Industry Overview

Equity | Americas | Internet/e-Commerce
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Top Internet themes for 1H'08

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We have identified our six top Internet themes/events for 1H'08 that could create trading opportunities in the group.

Intensifying 3rd party seller competition (negative)

As the industry giant ($57bn in TTM GMV) eBay's anticipated listing fee changes could impact the 3rd party market. We think Amazon ($5bn in TTM GMV) might incorporate some of this uncertainty (and consumer uncertainty), into its '08 outlook, potentially creating a buying opportunity as we expect little actual impact.

A bump Online media spending (positive)

We see two events that could build enthusiasm on the Internet advertising market into the summer: elections and the TV writers strike. Direct dollars won't be that material ($150mn possible direct benefit to Online adverting in '08), but extensive political spend could crowd non-political spending to Online display markets, which could be a catalyst for Yahoo or Google (YouTube).

Increasing focus on mobile market initiatives (both)

CES and the spectrum auction will provide greater clarity on Google's and Yahoo's mobile strategies, we expect each company to be aggressive in 2008. Difficult to handicap the risk of Google winning the spectrum auction, but losing could be a stock catalyst. Also, we expect Yahoo's to renegotiate its AT&T contract with a mobile partnership component, potentially clearing an overhang.

Improving display ad targeting technology (positive)

A Google/DCLK merger may highlight possibility for improved targeting technology to drive up the value of Online ad inventory. We think Online CPMs at around $2.50, which trail newspapers by 5-10x has room to grow, and targeting will make social networking sites more competitive, but also benefit Yahoo! in '08.

Asset value unlock speculation (positive)

The InterActive split into five entities expected in mid-2008 will be the catalyst and, in addition to potentially creating value for Interactive, the split could be an industry catalyst highlighting the underlying asset value for Yahoo ($10-11/share) and potentially even eBay (we value PayPal ~$10bn) or Expedia (TripAdvisor).

Social networking revenue model emergence (negative)

Audiences are moving to social networking sites and the "interest targeting" ad sales initiative by MySpace is just a first step in competitive audience monetization. We expect more display/sponsorship/ad network initiatives, followed by peer-to-peer eCommerce and possibly personalized search in a few years. All large cap. Internet stocks (eBay, Google, Yahoo) have some degree of risk, although AOL, MSN and Yahoo! could have most in '08.

Refer to important disclosures on page 11 to 12. Analyst Certification on page 10. Price Objective Basis/Risk on page 9.
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Top Internet themes for 1H'08

As a follow-on to our fundamental analysis report that highlighted Google and Priceline as best fundamental ideas for 2008, we are publishing our event almanac for the Internet group that outlines six key themes or events that could create trading opportunities in the group. For each theme we have outlined our views on the potential stocks that could be impacted. The table below is a rough summary of top events, in rough chronological order.

Chart 1: Key Internet catalysts

Event	Timeframe	Stocks Affected
Consumer Electronics Show - mobile announcements	January 7-10	YHOO, GOOG
700MHz spectrum auction	January 24 until March 2008 (likely)	GOOG
eBay fee structure changes	Late January, likely on or around the company's 1/23 reporting date	EBAY, AMZN
AT&T renegotiation	Sometime during 1Q, small chance it is completed before 1/29 reporting date	YHOO
EU issues opinion on GOOG/DoubleClick	Late 1Q or early April	GOOG, YHOO
Polital ad spend ramps	Should be most pronounced in early 1Q and in 3Q up until November election	GOOG, YHOO, IACI
Writers strike affects TV ad spending	Potential impact on 2Q/3Q TV ad spend	GOOG, YHOO, IACI
IACI break-up into 5 separate operating companies	Late-2Q, early-3Q	IACI, possible read across to YHOO, EBAY

