We also believe The9 still has the highest chance to obtain the renewal license for WoW, since The9 has cumulatively invested more than US$60MM in WoW servers over time, and we believe The9 still has a decent relationship with Blizzard. Therefore, we believe the partnership would likely continue, even though with likely higher revenue sharing. Further, despite positive cash flow generation, the stock is currently trading almost at cash.
- **2009 drivers:** In our view, the following factors will drive shares in 2009: (1) the launch of new games such as FIFA Online 2 and Audition 2, (2) the renewal of WoW's license, which is set to expire in June '09 (WoW still represents ~92% of The9's revenue), and (3) share buyback of up to US$50MM over the next few quarters (The9 ended 3Q08 with US$330MM in cash and short-term investments).

Our current and newly introduced 2010 estimates are in the table below.

Table 223: The9 Financial Snapshot

$ in millions, except per share data

	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
J.P. Morgan							
Revenue	65.8	254.9	309.4	363.7	50%	21%	18%
EBITDA	28.1	103.2	128.7	141.7	57%	25%	10%
GAAP EPS	0.36	1.95	1.58	1.48	69%	-19%	-6%
Adj. EPS	0.45	2.23	1.94	1.84	61%	-13%	-5%
Consensus							
Revenue	57.7	238.8	291.1	330.3	41%	22%	13%
EBITDA	23.9	94.2	95.9	90.5	43%	2%	-6%
GAAP EPS	0.51	2.12	1.97	1.55	84%	-7%	-21%
Adj. EPS	0.52	2.05	1.92	1.94	48%	-6%	1%

Source: Bloomberg and J.P. Morgan estimates. Note: Adj. EPS excludes share-based compensation expense.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Our Estimates and Outlook for 2009

We forecast net revenue of US$309.4MM in 2009, up 21% Y/Y, and GAAP diluted EPS of US$1.58, down 19% Y/Y, or adjusted EPS (ex-share-based expense) of US$1.94, down 13% Y/Y. We forecast WoW revenue of US$233.0MM in 2009 (~75% of total revenue, down from over 90% in 2008), flattish Y/Y, while we expect revenue contribution to begin from several of The9's new games (such as FIFA Online 2, Audition 2, Atlantica, MJSG, FM Online, Hellgate: London, Huxley, etc.).

We forecast gross margin at 42.2% for 2009, down from 45.6% for 2008 due to assumption of higher revenue share for WoW (30% from 2H09 vs. 22% in 2008). We expect adjusted operating margin (ex-share-based expense) of 20.4% for 2009, down from 25.1% for 2008, and adjusted net margin of 17.5% for 2009, down from 24.4% for 2008.

Our Estimates and Outlook for 2010

For 2010, we forecast net revenue of US$363.7MM, up 18% Y/Y, and GAAP diluted EPS of US$1.48, down 6% Y/Y, or adjusted EPS of US$1.84, down 5% Y/Y. On margins, we forecast gross margin at 39.0% (down Y/Y with full-year impact of higher revenue share for WoW); adjusted operating margin of 16.7% (down Y/Y) and adjusted net margin of 14.2% (also down Y/Y).

Price Target, Valuation and Rating Analysis

We maintain our Overweight rating on The9 on what we view as cheap valuation, as the stock is currently trading close to cash value per share (~US$12/share). Our price target is US$18 (June-09), which implies 9.2x 2008E, or 11.4x 2009E GAAP EPS, and 8.1x 2008E, or 9.3x 2009E adjusted EPS. Our price target is below our DCF valuation of ~US$36 (WACC of 12.8% and terminal growth of 0%) due to the current stock market environment and company-specific uncertainties in the near term (game launch delays, WoW license renewal). The9 has net cash of ~US$12 per share; excluding cash, our price target implies 4.3x 2008E and 4.8x 2009E adjusted EPS, which is at the low end of its historical trading range.

Risks to Our Rating

Risks to our rating and price target include (1) the company being unable to obtain second-term WoW license, or being required to pay a significant royalty / upfront fee, (2) lower-than-expected WoW revenue growth, (3) uncontrolled marketing spending, and (4) lower-than-expected acceptance of upcoming titles.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 224: NCTY Annual Income Statement

$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Revenue	169.9	254.9	309.4	363.7
Online games services	*169.1*	*254.1*	*308.5*	*362.8*
Game operation support	*1.0*	*0.1*	*0.0*	*0.0*
SMS services	*0.0*	*0.0*	*0.0*	*0.0*
Other revenue	*1.3*	*0.7*	*0.8*	*0.9*
COGS	-93.0	-138.6	-178.9	-222.0
Gross Profit	77.0	116.4	130.4	141.7
Operating Expenses	-45.6	-60.2	-77.3	-90.9
Sales & Mktg. expenses	*-13.7*	*-16.0*	*-24.7*	*-29.1*
G&A expenses	*-23.9*	*-33.8*	*-40.2*	*-47.3*
R&D expenses	*-5.5*	*-10.4*	*-12.4*	*-14.5*
Other expenses	*-2.5*	*0.0*	*0.0*	*0.0*
Share-based compensation	-6.4	-7.8	-10.0	-10.0
EBIT	31.3	56.1	53.1	50.8
Adj. EBIT (ex-share-based comps.)	37.7	63.9	63.1	60.8
EBITDA	65.8	103.2	128.7	141.7
Equity earnings in affiliates	-0.8	-0.3	-0.5	-0.5
Net Other Income	2.7	3.3	-3.4	-3.8
Pre Tax Profit	33.3	59.1	49.1	46.4
Tax Expense/(Credit)	1.2	4.6	4.9	4.6
Net Profit (after MI)	32.0	54.3	44.2	41.7
Net Profit (excl 123R option exp.)	38.4	62.1	54.2	51.7
Pre Tax EPS (US$)	1.21	2.14	1.78	1.67
After Tax EPS (US$)	1.17	1.96	1.60	1.50
After Tax EPS Diluted (US$)	1.16	1.95	1.58	1.48
After Tax EPS Diluted excl 123R option exp. (US$)	1.39	2.23	1.94	1.84
Margins (%)				
Gross Margin	45.3	45.6	42.2	39.0
Operating Margin (excl 123R option expense)	22.2	25.1	20.4	16.7
EBITDA Margin	38.8	40.5	41.6	39.0
Net Margin	18.8	21.3	14.3	11.5
Net Margin (excl 123R option expense)	22.6	24.4	17.5	14.2
Sequential Growth (%)				
Revenue	36.7	50.0	21.3	17.6
Gross Profit	32.2	51.2	12.1	8.6
Adj. EBIT	3.0	69.5	-1.3	-3.7
Pre Tax Profit	-13.9	77.5	-16.9	-5.6
Net Profit	-18.8	69.8	-18.6	-5.6
After Tax EPS Diluted	-27.9	69.0	-19.2	-6.2
After Tax EPS Diluted excl 123R option exp.	-18.7	61.0	-13.3	-5.2

