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Internet: Goliaths Pummel Davids

Internet **5 May 2015**

Amidst the swirl of unprecedented FX moves and shifts in behaviour by large advertisers, our outlook note for 2015 on Internet advertising-based business was entitled *Goliaths vs. Davids*, and this was how stocks played out: industry leaders Google and Facebook navigated a "tough quarter" of FX and new product rollouts, while Twitter, Yelp and LinkedIn all saw shares plummet, one or another disappointing. Yahoo remains balanced between underlying asset value and floundering internal operations. Below are short comments with our (slightly) adjusted numbers of key stocks; we are reluctant to draw definitive conclusions from 1Q15 figures (the lowest period of ad spend for the year), esp. with so many new ad offerings ramping at all major vendors. Yet we see **Google** and **Facebook** (both Best Idea Longs, with $675 and $95 price targets, respectively) in a position to take incremental ad spend, while **Yahoo** (Positive, $58 target, down from $60), **Twitter** (Negative, $30 target) and **Yelp**, if not also **LinkedIn** (both not covered) are obliged to focus on internal issues. We see three other issues, which we have written about in individual stock notes, but seem to be increasingly industry-wide issues. Investors should bear them in mind for the rest of 2015 and beyond, as they play out.

Regulation Looms

We have written many times before about regulatory risk for Internet names, but it always felt like a distant issue, and one easily ignored. No longer. Google now faces two cases in the EU, around favouritism in its search results and about bundling its applications into Android. It will be obliged to respond shortly to the first set of complaints. Facebook is facing several EU cases around privacy and permission to use personal data. **Government actions have caused questions to be raised about Alibaba, and probably will condition the fate of the largest asset likely to be targeted by a range of potential acquirers, eBay/PayPal.**

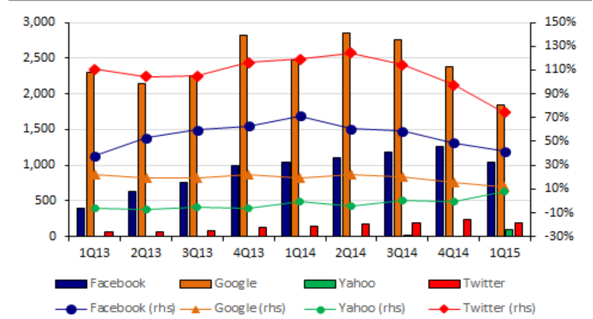
Costs Are Dollar-Based, Sales Less So

FX headwinds were substantial for Facebook and Google, less so Yahoo (given its smaller international presence). But the cost bases of these companies are primarily $-based, in both personnel costs and, we believe, in sourcing (where we understand technology purchasing is largely US$-based). **We think this masks higher underlying "earnings power" at Google in particular, though there remains a portion of investors that simply believe Google is seeking to obscure how profitable its core business truly is.** This also suggests there should be margin upside over the year as companies' adjust costs to the new FX world.

Less Fresh Sales for Everyone to Grab

As the Internet advertising market matures, we see several obvious impacts on stocks. First, each $ of incremental growth is implicitly getting valued at a higher rate. Second, as Fig. 1 shows, the absolute amount of "fresh money" pouring into the leading Internet brands is dropping. As "high-fliers" (in terms of growth rates) like Twitter, Linkedin, Yelp and others re-set expectations on growth, while Facebook manages its own top-line, this masks a deeper underlying trend: **larger advertisers are likely to get more selective, limiting arbitrage by some ad tech players, and demanding more from leading Internet brands.** This also should force more innovation by leading brands, as can be seen by Facebook's many new initiatives, and new AdWords, mobile search and potential DMP platforms at Google. Smaller brands are trying to emulate these moves, but often lack the resources or pool of advertisers to work with.

Fig. 1: Absolute Incremental Sales (yoy) and Growth Rates (rhs)



Source: Company websites, Statista, Arete Research.

Arete will be talking to or visiting 20-30 Internet-related companies during May, including trips to the US (SF, NYC and Boston) and seeing China Internet companies. Contact us for more info, and watch out for further summary notes on industry trends.