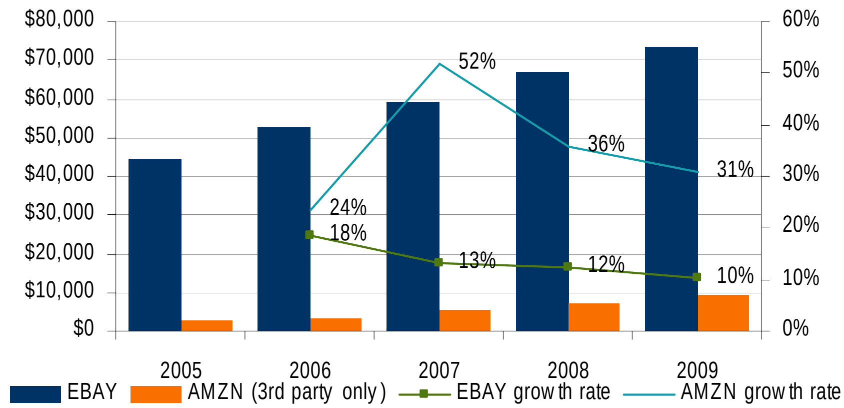
Source: ML estimates, public reporting

Our Six Top Themes

1) Intensifying 3rd party seller competition (negative)

As the industry giant ($57bn in TTM GMV versus ~$5bn estimated for Amazon) eBay's anticipated listing fee changes (lower listing fees, higher final value fees) could create a disruption in the 3rd party seller market for both eBay (EBAY, $32.81, C-2-9) and Amazon (AMZN, $95.21, C-2-9). Based on our assumption for a 8-9% take rate on GMV for Amazon, we think 3rd party sales are a significant driver of Amazon's net profitability and Amazon might incorporate some of the third party market uncertainty, plus some consumer spending uncertainty, into its 2008 guidance. Amazon stock volatility on guidance could be a buying opportunity, as we expect little actual impact on Amazon's demand levels from eBay's fee changes. We expect eBay's listings/conversion metrics to be closely watched in February and March, with opportunities for investors that can get an edge on underlying fundamentals.

Chart 2: eBay GMV versus Amazon's 3rd party sales



Source: Company reports, ML estimates

2) A bump in 2008 Online display ad spending (positive)

We see two events that could build excitement on the Internet display advertising market into the summer, which are the elections and the TV writers strike. The dollar amount moving Online is not expected to be that material ($150mn possible direct benefit to Online adverting in 2008 equal to 2% industry growth), but extensive political spend in other media could crowd non-political spending to Online display markets, a potential catalyst for Yahoo or Google (YouTube). This benefit could be at least as large as the direct dollar shift benefit estimated below.

Chart 3: Election and writers strike to benefit online ad spend

(in millions of dollars)	4Q'07	1Q'08	2Q'08	3Q'08	4Q'08	Total
Political Ad Spend	$100	$400	$400	$700	$1,100	$2,700
Percent of Spend Online	4%	4%	4%	4%	4%	
Potential Online Benefit	$4	$14	$14	$25	$39	$95
Writers Strike Lost Revenue			$300	$200		$500
Percent That Moves Online			10%	10%		
Potential Online Benefit			$30	$20		$50
Total Potential Online Benefit	$4	$14	$44	$45	$39	$145

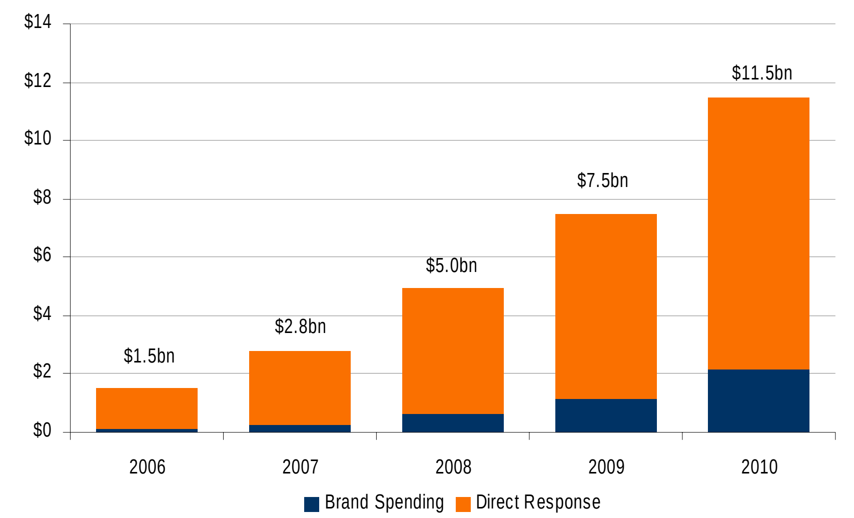
Notes: Writers strike estimate equal to 1988 revenue impact estimate from 5-month strike per Washington Post
Political estimate, in total, from ML analysts Jessica Reif Cohen and Karl Choi