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 225: NCTY Quarterly Income Statement

$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Revenue	270.0	270.0	316.0	423.7	439.4	455.1	408.4	446.6	467.2	479.3	570.2	583.8
Online games services	*266.8*	*262.3*	*310.9*	*427.4*	*438.0*	*454.0*	*406.8*	*445.2*	*465.8*	*477.9*	*568.7*	*582.3*
Game operation support	*2.5*	*7.0*	*2.0*	*-3.4*	*0.2*	*0.1*	*0.1*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*
SMS services	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Other revenue	*0.7*	*0.7*	*9.0*	*-0.4*	*1.3*	*0.9*	*1.5*	*1.3*	*1.4*	*1.4*	*1.4*	*1.4*
COGS	-139.7	-155.4	-183.8	-221.1	-231.4	-241.0	-227.6	-251.0	-265.3	-270.2	-334.8	-344.7
Gross Profit	130.3	114.6	132.2	202.5	208.0	214.0	180.9	195.6	202.0	209.1	235.4	239.1
Operating Expenses	-58.1	-74.5	-88.5	-122.6	-94.0	-100.3	-103.0	-116.1	-116.8	-119.8	-142.5	-145.9
Sales & Mktg. expenses	*-16.1*	*-22.5*	*-31.9*	*-32.8*	*-22.4*	*-26.8*	*-24.8*	*-35.7*	*-37.4*	*-38.3*	*-45.6*	*-46.7*
G&A expenses	*-32.4*	*-40.6*	*-48.6*	*-58.7*	*-59.1*	*-58.0*	*-56.9*	*-58.1*	*-60.7*	*-62.3*	*-74.1*	*-75.9*
R&D expenses	*-9.6*	*-11.4*	*-8.0*	*-12.4*	*-12.5*	*-15.6*	*-21.2*	*-22.3*	*-18.7*	*-19.2*	*-22.8*	*-23.4*
Other expenses	*0.0*	*0.0*	*0.0*	*-18.7*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Share-based compensation	-6.2	-9.2	-17.2	-15.4	-12.0	-12.1	-12.2	-17.0	-17.0	-17.0	-17.0	-17.0
EBIT	72.1	40.1	43.7	79.9	114.1	113.7	77.9	79.5	85.2	89.3	92.8	93.2
Adj. EBIT (ex-share-based comps.)	78.3	49.3	60.9	95.4	126.1	125.8	90.1	96.5	102.1	106.3	109.8	110.1
EBITDA	121.9	106.2	116.8	151.0	182.9	184.8	149.6	190.8	210.7	219.6	218.2	225.3
Equity earnings in affiliates	-1.5	-2.1	-0.7	-1.4	-0.4	-0.6	-0.3	-0.9	-0.9	-0.9	-0.9	-0.9
Net Other Income	3.5	13.7	2.0	1.4	-11.6	9.8	26.6	-2.2	-4.4	-4.6	-7.3	-7.0
Pre Tax Profit	74.2	51.7	45.0	79.9	102.0	122.9	104.3	76.4	79.8	83.8	84.6	85.3
Tax Expense/(Credit)	8.1	1.1	6.8	-6.7	10.5	7.0	6.4	7.6	8.0	8.4	8.5	8.5
Net Profit (after MI)	66.1	50.6	38.2	86.0	89.7	115.9	98.4	68.8	71.9	75.4	76.2	76.8
Net Profit (excl 123R option exp.)	72.3	59.8	55.4	101.4	101.7	128.0	110.6	85.7	88.8	92.4	93.1	93.7
Pre Tax EPS (US$)	3.00	1.96	1.53	2.73	3.65	4.46	3.78	2.77	2.89	3.03	3.06	3.08
After Tax EPS (US$)	2.67	1.92	1.30	2.94	3.21	4.20	3.57	2.49	2.60	2.73	2.75	2.77
After Tax EPS Diluted (US$)	2.65	1.90	1.29	2.93	3.21	4.19	3.56	2.47	2.57	2.70	2.72	2.73
After Tax EPS Diluted excl 123R option exp. (US$)	2.89	2.24	1.87	3.45	3.64	4.63	4.00	3.07	3.18	3.30	3.32	3.34
Margins (%)												
Gross Margin	48.2	42.4	41.8	47.8	47.3	47.0	44.3	43.8	43.2	43.6	41.3	41.0
Operating Margin (excl 123R option expense)	29.0	18.3	19.3	22.5	28.7	27.7	22.1	21.6	21.9	22.2	19.3	18.9
EBITDA Margin	45.1	39.3	37.0	35.6	41.6	40.6	36.6	42.7	45.1	45.8	38.3	38.6
Net Margin	24.5	18.7	12.1	20.3	20.4	25.5	24.1	15.4	15.4	15.7	13.4	13.1
Net Margin (excl 123R option expense)	26.8	22.2	17.5	23.9	23.1	28.1	27.1	19.2	19.0	19.3	16.3	16.1
Sequential Growth (%)												
Revenue	-4.5	0.0	17.0	34.1	3.7	3.6	-10.2	9.3	4.6	2.6	18.9	2.4
Gross Profit	-3.3	-12.0	15.3	53.2	2.7	2.9	-15.5	8.2	3.2	3.6	12.5	1.6
Adj. EBIT	-9.3	-37.0	23.5	56.6	32.2	-0.2	-28.4	7.1	5.9	4.1	3.3	0.3
Pre Tax Profit	-26.6	-30.3	-13.0	77.6	27.7	20.5	-15.2	-26.7	4.5	4.9	1.0	0.8
Net Profit	-37.1	-23.4	-24.6	125.2	4.3	29.2	-15.1	-30.1	4.5	4.9	1.0	0.8
After Tax EPS Diluted	-37.7	-28.3	-32.1	127.2	9.6	30.6	-15.1	-30.7	4.4	4.8	0.8	0.6
After Tax EPS Diluted excl 123R option exp.	-35.7	-22.5	-16.6	84.7	5.3	27.2	-13.5	-23.1	3.5	3.8	0.7	0.5