For Reg. AC certification and Important Disclosures, see the last two pages of this report.

Google: What Colour Is My Parachute?

Under a new CFO, investors will rightly ask what sort of company Google intends to put on show: one whose underlying earnings power is masked by rising R&D, SG&A, FX, etc., or one where further disclosures support $5bn of stock comp likely to come in '15. Our *Opening Pandora's Box* note (Feb. '15) remains valid, and we leave our $675 price target (based on 20x '16E GAAP EPS plus the $85/share in net cash) and Best Idea Long rating unchanged. **Google needs to prove to investors – and its own staff, handed $4bn of stock comp in '14 – that it can show profit and sales growth justifying $10bn R&D and capex investments rising in '14, rising to $12bn run-rates in '15E.**

Costs in $, FX Masks Underlying Profits. Google IR suggested to us that we should not assume the $1.1bn lower revenues due to FX would have all flowed through to the bottom line; we disagree, in that we believe Google's cost base is primarily in the US (as well as in countries where it likely bases costs on US$). While there is no disclosure of headcount, Google has 76% of its "long-lived assets" in the U.S., and we expect it would source most of its "production equipment" in US$. Adjusted for FX and hedging gains recognised, "rest of world" sales grew 20% while the UK rose 17%. **We think FX is dampening Google profits more than the company lets on, and as the impact eases in 2H15, margins could rise further.**

Turning Away from Hardware. Before Google started its "hardware adventures", it had a 64-65% gross margin; now with lower sales of Nexus products (and lower TAC paid out), Google saw a 210bps rise in gross margins in 1Q15. We think this will be the source of margin upside until a new CFO might impose stricter controls on opex spending. Both spending and headcount in every one of Google's opex categories grew faster than sales in FY14, and again in 1Q15, though both spending and staff growth slowed in 1Q15. While one does not think of Google as a company in need of "restructuring", the fact that G&A expense grew by 18% even before $314m of additional costs for legal and professional services in '14, suggests operations are not as "tight" as they might be. In a period of slowing growth, improvements in efficiency would be welcomed by investors, even as Google pursues opportunities in commerce, health, transport, and other fields. **Google needs to match the 210bps boost to gross margins by showing it can rein in opex, which was up 270bps as a percentage of sales.** We are less impressed by a 60bps rise in non-GAAP margins, which reflect higher stock comp.

Table 1: Spending vs. Headcount

	Spending		Headcount	
	FY14	1Q15	FY14	1Q15
R&D	*38%*	*30%*	*27%*	*24%*
S&M	*24%*	*19%*	*15%*	*15%*
G&A	*32%*	*10%*	*24%*	*17%*

Source: Company websites, Arete Research.

Use It or Lose It? One of the key questions is what Google can do with its $65bn of gross cash; it made just $64m of acquisitions in 1Q15, and we think it needs to dramatically boost its fortunes in areas like e-commerce, payments and social media (beyond the extensive YouTube engagement). **It quietly brought down the portion of overseas gross cash from 67% in 3Q14 to 57% as of 1Q15; US cash has risen by $7.5bn in the past two quarters, now at $28bn.** We still wonder whether Google's reticence in making acquisitions – it has not bought anything sizeable since Nest and before that, the ill-fated Motorola – is linked to the regulatory scrutiny it faces. **We still see eBay/PayPal as each individually offering Google presence in areas where it is weak, and among the few scale assets that could affect Google's P&L**, though Google probably prefers to buy private companies.

Paid Clicks, CPCs and Other Nonsense Measures. We think Google was obliged to "add colour" around the impact of TrueView ads on clicks and CPCs to avoid a negative reaction to the -13% yoy decline in CPCs (cost per click), and to forestall the assumption that mobile search was monetising poorly. Once again Google is emphasizing its own Websites over Network growth, even with a boost from reclassifying $130m of programmatic ad platform sales into that unit. With PlayStore seemingly the sole driver behind "Other" growth – and depending on RoW sales – we see even more the need for Google to make serious moves in enterprise and e-commerce, while avoiding falling back into the habit of boosting sales with low-margin hardware (mostly its own Nexus products, Chromecast, etc.). Nest seems to have made almost no impact on sales, despite its $3bn price tag. **Our estimates are largely unchanged, with slightly higher margins offsetting slightly lower sales. We still value Google at 20x GAAP EPS of $30.64, plus its fully-taxed cash (i.e., the offshore portion adjusted for repatriation tax), and are even more hesitant to use non-GAAP measures given Google's rising level of stock comp.**

