



# Qihoo 360 Technology (NYSE:QIHU)

The Good, The Bad and The Ugly

THE PURPOSE OF THIS REPORT IS TO ENABLE INVESTORS TO GAIN A MORE COMPLETE UNDERSTANDING OF VARIOUS ISSUES REGARDING QIHOO 360 TECHNOLOGY.

A COPY OF THIS REPORT HAS BEEN FORWARDED TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION AND TO QIHOO'S AUDITOR, DELOITTE.



TO: The US Securities and Exchange Commission

ATTENTION: Mary Schapiro, Robert Khuzami, Helaine Schwartz,  
Lisa Deitch, Jonathan Cowen, Avron Elbau

**Deloitte.**

TO: Deloitte Touche Tohmatsu

ATTENTION: Punit Renjen, Joe Echevarria, Richard George,  
Jim Jamison, Wai Chee Loh

# Qihoo 360: Overview

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- Founded in 2005, IPO on NYSE in March 2011
- CEO Hongyi Zhou, former Yahoo! China CEO
- Revenues were originally derived from the sale of internet security products. These products are now given away for free
- Qihoo derives its revenues entirely from advertising and games on its website hao.360.cn
- Google search revenues of \$4.6 million in Q3 2011
- Qihoo reports over 360 million+ active users and an 87% penetration rate among internet security users
- Qihoo newly launched 360 Browser is claimed to have over 50% market share, greater than Microsoft's Internet Explorer
- Current initiatives include Search and Mobile Security which are projected to be monetized in approximately 2 years



# Qihoo: The Good

(The Bull Case)

# The Bull Case: Growth, Growth, Growth

Revenue Growth (\$US Millions)



In only 2 years, revenues have quintupled

User Growth (Millions)



In only 2 years, the user base has tripled



# A China Outperformer

1H 2011 China IPO Performance



Of the China IPO's in 1H 2011, Qihoo is the only stock which remains above IPO price



# An Internet Land Grab

Mobile – “build it and they will come”

- Currently offering mobile security solutions which are provided free
- Some form of monetization has been promised in approximately 2 years

Search

- Currently developing Qihoo Search which is intended to compete directly with search services provided by Google, Baidu, Sohu and others
- Monetization expected in approximately 2 years



Traffic Growth = Future Monetization !!

The diagram features a central blue-bordered box containing the text 'Traffic Growth = Future Monetization !!'. To the left of the box is a large blue arrow pointing right, and to the right is a large blue arrow pointing left, both pointing towards the central box.



# An Internet Land Grab (cont'd)

## Gaming

- Revenue sharing with online gaming partners who advertise on website
- Q3 gaming revenues of over \$12 million
- Gaming ARPU RMB380 per month

## Increasing Ad Rates

25% per quarter (144% growth year over year) ...