Source: Company reports and J.P. Morgan estimates.

Table 226: NCTY Annual Balance Sheet

$ in millions

	2007	2008E	2009E	2010E
Cash and Cash Equivalents	294.17	279.74	327.44	400.27
Account Receivables	3.54	4.99	6.60	7.28
Inventory	13.40	14.26	18.84	20.80
Total Other Current Assets	9.55	13.41	13.56	13.56
Total Current Assets	320.66	312.41	366.43	441.90
Gross Fixed Assets	78.63	137.52	198.99	264.99
Accumulated Depreciation	(32.89)	(60.56)	(106.54)	(170.66)
Net Fixed Assets	45.73	76.95	92.45	94.33
Other Long Term Assets (Intangibles + Goodwill)	40.83	32.37	38.18	21.34
Long Term Investments and Associates	23.83	71.07	71.30	70.76
Total Long Term Assets	110.39	180.39	201.93	186.44
Total Assets	431.05	492.81	568.36	628.33
ST Debt and Current Portion of LT Debt	14.15	-	-	-
Accounts Payable	37.85	35.66	47.11	51.99
Other Current Liabilities	6.42	10.41	13.76	15.18
Total Current Liabilities	58.43	46.07	60.87	67.17
Long Term Debt	-	-	-	-
Other Long Term Liabilities	-	0.03	0.03	0.03
Total Long Term Liabilities	-	0.03	0.03	0.03
Share Capital	0.31	0.33	0.33	0.33
Share Premium	294.60	319.40	334.58	346.50
Other Reserves	2.75	3.62	3.66	3.66
Retained Earnings	74.96	123.36	168.90	210.64
Preferred Stock	-	-	-	-
Total Equity	372.62	446.71	507.47	561.13
Total Liabilities and Equity	431.05	492.81	568.36	628.33

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 227: NCTY Annual Cash Flow Statement

$ in millions

	2007	2008E	2009E	2010E
Net Income	31.99	54.31	44.21	41.75
Add Non cash Expenses/(income)	-	-	-	-
Depreciation and Amortization	28.15	39.29	65.61	80.96
Extraordinaries	0.08	0.21	-	-
Other Non-Cash Items	6.38	7.77	10.00	10.00
Changes in Working Capital:	-	-	-	-
(Increase)/Decrease Receivables	(2.19)	(1.11)	(1.55)	(0.68)
(Increase)/Decrease Inventories	1.41	0.44	(4.43)	(1.95)
(Increase)/Decrease Other Current Assets	(5.89)	(2.93)	-	-
Increase/(Decrease) Payables	11.38	(5.88)	11.07	4.88
Increase/(Decrease) Other Current Liabilities	(0.55)	3.37	3.23	1.43
Net Cash from Operations	70.76	95.47	128.14	136.38
Cash Flow from Investing	-	-	-	-
Purchase of Property, Plant & Equipment	(31.81)	(50.36)	(60.00)	(66.00)
Purchase/Sale of Other LT assets / amortization	(16.24)	(3.27)	(25.74)	-
Purchase/Sale of Investments	(19.12)	(44.91)	0.53	0.53
Net Cash from Investing Activities	(67.17)	(98.55)	(85.21)	(65.47)
Cash Flow from Financing	-	-	-	-
Issuance/Repayment of Debt	9.29	(15.53)	-	-
Change in other LT liabilities (Intangibles + Goodwill)	-	0.03	-	-
Change in Common Equity - net	163.20	(11.06)	1.76	1.92
Payment of Cash Dividends	-	-	-	-
Other Financing Charges, Net	(6.46)	(13.41)	(0.00)	0.00
Net Cash from Financing Activities	166.04	(39.98)	1.76	1.92
Net Effect of Exchange Rate Changes	-	-	-	-
Net Change in Cash and Cash Equivalents	169.63	(43.06)	44.69	72.83
Cash at end of the Period	294.17	279.74	327.44	400.27

Source: Company reports and J.P. Morgan estimates.