Table 2: Summary Financials, '12-'16E — **Ticker: GOOG US** — **Price at 5 May '15: $552.8**
Enterprise Value: $321bn — **Target Price: $675 (+22%)** — **DCF Value: $669**

Year to Dec.	Sales	Growth	EBIT	Margin	EPS	Non-GAAP EPS	P/E	Pro Forma P/E	FCF/ Share	FCF Yld
2012	$46.0bn	*21%*	$13.8bn	*30.0%*	$35.38	$39.56	15.6x	14.0x	$19.7	*4%*
2013	$55.5bn	*21%*	$15.4bn	*27.7%*	$19.04	$21.90	29.0x	25.2x	$16.6	*3%*
2014	$66.0bn	*18%*	$16.5bn	*25.0%*	$21.02	$26.37	26.3x	21.0x	$17.9	*3%*
2015E	$75.7bn	*15%*	$20.5bn	*27.1%*	$24.32	$30.11	22.7x	18.4x	$25.5	*5%*
2016E	$87.2bn	*15%*	$26.0bn	*29.8%*	$30.64	$36.58	18.1x	15.1x	$39.1	*7%*

Source: Arete Research estimates. We adjust cash for tax on the offshore portion in our enterprise value.

Facebook: All About the Dataset

Facebook's 1Q15 revenues of $3.5bn were hit by a $190m headwind from FX, slowing growth from 55% at constant currency to "just" 42% in 1Q15, slightly missing consensus estimates. Its CFO said FX will also affect 2Q15E numbers as Facebook generates only 49% of sales in N. America (a sharp difference vs. Twitter at 66% and Yahoo at 80%, but similar to Google at 43%). Even though Facebook narrowed its R&D guidance to a 55-65% increase yoy vs. the previous 55-70% on clearer views of likely projects and spend, with little benefit on FX in terms of R&D spend outside the US, **2015 remains a "big investment year" for Facebook.** While it has a heavy burden of amortisation and stock comp in GAAP numbers, Facebook still grew non-GAAP operating profit by 34% to $1.84bn (GAAP $0.93bn). **At a company as loved as Facebook, investors are valuing the long-term franchise for its messaging- and time-spend-led template (similar to Tencent), and investors are looking past FX.** Facebook can still show 17% growth in DAUs to 936m (ahead of our forecast), and 13% growth in MAUs to 1.44bn, with 1.25bn of those mobile MAUs in 1Q15 (73% of revenues), and underscored its claim on time spent with the core MAUs, plus Instagram's 300m MAUs, Messenger's 600m users, and WhatsApp's 800m users.

Low to Grow? Facebook keeps repeating its mantras of "low share of ad spend is relative to time spent" and "people-based marketing." Industry data suggests US adults spend 25% of their media time on mobile, whereas advertisers spend only 11% of their budgets, and Facebook clearly has a regular engagement by virtue of groups, NewsFeed updates and messaging. **From this perspective, Facebook is simply an execution story for 2015, esp. given all its many new initiatives.** The three core efforts remain (1) monetisation of the messenger platforms, (2) development of its third-party ad-tech stack, and (3) lifting video "experiments" into the revenue mix. **One should not forget the EU regulation risk we flagged in *Facebook: So Close, and Yet So Far…* (Feb. '15), but equally, no one doubts how much Facebook still has to do in realising its franchise value.**

Messenger Platforms Growing Shares. In *Facebook: Getting the Message* (Mar. '15), we spoke about Facebook providing a way for developers to create apps integrated within Facebook Messenger, positioning itself for further app install revenue via the Facebook newsfeed. Last year Facebook did 3.5bn app installs, which is a massive channel. **We think the next step would be to create its own "app store" for messenger add-ons, moving beyond installs to hosting apps and working more closely to develop Facebook-specific apps (and not ones with Google's "deep links"), though it must circumvent Apple's and Google's app distribution.** The aim is to capture more revenues from developers and keep its rising 600m user base in the Facebook Messenger environment (time spent to place ads against). WhatsApp is the simpler "lightweight" pure messaging platform (up by 100m users in 1Q15 to 800m) and with the integration of Skype-like VoIP calls early this year, Facebook make some heady (but unverified) claims of 10% market share of global VoIP calls, while FBM and WhatsApp handle 45bn messages/day.