vs. peers SOHU and SINA at 20% - 25% year over year



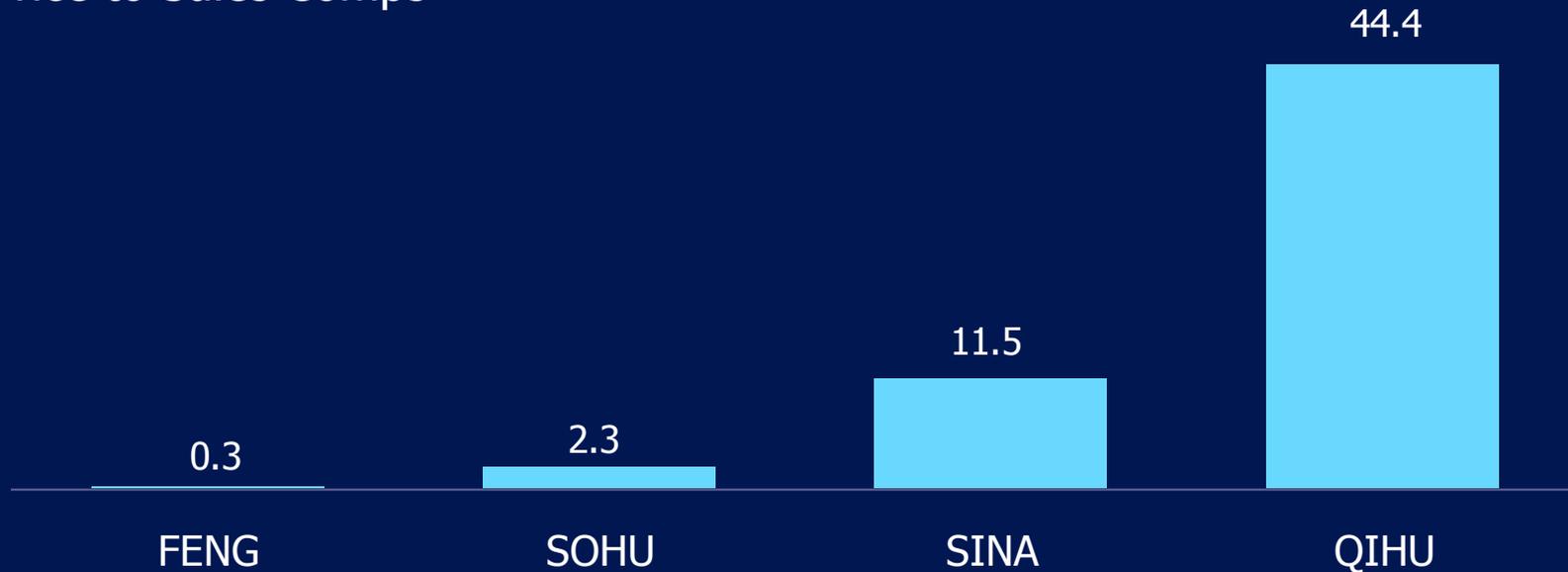


# Qihoo: The Bad

(The Bear Case)

# A Dramatically Overvalued Stock

Price to Sales Comps



Qihoo trades at 44.4x sales vs. SINA and SOHU which trade at 11x and 2x



# A Declining Ad Market

- Warnings from both SINA and SOHU indicate that pricing in the ad market is softening substantially
- Qihoo's web page caters specifically to the least sophisticated internet users (those who rely on a navigation page), the demographic that is least attractive to advertisers
- As a result, advertisers will be unwilling to accept continued price increases which have been greatly in excess of competing sites
- In addition, Qihoo's revenues should be expected to flatten or decline due to a deteriorating market and Qihoo's weak position (due to lack of differentiation)



# A Terminal Business

Commodity / Undifferentiated Product Leads to  
Unsustainable Ad Rates

- Qihoo's only current revenue driver is hao.360.cn, which is identical to multiple of other Chinese web directories, including hao123.com by BIDU
- As a result, the ability to maintain (much less increase) pricing is unsustainable

Increased competition in Chinese internet space from well capitalized competitors



Traffic Growth  $\neq$  Future Monetization !!



# Failure to monetize

- Qihoo has failed to monetize, failed to innovate and failed to build a positive image
- Qihoo's only success has been in giving away software for free
- Failure to monetize existing products
  - Despite generating traffic, Qihoo has dramatically failed at monetizing anything but ad revenues and some gaming revenue sharing
  - Notably, even search revenue from Google has been anemic growing only \$1-2m in 2 years
- Stuck in the imitation phase not the innovation phase – Web page is imitation of existing products — browser is a version of Internet Explorer with an almost identical logo
- Reputational problems — numerous lawsuits, customer complaints, spyware image of product

Innovation? You decide....

Microsoft IE  
Logo



Qihoo Browser  
Logo



# Business Model Not So Unique

Qihoo Asserts Unique Business Model with No Comparables in China or Worldwide

Qihoo PR: “Qihoo 360 is running a very unique business model that is hard to find a close comp in China or globally.”

[online.wsj.com](http://online.wsj.com)

## But how unique is it?

“Freemium” is an extremely well-known, widely used internet strategy.

- The 2009 book “Free”, published by Chris Anderson, editor-and-chief of “Wired” Magazine, extensively covered this model.
- The June 2009 PC World article states that all antivirus technology, including the recently IPO’d AVG Technologies are rapidly going to this model. [pcworld.com](http://pcworld.com)

**So the question is:**

“What is unique about Qihoo’s business model?”