UOL, Neutral, R$7.3

Latin American Media & Internet
Andre Baggio[AC]
(55-11) 3048-3427
andre.baggio@jpmorgan.com
Banco J.P. Morgan S.A.

We maintain our Neutral rating and R$7.5 Dec-09 price target for UOL, a leading Brazilian online media portal and Internet company. We expect advertising revenues to suffer from weaker GDP growth in Brazil. Key points on the company:

- **Weak resource allocation and potential lack of opportunities:** the company holds a net cash position of R$567m, constituted by R$264m raised during the IPO in the end of 2005 and free cash flow thereafter, which was intended to be used for acquisitions. However, only minor acquisitions were made, and there is no guidance that a deal of significant stature will be closed or the cash distributed back to shareholders (bylaws set minimum dividend payout of 1%, unlike usual 25% for Brazilian companies). We believe the long permanence of these resources might indicate a lack of opportunities for the company.
- **Downside to advertising business on global downturn:** Internet advertising has been presenting strong growth, which we believe will be affected by the economic downturn (JPM revised '09E Brazilian GDP growth to 1.8% from 5.1%). During the conference call with investors, UOL admitted that there might be a slowdown in this line in 1Q09.
- **Low visibility on margins ex-subscription business:** while there is no margin disclosure per business, declining or stagnant margin trends challenge company guidance that advertising revenues have higher margins than subscription revenues. The company attributes this to development and marketing costs for new products, but we believe there could be a recurring need to update the portal and keep revenues growing.
- **2009 drivers.** In our view, the following factors will drive shares in 2009: (1) impact of downturn in advertising, (2) margin recovery.
- **4Q'08 estimates.** We expect the company to post net revenues of R$151m, EBITDA of R$32m and EPS of R$0.2.shr in the fourth quarter.

Our estimates for 2008-10 are in the table below. They were introduced in our note *Brazilian TMT: Small Caps Also Affected by Downturn, Cutting Estimates for Positivo/UOL*, published on Nov 17th.

Table 228: UOL Financial Snapshot
R$ in millions, except per share data

UOL	4Q'08E	F'08E	F'09E	F'10E	F'08E Y/Y	F'09E Y/Y	F'10E Y/Y
JPMorgan							
Revenue	150.6	573.6	574.9	636.9	9.2%	0.2%	10.8%
EBITDA	32.1	132.7	132.9	149.5	-2.5%	0.1%	12.4%
EPS(R$/shr)	0.2	0.9	0.9	0.9	-6.2%	0.3%	2.3%
Consensus							
Revenue	NA	575	626	670	10%	9%	7%
EBITDA	NA	138	154.5	170	1%	12%	10%
EPS	NA	0.85	0.86	1.035	-8%	2%	20%

Source: J.P. Morgan estimates, Company data, and Bloomberg

Our Estimates and Outlook for 2009

We expect a sharp deceleration in revenue growth during 2009, to 0.2% from 9.2% in 2008E, given that the key driver of the company has been the advertising business, which we expect to suffer as companies reduce marketing expenses on the global crisis. EBITDA is expected to increase 1.4% in 2009, as we believe margins could present some recovery in 2009 to 23% from 3Q08's low of 20%. EPS are expected to increase 0.2%, lower than EBITDA as depreciation charges should be higher on the back of investments in the company's new datacenter.

Our Estimates and Outlook for 2010

We assume the economic crisis will be mostly over by 2010, and that growth should resume for UOL. We expect revenues to increase 10.8% and EBITDA to rise 12.4% on a 0.2pp margin expansion. EPS are projected to increase 2.3%, on the back of higher tax rates, as currently the company enjoys fiscal benefits of investing in Norway bonds, which we assume will end in 2010.

We Hold a Price Target of R$7.5

Our R$7.5/shr price target for Dec-09 is based on a DCF model employing 13.7% WACC (454bps country risk), 4.2% 10yr revenue CAGR, 24% long-term EBITDA margins, 12% long-term CAPEX, 2% growth in perpetuity, all in nominal US$. We apply a 25% discount factor on our DCF to account for increased investor aversion to small-cap stocks with reduced visibility.

Valuation and Rating Analysis

We maintain our Neutral rating for UOL. The company trades at a low multiple of 8.5x P/E'09E, 55%, lower than peers' 18.8x, but we believe this is offset by (1) negative short-term prospects given GDP slowdown, (2) low visibility regarding long-term margins and margin recovery from current low levels, and (3) a large net cash position of R$567m as well as a dividend policy of distributing only 1% of net income.

Risks to Our Rating and Price Target

Key risks to the upside include: (1) high resilience in Brazilian Internet advertising industry, which could gain share in total advertising revenues offsetting the economic downturn; (2) change in dividend policy or high dividend payment; (3) significant uptake in margins; and (4) large and accretive acquisitions.