Third-Party Ad-tech Investments and Video to Ramp Slowly. As we said in *Facebook: So Close, and Yet So Far…* (Feb. '15), we expect gradual monetisation from integrating ad-tech stacks LiveRail, Atlas and FAN. The LiveRail acquisition is expected to benefit Facebook's 4bn video views per day (3bn at the end of 4Q14; a view equals watching a video for minimum of 3sec). We also expect further monetisation from Atlas (bought from Microsoft in '13, re-launched in Sept. '14), Facebook's cross-device and offline sales tracking advertising platform and measurement tool, working with advertisers to place ads on third-party websites and integrating app developer inventory via its FAN (Facebook's Audience Network). **We expected Facebook to do more to integrate those assets, which it calls "strategic" (i.e., not material to short-term revenues).** LiveRail is generating revenues booked ex-TAC in Payments (mainly selling ads against third-party videos using Facebook audience data; as well as monetising 80k embedded Facebook videos on third-party pages), but will remain independent for the time being; we view Google's DoubleClick as a much broader integrated product ($1.1bn ex-TAC in 1Q15).

Valuation. We slightly change our revenue expectations for 2015 and account for the lowered guidance on R&D expenses, but our long-term investment case and $95 price target are unchanged, and we reiterate our Best Idea Long rating. We value Facebook on a blend of 11x '17E Adj. EV/EBITDA and a DCF (25% '21 sales CAGR, 8% WACC, 4% terminal growth rate). **Facebook remains a leap of faith in its ability to monetise the "community", but one investors seem more than willing to take.**

Table 3: Summary Financials, '12-'17E — Ticker: FB US — Price at 5 May '15: $78.8
Enterprise Value: $208bn — Target Price: $95 (+21%) — DCF Value: $109

YE Dec.	Sales $m	Growth	Adj. EBITDA	GAAP Dil. EPS	Non-GAAP Dil. EPS	P/E	Non-GAAP P/E	EV/Adj. EBITDA	FCF/ Share	FCF Yield
2012	5,089	*37%*	2,910	$0.01	$0.61	n.m.	n.m.	70.9x	$0.14	*0.2%*
2013	7,872	*55%*	4,814	$0.59	$0.87	n.m.	n.m.	42.9x	$1.04	*1.3%*
2014	12,466	*58%*	8,132	$1.10	$1.65	72.0x	47.8x	25.4x	$1.31	*1.7%*
2015E	17,291	*39%*	11,317	$1.06	$2.04	74.2x	38.7x	18.2x	$2.11	*2.7%*
2016E	22,790	*32%*	14,734	$1.64	$2.77	48.1x	28.4x	14.0x	$3.11	*3.9%*
2017E	29,230	*28%*	19,461	$2.25	$3.57	35.0x	22.1x	10.6x	$4.01	*5.1%*

Source: Arete Research estimates.