Source: ML estimates, Washington Post (see note above)

3) Increasing focus on mobile market initiatives (both)

We think Google's recent mobile operating system initiatives and notice that the company will bid in the upcoming spectrum auction are precursors to even more mobile systems development and partnership activity in 2008. After all, PC Internet users are Online for less than an hour per day at home, while a mobile device can be with the user every waking hour. The upcoming consumer electronics show and the spectrum auction will provide more details on Google's and Yahoo's mobile strategies, we expect each company to be aggressive in 2008. The mobile market opportunity is large and growing and eMarketer estimates that global mobile advertising revenues will grow 79% in 2008 to $5.0bn, and will reach $11bn by 2010.

Chart 4: Global mobile advertising revenue ($bn)



Source: eMarketer

Our take on two key events, the spectrum auction and Yahoo AT&T contract renegotiation, which will include a mobile component, are outlined below:

We think Google is unlikely to win the spectrum auction AND "go it alone" on a network build.

The potential for Google to win the spectrum ($4.6bn+) and spend capital ($3bn+) in order to build a wireless network creates near term strategic and financial model uncertainty, which is being partially discounted in Google's stock price. We believe Google has a less than 50% chance of winning spectrum in the auction, as a Verizon bid on the open access licenses seems likely given recent company announcements. The business model for Google using the 700 MHz spectrum if the company were to win is unclear, and partnering seems likely as we don't think the industry needs another wireless network. In our moderate case scenario, we estimate about 10% potential EPS dilution in 2010 if Google were to win and build its own wireless network. *Therefore, we believe that a loss in the spectrum auction, which is the most likely outcome, could be a potential catalyst for Google, while a win without a network partner announcement would be an overhang.*

Expect Yahoo to keep a less profitable AT&T deal with a mobile component

We think the near-term biggest risk for Yahoo's 2008 growth outlook is the potential loss of Internet access fees associated with AT&T contract, which we estimate at $225mn in 2007. This risk was highlighted by the recent change in Yahoo!'s agreement with Rogers Communications, which switched the payment structure of their deal from Rogers paying Yahoo! a percentage of subscription fees to Yahoo! sharing a percentage of the ad revenue generated from Rogers subscribers. (Yahoo! received a one-time payment of $52mn and lower data costs to forego revenue on current monthly subscribers that Yahoo! co-owned with Rogers.)

We believe that Yahoo will keep a restructured from of the AT&T partnership, which could act as a positive for stock given resolution of uncertainty that has been weighing on the shares. We note several factors that should help Yahoo keep a profitable partnership with AT&T: 1) The companies have a long-standing, positive, relationship and Yahoo has rights to revenues from existing sub base in event of contract termination, 2) ad revenues for partnership are ramping quickly, which is evident by the $18mn q/q increase in Yahoo O&O TAC, 3) there precedent for a revised deal from the Rogers deal, 4) Google is threatening to compete more aggressively in wireless.

4) Improving display ad targeting technology (positive)

The Google/DoubleClick merger, combined with more visibility on the results of Yahoo's recent acquisitions of Blue Lithium and Right Media, should highlight possibility for improvements in ad targeting technology to increase the value Online display inventory. We estimate that Online CPMs average around $2.50, which trails newspapers and magazines by 5-10x. We believe greater advertiser access to this inventory through ad exchanges and ad networks, combined with improving targeting for this inventory could help drive 5-10% CPM growth 2008 assuming the ad market doesn't slip into a recession.