To the downside, risks include: (1) further deterioration in margins and (2) steeper decline in Internet access markets.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 229: UOLL4 Annual Income Statement

R$ in millions

INCOME STATEMENT	2007	2008E	2009E	2010E
Paying subscribers	1,685	1,816	1,914	2,031
Subs Revs, Gross	525	518	538	561
Ads and Other Revs, Gross	192	276	273	338
Gross Revenue	716	794	812	899
Net Revenue	525	574	575	637
Recurring Cash Costs	-389	-441	-442	-487
Adj. EBITDA	136	133	133	149
Adj. EBITDA Margin	25.9%	23.1%	23.1%	23.5%
Non Recurring Items	18	-2	0	0
EBITDA	154	131	133	149
EBITDA margin	29.4%	22.9%	23.1%	23.5%
Depreciation	-44	-58	-77	-82
Net Interest Expense	31	52	68	71
Non Op Income	-8	0	0	0
Income Taxes	-23	-23	-21	-33
Net Income	109	103	103	105
Shares O/S	120.1	120.1	120.1	120.1
EPS (R$/shr)	0.91	0.85	0.86	0.88

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 230: UOLL4 Quarterly Income Statement

R$ in millions

	1Q'07	2Q'07	3Q'07	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08E	1Q'09E	2Q'09E	3Q'09E	4Q'09E
Paying subscribers	1,640	1,700	1,730	1,685	1,700	1,740	1,780	1,816	1,841	1,864	1,889	1,914
Subs Revs, Gross	128	131	134	132	130	127	130	132	133	134	135	136
Ads and Other Revs, Gross	34	52	46	59	53	69	73	81	54	69	71	80
Gross Revenue	162	183	180	191	183	196	203	213	187	203	206	216
Net Revenue	118	129	132	146	137	142	144	151	133	144	146	153
Recurring Cash Costs	-90	-93	-96	-111	-101	-108	-113	-118	-103	-110	-112	-117
Adj. EBITDA	28	36	37	36	36	34	31	32	30	34	34	36
Adj. EBITDA Margin	23.7%	27.9%	27.8%	24.4%	26.3%	23.8%	21.3%	21.3%	22.3%	23.3%	23.3%	23.3%
Non Recurring Items	2	17	1	-1	-1	1	-2	0	0	0	0	0
EBITDA	30	53	37	34	35	35	29	32	30	34	34	36
EBITDA margin	25.3%	41.0%	28.2%	23.5%	25.5%	24.6%	20.2%	21.3%	22.3%	23.3%	23.3%	23.3%
Depreciation	-9	-11	-12	-12	-13	-14	-15	-16	-18	-19	-20	-20
Net Interest Expense	9	8	8	5	8	11	17	17	16	17	17	18
Non Op Income	0	0	0	-8	0	0	0	0	0	0	0	0
Income Taxes	-8	-12	-1	-3	-5	-9	-4	-5	-5	-5	-5	-6
Net Income	22	38	32	18	25	24	27	27	23	26	26	28
Shares O/S	120.1	120.1	120.1	120.1	120.1	120.1	120.1	120.1	120.1	120.1	120.1	120.1
EPS(R$/shr)	0.19	0.31	0.27	0.15	0.21	0.20	0.22	0.22	0.19	0.22	0.22	0.23

Source: J.P. Morgan estimates and Company report

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 231: UOLL4 Annual Balance Sheet

R$ in millions

	2007	2008E	2009E	2010E
Cash and Equivalents	475	598	685	789
Accounts receivable	74	83	85	88
Other Current Assets	38	32	33	36
Total Current Assets	588	714	803	913
Total LT Assets	114	117	119	132
PP&E, Net	65	59	74	68
Deferred charges	0	0	0	0
Total Assets	798	938	1,043	1,161
Suppliers + Other Acc. Payable	59	88	89	93
Short Term Debt	0	0	0	0
Other Current Liabilities	83	88	90	99
Total Current Liab.	142	176	179	192
Long Term Debt	0	0	0	0
Other LT Liabilities	15	18	18	18
Minorities	2	2	2	3
Shareholder Equity	639	742	844	949
Net Debt	-475	-598	-685	-789
Adj. Net Debt	-475	-598	-685	-790
BVPS (R$/shr)	5.32	6.17	7.03	7.90

Source: Company reports and J.P. Morgan estimates.

Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Table 232: UOLL4 Annual Cash Flow Statement

R$ in millions

	2007	2008E	2009E	2010E
Net Income	109	103	103	105
Depreciation	44	58	77	82
Cash Earnings	153	161	180	188
Chg Work. Cap	-6	31	1	6
Cash Flow After WC	147	192	181	194
Capex	-60	-103	-92	-76
as % of revs	11%	18%	16%	12%
LT Assets	1	-4	-2	-13
Total Investment	-59	-106	-94	-89
Free Cash Flow Equity	88	85	87	105
Chg Short Term debt	0	0	0	0
Chg Long Term debt	0	0	0	0
Chg Other LT Liabilities	0	2	0	0
Chg Other Financing	-8	36	0	0
Dividend Payments	0	0	0	-1
Total Financing CF	-8	38	0	-1
Change in Cash	80	124	87	104
Dividend per Share(R$/shr)	0.00	0.00	0.00	0.01

Source: Company reports and J.P. Morgan estimates.