Twitter: Lost in Metrics

Similar to Yelp and LinkedIn, Twitter missed 1Q15 revenues by 2% (-4% vs. consensus) and cut its FY15 guidance to $2.22bn at midpoint (from $2.33bn). The FX headwinds were moderate compared to other Internet peers (80% top-line growth vs. 74% reported), and profitability has not become an issue given the market's willingness to look at Adjusted EBITDA margins, which improved 910bps yoy to 24% in 1Q15, even as Twitter had a GAAP EBIT loss of -$161m. This is mainly the result of 42% of sales being paid out in stock comp; there is no consideration at Twitter over diluting shareholders (executives have sold $415m worth of stock since Mar. '14). Nor was there much reaction to the news that its CEO had personally invested $5m in TellApart (via Series A funding in '10), worth many multiples when its $533m acquisition will close. We also have a hard time squaring the CFO's projected diluted share count of 700m in 2Q15 with our ~780m (given a large number of RSUs, stock options and warrants). **Its 2Q15 top-line guidance of $478m at midpoint implies that even when Twitter comes in at the top end of the range, 2H15 revenues will have to be 41% higher than 1H15 to reach FY15 guidance of $2.22bn. Thus, we expect Twitter to cut its FY15E guidance further during the year,** as the company tackles a variety of issues: (1) ongoing slowing of user growth, (2) weak user engagement causing inventory demand to be lower than supply, (3) convincing advertisers Twitter is "brand-safe", and (4) integrating Periscope and TellApart.

Slowing User Growth, and Engagement. The growth rate of MAUs was down again to 18% yoy (was 25% in 1Q14, 20% in 4Q14). In *Twitter: Spring Cleaning?* (Feb. '15), we have laid out Twitter's various reasons why MAUs are not rising faster and in 1Q15 Twitter now added SMS Fast Followers (Twitter users with feature phones mostly in emerging markets, who might convert to smartphone users over time), to boost MAUs from 301m to 308m in 1Q15, while management said 2Q15 MAUs had a "slow start". And while Twitter may have a huge audience (MAUs, SMS Fast Followers, and claims of a 500m base of monthly non-logged-in users, soon to get more exposure via Google search), the key remains engagement. Twitter doesn't disclose its timeline views anymore and hasn't replaced the metric with any more appropriate engagement measures (e.g., DAUs); Twitter roughly speaks about 50% of MAU vs. Facebook's 65%, or time spent on the site (comScore: the average US Facebook user spends ~1,000 mins online each month vs. Twitter's ~100 mins, Instagram's ~200 mins and even Tumblr and Pinterest getting slightly more time spent). **Inventory demand in 1Q15 was lower than supply, which seems to be a function of weak engagement, brand-safety issues and Twitter's overall knowledge of the individual user.** Twitter's dataset cannot be compared to Facebook as the firm has a far smaller reach (301m MAUs vs. 1.44bn), lacks the single-sign-on for user identification, has a much lower base of advertisers "contributing" data (10's of thousands vs. Facebook's 2m), a lack of user authentication and far less detailed user profiles. Further, it has agreed to a deal with DoubleClick for attribution, while its wider Google search deal only rolls out in May '15. **Twitter seems to be doing whatever it can to entice fresh users to the platform, with limited success.**

Product Innovation or Desperate Hunt for Engagement? Twitter bought video live-stream start-up Periscope for an estimated $50-$100m even before the product went live (it did the same with Vine, still a stand-alone product) and acquired retargeting-focussed ad-network and Criteo competitor TellApart for $533m worth of Twitter shares at $42.3 each (a 6.5x '15 EV/Sales transaction multiple, similar to Yahoo-BrightRoll and Facebook-LiveRail). **While the former currently much-hyped Periscope lacks a monetisation strategy, we think TellApart could add ~$200m of annual sales (~$80m ex-TAC revenues, applying Criteo's take rate of ~40%), but may lose sales as it shifts from its majority inventory source (Facebook FBX).** It will be interesting to see if Twitter is willing to break out TellApart to show "organic" growth, or use TellApart to stabilise Twitter's faltering DR business (which saw its first-ever sequential decline in absolute sales in 1Q15) as its "prediction engine" brings deeper knowledge of users in terms of likes and shopping history, to help Twitter increase ad load and relevance. **The question remains what Twitter will do with its $3.6bn in gross cash; we fear it could undertake a similar buying spree as Yahoo, which acquired ~70 companies under its new CEO.**

Valuation. We keep our long-term estimates mainly unchanged with sales of $14bn by '23 (as laid out on its Nov. '14 analyst day). Our unchanged $30 target price is based on a DCF model looking out to 2020, using a 49% advertising sales CAGR (47% overall) through '18, or a 40% CAGR overall through '20E, a 9% WACC, as well as a 4% terminal growth rate. We reiterate our Negative rating.