Chart 5: Increasing the amount of monetizable inventory giving way to CPM growth in '08

	2006	2007	2008	2009
Page views (bn)	5,575	5,700	5,919	6,061
Revenue per 1000 page views (RPM)	$0.97	$1.17	$1.32	$1.44
Growth in RPM		20%	13%	9%
Monetizable page views	40%	46%	48%	50%
Monetized inventory (bn)	2,230	2,622	2,841	3,030
CPM	$2.42	$2.54	$2.74	$2.88
Growth in CPM		5%	8%	5%
Online U.S. display ad revenue (mn)	$5,400	$6,650	$7,790	$8,720
Growth in display ad revenue		23%	17%	12%

Source: ML estimates, comScore

5) Asset value unlock (positive)

We think that the InterActive split into five entities (expected in mid-2008) will unlock potential value for Interactive shareholders, and could highlight underlying asset value in other stocks. On a sum-of-parts basis and using 2009 estimates, we value IAC at $38/share and we believe individual company management presentations in 2Q could increase enthusiasm for these assets, which could begin to trade in late 2Q.

Chart 6: IACI sum of parts analysis

($ millions)	2009E					
	Revenues	% Total	EBITDA	Est. Margin	EBITDA Multiple	EV
Retail ($mn)	$ 3,255	45.7%	$ 295	9.1%	8.5 x	$ 2,510
U.S. Retail (HSN, Cornerstone)	3,255	45.7%	295	9.1%	8.5 x	2,510
Services ($mn)	$ 1,697	24.8%	$ 351	20.7%	9.7 x	$ 3,394
Ticketing (Ticketmaster)	1,219	17.8%	298	24.4%	8.0 x	2,382
Lending (LendingTree)	293	4.3%	20	7.0%	15.0 x	305
Real Estate	63	0.9%	(7)	-11.2%	nm	189
Home Services	122	1.8%	40	32.6%	13.0 x	517
Media & Advertising ($mn)	$ 1,114	16.3%	$ 172	15.4%	12.0 x	$ 2,062
Membership & Subscriptions ($mn)	$ 1,042	15.2%	$ 300	28.8%	8.5 x	$ 2,541
Vacations (Interval)	446	6.5%	185	41.5%	8.5 x	1,574
Personals (Match.com)	397	5.8%	94	23.5%	9.0 x	842
Discounts	198	2.9%	21	10.5%	6.0 x	125
Eliminations						
Other (TVTS, Emerging, Corporate)	$ 16	0.2%	$ (113)	nm	10.0 x	$ (1,126)
IAC Total	$ 7,123		$ 1,005	14.1%	9.3 x	$ 9,381
			Plus Net Cash ('08 Target)			$ 1,500
			Shop Channel & Europe Equity			$ 700
			Equity Value			$11,581
			Shares Outstanding			305
			Per Share Value			$38

Source: ML estimates,

The most interesting asset value read-across could be Yahoo, which we estimate has $10-11/share in asset value at trades at 7.6x our 2009 EV/EBITDA estimates. Other potential beneficiaries are eBay (we value PayPal ~$10bn) or Expedia (EXPE, $30.56, C-2-9) (TripAdvisor).

Chart 7: Yahoo! investment asset value

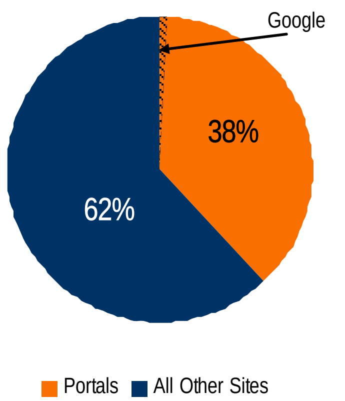
Investments	Market Value	Yahoo % Ownership	Aggregate Value	Tax/Liquidity Discount %	Yahoo! Value	Per share Value
Cash	$1,528	100%	$1,528	0%	$1,528	$1.10
Short term investments	684	100%	684	0%	684	0.49
LT marketable debt securities	551	100%	551	0%	551	0.39
Gmarket		N/A	107	30%	75	0.05
Alibaba.com	17,860	30%	5,358	30%	3,751	2.69
Alibaba Group other assets	6,000	39%	2,340	30%	1,638	1.17
Yahoo! Japan	26,485	34%	9,005	30%	6,303	4.52
NOL			500	0%	500	0.36
Total - current						**$10.77**
Alibaba Group - high end	12,000	39%	4,680	30%	3,276	2.35
Total - aggressive estimate						**$11.95**