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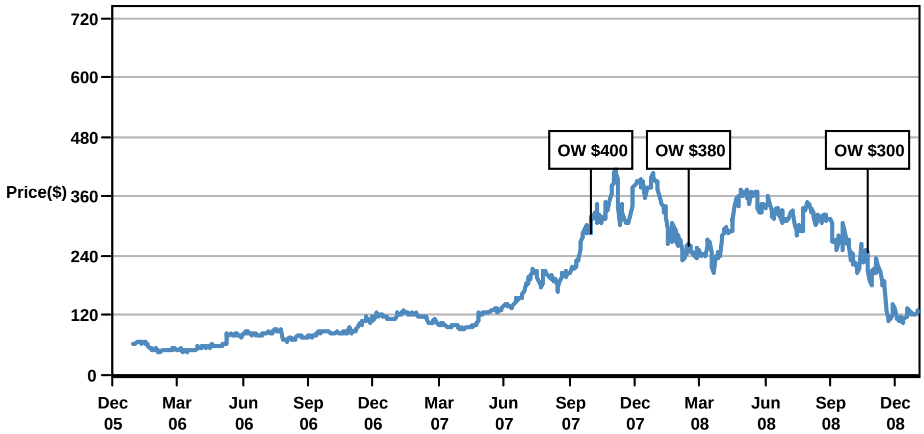
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Baidu.com (BIDU) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
02-Oct-07	OW	284.81	400.00
14-Feb-08	OW	261.09	380.00
23-Oct-08	OW	249.09	300.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Oct 02, 2007. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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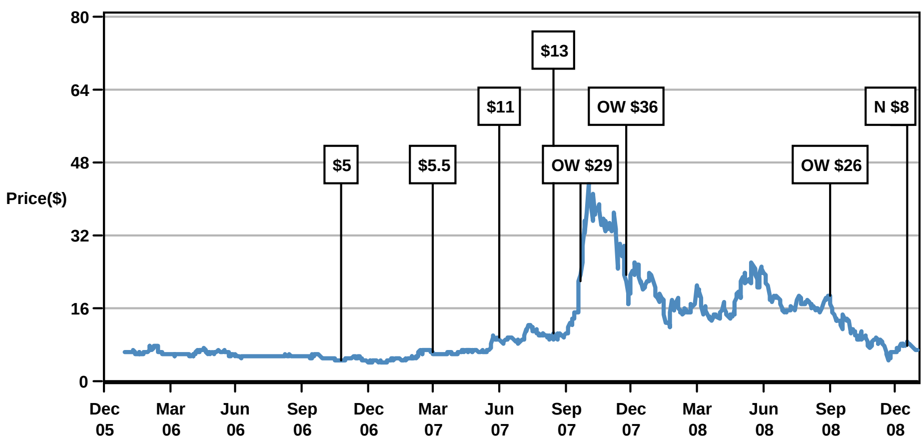
China Finance Online (JRJC) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
21-Sep-07	OW	22.10	29.00
23-Nov-07	OW	23.29	36.00
01-Sep-08	OW	18.75	26.00
16-Dec-08	N	8.00	8.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Sep 21, 2007. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Daum Communications (035720.KQ) Price Chart

Date	Rating	Share Price (W)	Price Target (W)
10-Nov-08	UW	28300	26000

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Nov 10, 2008. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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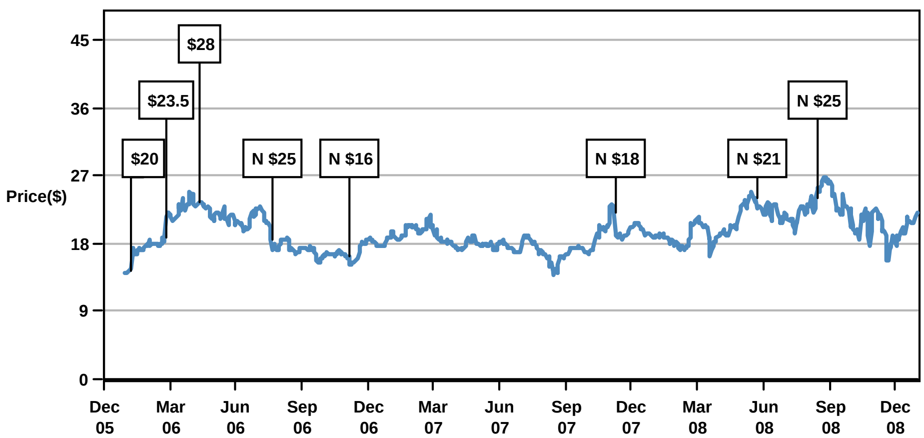
Netease (NTES) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
21-Jul-06	N	18.67	25.00
07-Nov-06	N	16.32	16.00
08-Nov-07	N	22.28	18.00
22-May-08	N	24.05	21.00
14-Aug-08	N	24.05	25.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Jul 21, 2006. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

NHN (035420.KS) Price Chart

Date	Rating	Share Price (W)	Price Target (W)
01-Oct-07	OW	215000	260000
30-Oct-07	OW	286400	340000
10-Nov-08	N	122600	140000
09-Dec-08	N	113000	130000

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Feb 16, 2007. Break in coverage Feb 16, 2007 - Oct 01, 2007, and Jul 24, 2008 - Nov 10, 2008. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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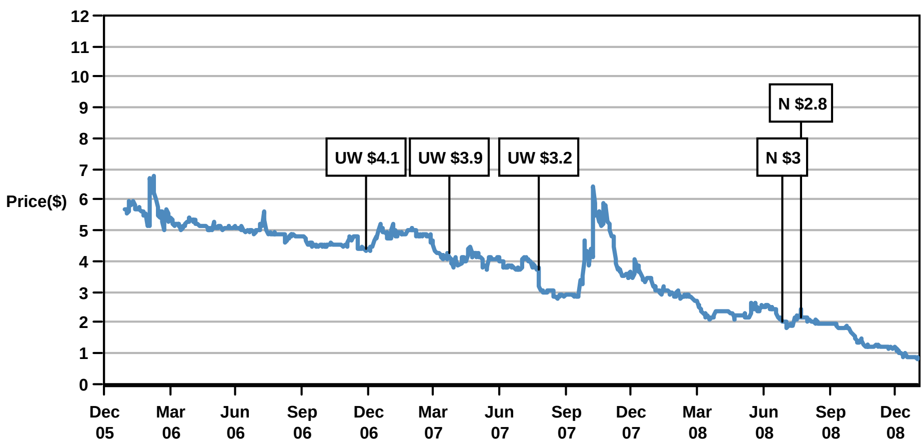
Ninetowns Internet Technology Group Co. Ltd. (NINE) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
28-Nov-06	UW	4.38	4.10
23-Mar-07	UW	4.26	3.90
27-Jul-07	UW	3.74	3.20
28-Jun-08	N	2.03	3.00
22-Jul-08	N	2.17	2.80