Table 4: Summary Financials, '12-'17E | **Ticker: TWTR** | **Price at 5 May '15: $37.9**
Enterprise Value: $22.1bn | **Target Price: $30 (-21%)** | **DCF Value: $30**

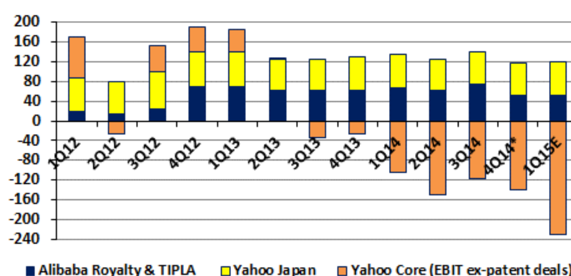
Year to Dec.	Sales	Growth	EBIT	EBIT Margin	Dil. EPS	Non-GAAP Dil. EPS	P/E	Pro Forma P/E	FCF/ Share	FCF Yield
2012	$317m	*198%*	-$77m	*-24%*	-$0.37	-$0.17	n.m.	n.m.	-$0.12	*-0.3%*
2013	$664m	*110%*	-$636m	*-96%*	-$1.90	-$0.10	n.m.	n.m.	-$0.12	*-0.3%*
2014	$1,403m	*111%*	-$539m	*-38%*	-$0.77	$0.14	n.m.	n.m.	-$0.19	*-0.5%*
2015E	$2,223m	*58%*	-$458m	*-21%*	-$0.65	$0.35	n.m.	n.m.	-$0.04	*-0.1%*
2016E	$3,385m	*52%*	-$271m	*-8%*	-$0.41	$0.65	n.m.	58.6x	$0.22	*0.6%*
2017E	$4,832m	*43%*	-$24m	*-1%*	-$0.10	$1.03	n.m.	36.9x	$0.63	*1.7%*

Source: Arete Research estimates.

Yahoo: At a Standstill

That Yahoo reported a weak 1Q15 was no surprise: revenues of $1,226m (up 8% yoy), but down 4% yoy ex-TAC (at $1,043m), while it made a GAAP operating loss of -$87m ($30m in 1Q14). As we highlighted in *Yahoo!: Re-Writing the Script* (Feb. '15), Yahoo is "masking" results by talking about a "return to growth" after ~70 acquisitions under its new CEO. Display grew 2.3% (-6.7% ex-TAC) mainly on incremental revenues coming from BrightRoll with desktop display in further decline, while Search grew 20%, driven by Mozilla traffic, though Search ex-TAC fell -3%, despite blaming a few one-time items for the lack of growth. To reduce costs, Yahoo cut some 2,000 contractors and 3,000 FTEs, closed 80 products and 17 sites (down from 12K to 11.4K staff, despite all the acquisitions), notably retreating in many foreign markets. Yahoo is trying to show top-line growth by any means, but acquisitions and search deals are hurting profitability with higher stock comp (up 8% yoy) and TAC (15% of revs. in 1Q15 vs. 4% a year ago). **We see 1Q15 as one of the worst quarters in years for Yahoo excl. Yahoo Japan income, Alibaba amortisations, and patent license sales. Losses widened to ~$230m.p We see the core of Yahoo living on borrowed time (posting losses for seven consecutive quarters; see Fig. 2).** Irrespective of emotive views on management, there is little doubting the size of the task in turning the ship around, whether from its favoured MaVeNS segments or Search.

Fig. 2: Yahoo "Core" Is Making Losses for the Past Seven Quarters ...



Source: Arete Research. *Excl. Alibaba, YJ, Patent sales.