Source: ML estimates, company filings, Reuters

6) Emergence of social networking rev models (negative)

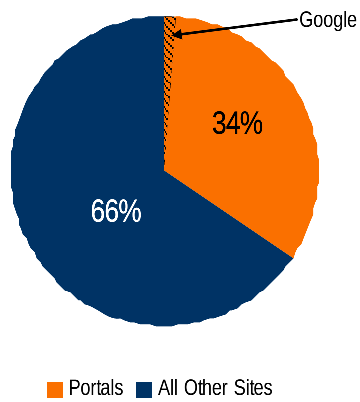
Internet audiences are fragmenting away from portals (AOL, MSN, Yahoo), and social networking sites are picking up a significant piece of this usage. The amount of time spent on portals has fallen from 38% in 2003 to 32% in 2007, while time spent on Social Networking sites has increased to 8%, creating a usage base that has extensive monetization opportunities.

Chart 8: Portals accounted for 38% of time spent online in 2003…



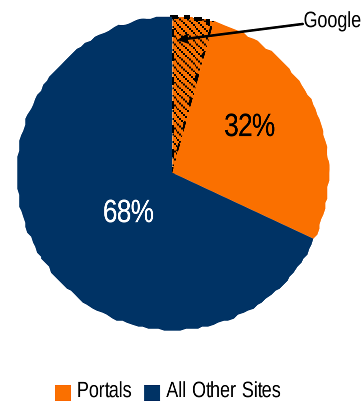
Source: comScore Media Metrix

Chart 9: …but that number fell to 34% in 2005…



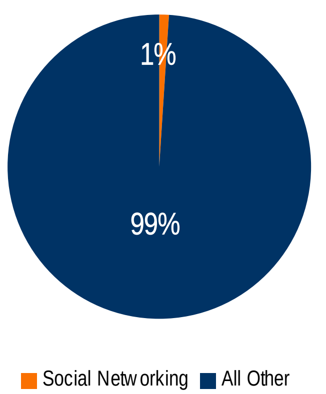
Source: comScore Media Metrix

Chart 10: …and in 2007, Portals will account for just 32% of time spent online



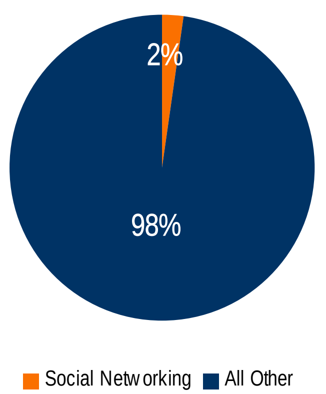
Source: comScore Media Metrix

Chart 11: Social Networking accounted for 1% of time spent online in 2003



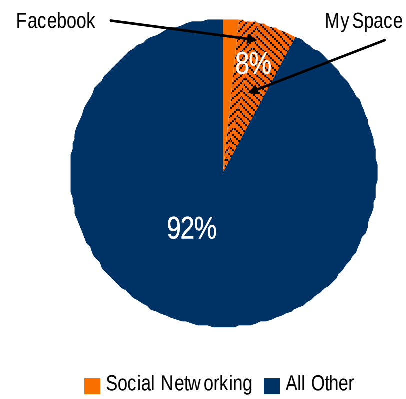
Source: comScore Media Metrix

Chart 12: …growing to 2% of Online time with entry of MySpace and Facebook in 2005



Source: comScore Media Metrix

Chart 13: and will reach about 8% of time spent in 2007



Source: comScore Media Metrix

The high valuation recently paid by Microsoft for a stake in Facebook hints to something well known by industry executives: Facebook's (and other social networking sites) high user engagement combined with their huge amount of user supplied information is a potential marketer's optimal advertising platform. Although it may take a while for Facebook to grow into this $15bn valuation, we do not believe that this is the top of a social networking bubble. On the contrary, we believe that as Facebook and MySpace expand their ad targeting abilities, social networking will remain a big industry theme in 2008, potentially taking a larger-than-expected slice of the publicly-traded Internet companies' advertising pie.