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
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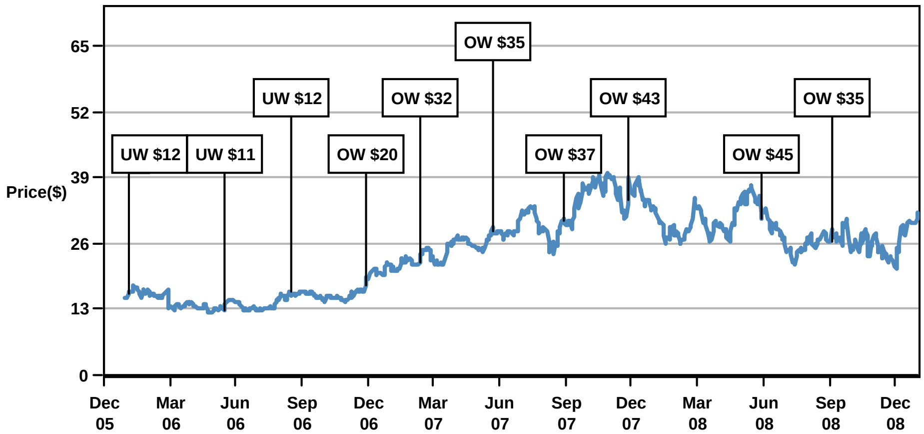
Shanda Interactive Entertainment Ltd (SNDA) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
05-Jan-06	UW	16.06	12.00
18-May-06	UW	12.78	11.00
16-Aug-06	UW	16.55	12.00
29-Nov-06	OW	17.53	20.00
13-Feb-07	OW	22.30	32.00
23-May-07	OW	28.64	35.00
28-Aug-07	OW	30.71	37.00
28-Nov-07	OW	34.50	43.00
30-May-08	OW	30.80	45.00
03-Sep-08	OW	26.42	35.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
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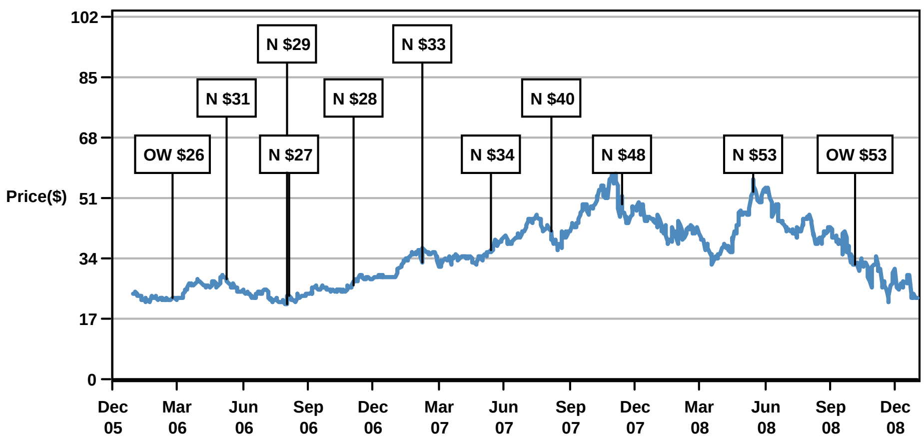
Sina Corp (SINA) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
23-Feb-06	OW	22.97	26.00
10-May-06	N	28.45	31.00
03-Aug-06	N	20.91	29.00
04-Aug-06	N	23.64	27.00
03-Nov-06	N	26.68	28.00
08-Feb-07	N	33.05	33.00
15-May-07	N	36.17	34.00
07-Aug-07	N	41.66	40.00
15-Nov-07	N	49.50	48.00
15-May-08	N	53.15	53.00
05-Oct-08	OW	32.10	53.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
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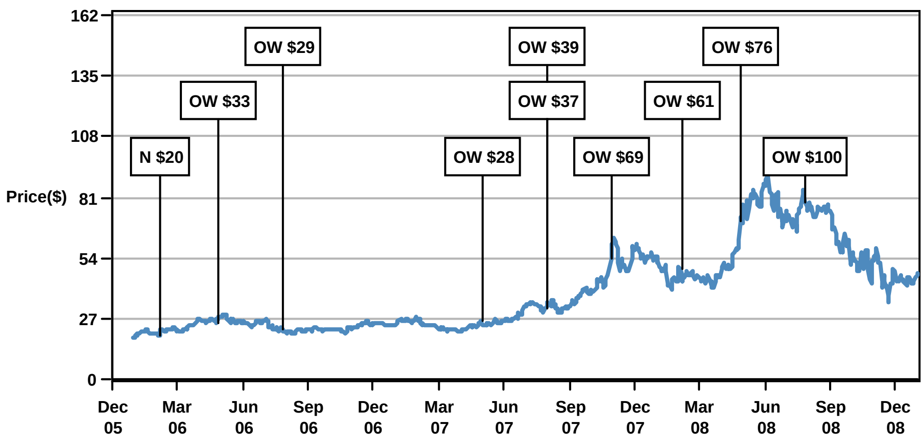
Imran Khan
(1-212) 622-6693
imran.t.khan@jpmorgan.com