Mobile Is the New Black. In Display, there was a step-up in ads sold (+29%, vs. weak comps) with the usual price drop (-17% yoy, vs. -15% yoy in 4Q14) as a consequence of the shift towards mobile, which shows some progress as Yahoo is merging Flurry (complementary offering for app developer) with Gemini (Native ads, $250m of sales in FY14 and $110m in 1Q15) creating a self-serve platform for advertisers to sell ads across some 700K apps, having integrated the Flurry SDK as of 1Q15. Yahoo also held its first mobile developer conference (similar to Facebook's f8 or Google I/O). With the acquisition of BrightRoll (for Video advertising), which integrated a lot of Yahoo data, it has now all the products together, but they are me-too offers. Yahoo will has to prove that it can offer the "complete stack", meaning it has to find a way to sell ads against a 600m MAUs mobile audience (we believe that incl. some double-counting across its various products: Mail, News Digest, Finance, Weather, Flickr, Tumblr, etc.). Tumblr got less time, claiming a 474m "monthly audience". **Mobile revenues were up 61% yoy to $234m in 1Q15, balanced by ongoing declines in legacy platforms as ad sales shift to programmatic. Yahoo will have to prove soon that its various MaVeNS offerings (mainly BrightRoll, Tumblr, Flurry, Gemini) can outgrow the decline of legacy display businesses.**

Search: Waiting for Monetisation. Mozilla traffic was the main inflection behind +21% growth in paid clicks and +3% in price per click. Yahoo's market share jumped to 13% in Jan. '14, but is stagnating at best. Overall 20% sales growth (TAC increased from $5m in 4Q14 to $100m in 1Q15) came at a cost, and Yahoo realises market share gains don't equal a monetisation increase. Yahoo also re-negotiated the Microsoft deal terms, giving both more flexibility (non-exclusivity now for Yahoo on mobile and desktop) and Yahoo the chance to invest more into a search offering with credible quality.

Table 5: Mozilla Deal Effective in Dec. '14

	Nov-14	Dec-14	Jan-15	Feb-15	Mar-15
Google Sites	*67.0%*	*65.4%*	*64.4%*	*64.5%*	*64.4%*
Microsoft Sites	*19.6%*	*19.7%*	*19.7%*	*19.8%*	*20.1%*
Yahoo! Sites	***10.2%***	***11.8%***	***13.0%***	***12.8%***	***12.7%***
Ask Network	*2.0%*	*2.0%*	*1.8%*	*1.8%*	*1.8%*
AOL	*1.3%*	*1.2%*	*1.1%*	*1.1%*	*1.1%*
Total	***100%***	***100%***	***100%***	***100%***	***100%***

Source: Arete Research, comScore.

Valuation. While we await SpinCo in 4Q15 (in which Yahoo may also dump additional weak legacy business besides Yahoo Small Business) and a plan for Yahoo Japan, we keep our estimates mainly unchanged, but with Alibaba shares dropping to $81, **we reduce our SoTP target price to $58 from $60.** We reiterate our Positive rating.

Table 6: Summary Financials, '13-'17E | **Ticker: YHOO US** | **Price at 5 May '15: $42**
Enterprise Value: $35.8bn** | **Target Price: $58 (+38%)** | **DCF Value: $23 (ex-stakes)**

Year to Dec.	Sales	Growth	Adj. EBITDA	GAAP Dil. EPS	Non-GAAP Dil. EPS	P/E	Non GAAP P/E	Adj. EV/ EBITDA	FCF Yield
2013	$4,681m	*-6%*	$1,505m	$1.28	$1.45	32.9x	29.0x	23.8x	*1.9%*
2014	$4,618m	*-1%*	$1,273m	$7.49*	$1.55	5.6x	27.1x	28.1x	*1.4%*
2015E	$5,025m	*9%*	$987m	$0.25	$0.70	nm	59.8x	36.2x	*-6.1%*
2016E	$4,939m	*-2%*	$1,563m	$0.77	$1.22	54.8x	34.3x	22.9x	*2.7%*
2017E	$5,107m	*3%*	$1,814m	$0.88	$1.37	47.8x	30.6x	19.7x	*3.3%*

Source: Arete Research estimates. *Incl. Alibaba proceeds. **EV incl. $9bn of net cash, less $3.3bn of tax liabilities.

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Required Disclosures

Company Name: Google (Best Idea Long), Target Price: $675 (YE15)

Valuation Methodology: We value Google on 20x '16E GAAP EPS of $30.64, plus the net cash it held at 1Q15, adjusted for offshore tax.