# Monetization is Possible for Others

Qihoo repeatedly states that their “freemium” model can’t be compared to anyone.

Compared to AVG, a leader in global web and computer security:

	<b>AVG</b>	<b>Qihoo</b>
Users	120 Million	330 Million
Referred search Revenue (Google) Annual Run Rate	<b>\$100 Million</b>	<b>\$18 Million</b>
Referred Search Annual Referral Growth Rate	100% +	20% - 25%?
Market Cap	\$735 Million	2.03 Billion

AVG continues to succeed in generating substantial search revenues and continued growth – despite having 1/3 the users that Qihoo has  
Qihoo continues to fail to monetize its user base





# Qihoo: The Ugly

(The Fraud case)

# Is Everyone Else Wrong ?

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Qihoo 360's business story is increasingly isolated in a world of its own fabrications.

To believe Qihoo 360's business disclosures, you have to conclude:

- Baidu is Wrong
- Google is Wrong
- China Construction Bank Securities is Wrong
- Tencent is Wrong
- China's Ministry of Information is Wrong
- Amazon is Wrong
- Alibaba is Wrong



# Is Baidu Wrong ?

About its directory site hao123, which Qihoo's hao.360 is a direct copycat of, Baidu stated on their most recent conference call:

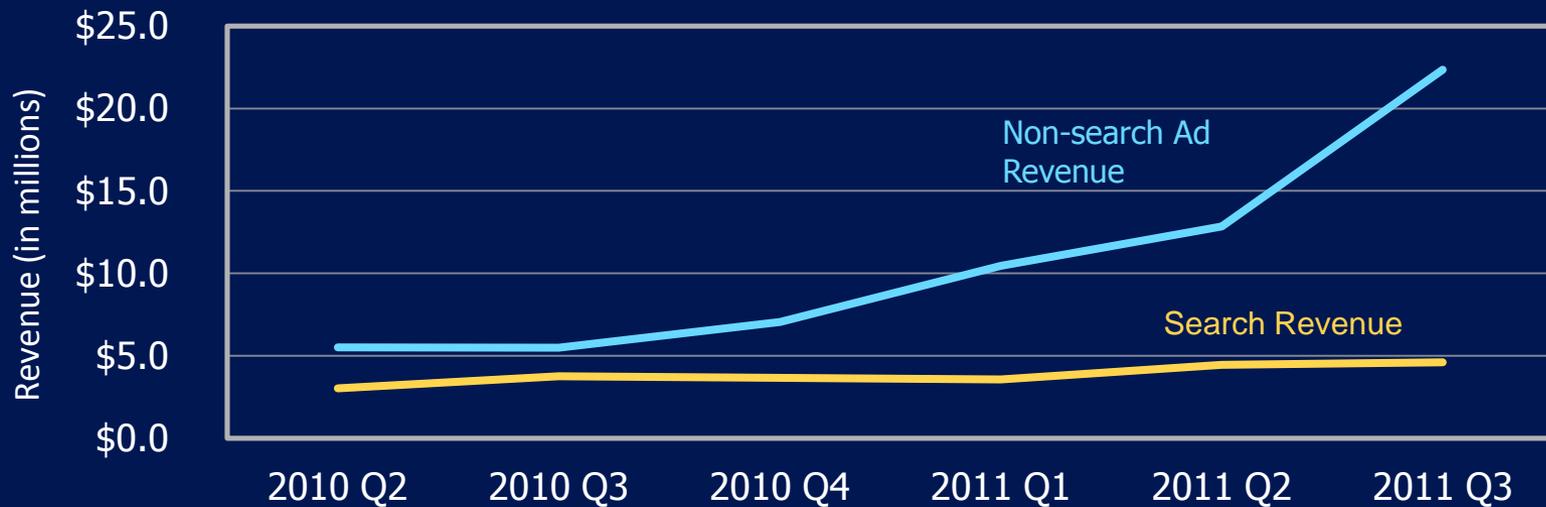
“Hao123, as I mentioned, has been around for a number of years and it does generate some level of monetization for us, but not materially large... we see some cooling off in vertical areas like group buying or classified ads and naturally these players also do a little bit of business on the Hao123 side”

Yet Qihoo's directory generates \$50m per qtr? And its ad rates are growing by over 150% and advertising revenues growing by over 400% year over year?