We think the management teams at the social networking sites will aggressively seize the advertising opportunity in 2008, with MySpace's "interest targeting" just the tip of the iceberg. Looking out to 2009, social networking sites might also be able to add C2C e-commerce capabilities which could compete with auction and 3rd party eCommerce sites. Also, search engines, like Google and Yahoo! could face long-term competition if social networks, particularly Facebook, can create a search engine that provides results tailored to each user's specific interests and place in the social graph. We believe Facebook is a long way from building its own search engine, but the user data it can access has very interesting long-term possibilities. All large cap. Internet stocks (eBay, Google, Yahoo) have some degree of risk, although AOL, MSN and Yahoo could have most competitive risk in 2008.

Price objective basis & risk

Google (GOOG, $685.33, C-1-9)

Our 12-month price objective for Google is $740 which represents 30x our PF FY09E EPS estimate of $25.02 (33x FY09E GAAP EPS). We believe a 30x multiple is reasonable relative to our 35%+ growth assumption over the next 3 years. Risks to our price objective are revenue pressure from competitive initiatives at Yahoo! and Microsoft, margin pressure from increased investment spending and lack of company disclosure that makes revenue and margin trends less predictable.

Interactive (IACI, $25.93, C-1-9)

Our 12-month price objective for IAC is $38/share based on a sum-of-parts valuation analysis using comparable '09 EBITDA multiples. Our sum-of-parts analysis values the Retail segment at 8.5x EBITDA, Services at 9.7x, Media and Advertising at 12.0x and Membership and Subscriptions at 8.5x. Our EBITDA valuation multiples value the retail segment at 0.8x sales, Services at 2.1x, Media at 1.8x and Membership at 2.4x, plus estimated cash and equity value of $1.5bn. We believe these target multiples are appropriate given operating margin opportunity and accelerating revenue growth in 2008.

Risks are ongoing operating and corporate complexity, uneven results at HSN, 2009 EPS pressure from loss of LiveNation ticketing contract, potential for further secular decline in real estate and lending markets and market share decline at Ask.com.

Priceline.com (PCLN, $111.40, C-1-9)

Our $120 price objective based on 25x our 2009 tax adjusted EPS of $4.80, a two-year PEG ratio on gross profit and operating income growth of 1.0x and a PEG on EPS growth of 1.5x (our price objective is equal to 22x our street consensus comparable '09 EPS estimate of $5.33). We believe our 2008 bookings and gross profit growth estimates remain conservative.

Risks to our price objective are: A global economic downturn could limit Priceline's near-term growth rate as we would expect fewer travel bookings; increasing competition for European traffic given Priceline's increasing visibility in the market, potentially lowering the company's growth below street expectations; hotels may choose to favor alternative distribution channels, limiting Priceline's access to inventory; company is highly dependent on agency bookings growth to drive EPS growth, and slowdown in Europe markets could cause EPS growth to materially slow below our forecasts; we expect EPS growth below gross profit growth as Priceline's proforma tax rate and share count trend higher.

Yahoo! (YHOO, $23.84, C-1-9)

Our 12-month price target is $33, based on 13x 2009E EBITDA plus $11 in asset value. At $33/share Yahoo would have a 2008 EV/EBITDA multiple of 15x, in-line with current multiples for leading Internet companies such as eBay and Amazon and at a discount to Google. Risks to our price objective are: changing fee contracts, continued Search share loss, and pressure from Social Networking on branded revenue.

Analyst Certification

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Buy	92	36.65%	Buy	22	26.51%
Neutral	129	51.39%	Neutral	23	19.33%
Sell	30	11.95%	Sell	1	4.00%

Investment Rating Distribution: Global Group (as of 01 Jan 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1714	46.25%	Buy	445	29.10%
Neutral	1653	44.60%	Neutral	454	30.55%
Sell	339	9.15%	Sell	67	21.82%

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