Sohu.Com (SOHU) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
07-Feb-06	N	19.30	20.00
27-Apr-06	OW	25.36	33.00
28-Jul-06	OW	22.06	29.00
02-May-07	OW	25.52	28.00
31-Jul-07	OW	31.25	37.00
02-Aug-07	OW	33.99	39.00
30-Oct-07	OW	53.53	69.00
05-Feb-08	OW	48.95	61.00
29-Apr-08	OW	70.81	76.00
28-Jul-08	OW	78.61	100.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
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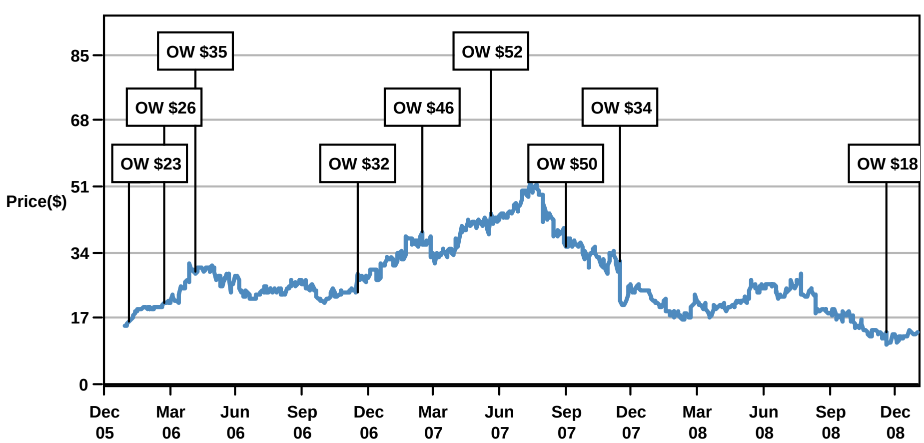
The9 Limited (NCTY) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
05-Jan-06	OW	16.06	23.00
23-Feb-06	OW	20.90	26.00
06-Apr-06	OW	28.75	35.00
16-Nov-06	OW	23.44	32.00
15-Feb-07	OW	39.18	46.00
22-May-07	OW	43.54	52.00
02-Sep-07	OW	35.58	50.00
16-Nov-07	OW	31.65	34.00
19-Nov-08	OW	13.36	18.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Jan 05, 2006. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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Imran Khan and the J.P. Morgan Internet, Media and Entertainment Team

Imran Khan
Imran Khan is a Managing Director and the Head of Global Internet Research at J.P. Morgan. In addition to his Internet coverage, Mr. Khan is responsible for covering U.S. diversified Media and Entertainment companies. Mr. Khan has been consistently ranked as one of the top Internet analysts by independent third-party surveys, including #1 in the Institutional Investor Alpha Magazine Survey in 2008, and #2 the Institutional Investor All American Research Poll every year since 2005. He is the author of several widely read research reports, including The Rise of Ad Networks, Large Cap Courtship and Consolidation, and Nothing But Net (which has been JPM's most-accessed research report in 2006, 2007 and 2008). Mr. Khan has spoken at various industry conferences and has appeared on financial television networks such as CNBC and Bloomberg. In addition, he is one of the youngest Managing Directors at J.P. Morgan, having been promoted to MD at age 29.

Mr. Khan came to J.P. Morgan in 2004 after three years at Fulcrum Global Partners, where he was a Managing Director in Equity Research covering Internet and Software. Prior to Fulcrum, Mr. Khan worked as an investment banker at ING covering Telecom. Before ING, he worked for Wild Blue, a satellite start-up company.

Bridget Weishaar
Bridget Weishaar joined the J.P. Morgan Internet, Media and Entertainment team in 2006. Prior to J.P. Morgan, Ms. Weishaar was an associate analyst on the Retail team at Bear Stearns, ranked #1 in the Institutional Investor All America Research Poll. Ms. Weishaar obtained her MBA at the Wharton School, University of Pennsylvania, and holds a B.S. from the University of Notre Dame.

Lev Polinsky
Lev Polinsky joined the J.P. Morgan Internet, Media and Entertainment team in 2006. Prior to J.P. Morgan, Mr. Polinsky was a trader at Susquehanna Investment Group, covering a variety of industries. Mr. Polinsky is a CFA charterholder and received an A.B. in Economics from Harvard University.

Vasily Karasyov
Vasily Karasyov joined the J.P. Morgan Internet, Media and Entertainment team in 2006, focusing on Media and Entertainment companies. Prior to J.P. Morgan, he was an Executive Director, Corporate Development at Sony Pictures, where he worked on M&A and financing transactions, as well as strategic planning in film, television, home entertainment and new media. Mr. Karasyov holds an MBA from INSEAD.

Dick Wei
Dick Wei's primary research focus is on China Internet. In addition, he is also responsible for global technology research. Prior to joining J.P. Morgan in 2002, Mr. Wei worked with Merrill Lynch in the Hong Kong and New York offices. He was also a design engineer at Quantum Corporation (acquired by Maxtor). Mr. Wei graduated with an MBA from the Wharton School and obtained his M.Sc. degree in mechanical engineering from Stanford University.

Elena Bazhenova
Elena Bazhenova joined the J.P. Morgan equity research group in Moscow in 2007. Previously, Ms. Bazhenova worked in Equity Research at MDM Bank (Moscow) and Aton Capital brokerage company (Moscow). Ms. Bazhenova is a graduate of the Russian Academy of Economics (G.V. Plekhanov) in Moscow and received an MBA diploma from California State University, East Bay.