Investment Risks:
1) Google faces material risks from various regulatory investigations, which in the worst case could force a structural separation of its search and other businesses;
2) Rivals may attack Google's search dominance with deals to buy market share, or encourage customer to use vertical search.
3) Google also faces reputation risk from its tax and privacy policies;
4) Google is exposed to lower ad pricing based on rising levels of digital ad inventory and competes with alternative digital ad platforms and locations;
5) Costs of distributing video or acquiring content for YouTube could rise significantly; advertisers may only slowly shift to digital and mobile and reduce spend on traditional media.

Price Chart

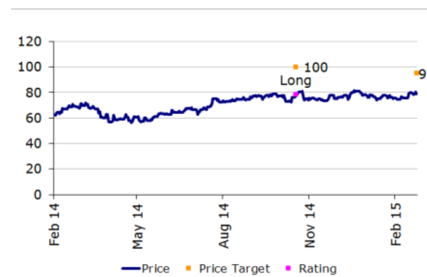
Source: Arete Research.

Company Name: Facebook (Long), Target Price: $95 (YE15)

Valuation Methodology: We value Facebook based on a blend of an 11x 2017E Adj. EV/EBITDA and a DCF (25% sales CAGR until 2021, 8% WACC, 4% terminal growth rate).

Investment Risks:
1) Facebook competes for volatile digital advertising budgets with larger vendors like Google and a range of smaller companies;
2) Without having its own hardware ecosystem Facebook is beholden to the policies of Apple and Google around apps permissions;
3) Facebook is likely to face scrutiny over user data and privacy, especially in the EU where data protection laws are stronger;
4) A high-profile COO may leave in the coming few years, while the company will also likely continue to use its cash flow to acquire more technology assets.

Price Chart



Source: Arete Research.

Company Name: Twitter (Negative), Target Price: $30 (YE15)

Valuation Methodology: With no GAAP earnings basis, and a high level of options issuance distorting non-GAAP numbers, we value Twitter based on a DCF to '20E (40% sales CAGR until 2020, 8% WACC, 4% terminal growth rate).

Investment Risks (to our Negative rating):
1) Twitter could boost user numbers (in the form of rising MAUs) or engagement (offering a new metric to replace timeline views);
2) Twitter needs relatively small increments of sales to "beat" earnings;
3) Twitter could push through meaningful price increases to its timeline views, though this may require limiting ad loads for attractive consumer segments;
4) An investment banker CFO could seek to do a "transformational" deal to smooth over short-term issues and re-focuss investors beyond the near-term stagnation in its sales and user base;
5) An old world media company could be tempted to bid for Twitter to increase its Internet presence.

Price Chart

Source: Arete Research.

Company Name: Yahoo (Positive), Target Price: $58 (YE15)

Valuation Methodology: We assume Yahoo puts half of its initial Alibaba proceeds to a buyback, and then use a blend of 15x GAAP and 10x non-GAAP '16 EPS estimates.

Investment Risks:
1) The SOTP valuation remains heavily reliant on Alibaba's share price, where Arete's price target ($72) remains below the current levels;
2) Excluding income from Asian equity stakes and from selling or licensing assets, Yahoo's core business has been loss-making in the past five quarters as it seeks to develop new products and advertising offerings;
3) Yahoo has many initiatives to "fix" its low-growth display business that relies on management execution, despite extensive executive turnover and reshuffling of roles;
4) Yahoo may be under-investing in its own infrastructure with sharp cuts to capex, a tiny fraction of what Internet peers are investing (as befits a business one-third of the sales of Facebook and 1/12th that of Google);
5) Yahoo's $1.1bn Tumblr deal and its many other acquisitions face a long road to monetisation and multiple integration challenges with its own ad tech stacks.

Price Chart

Source: Arete Research.

Primary Analyst(s) Coverage Group: AOL, ASOS, Alibaba, Apple, Autohome, Baidu, Bitauto, BlackBerry, Criteo, Facebook, Google, HTC, LG Electronics, Nokia, Qihoo, Rocket Fuel, Samsung Electronics, Sony, Technicolor, Tencent, Twitter, Vipshop, Weibo, Yahoo, Zalando.

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