# Is Google Wrong ?

QIHU Revenue by Segment

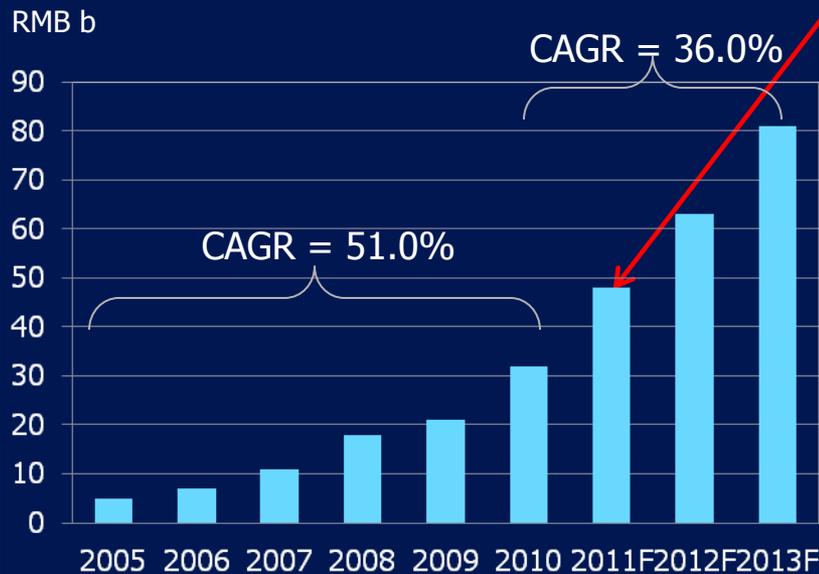


Qihoo reports a nearly flat search referral revenue from Google, yet soaring ad rates revenues ... from the same user traffic!



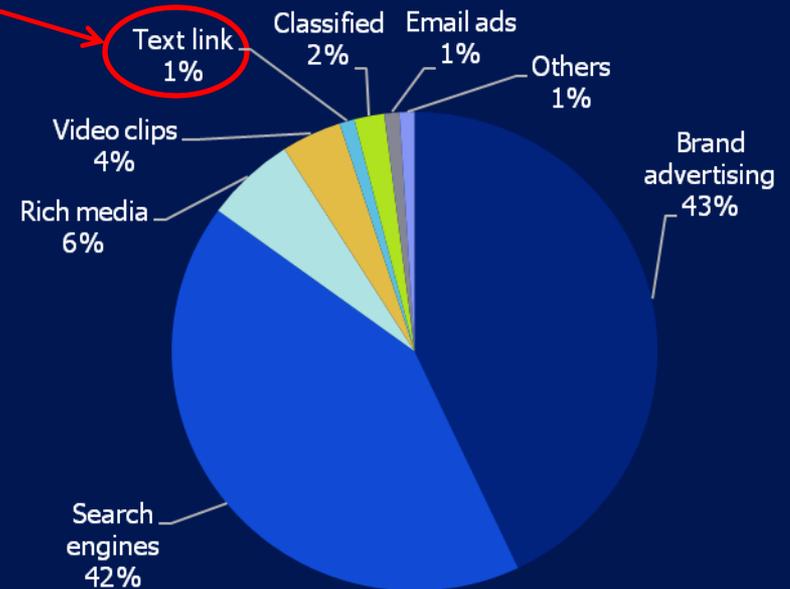
# Is China Construction Bank Securities Wrong ?

## Online Advertising Market Revenue (2005-2013F)



Source; iResearch, CCBIS estimates.

## Breakdown of Online Advertising Revenue (2010)



Source; iResearch, CCBIS estimates.



# Is China Construction Bank Securities Wrong ?

(cont'd)

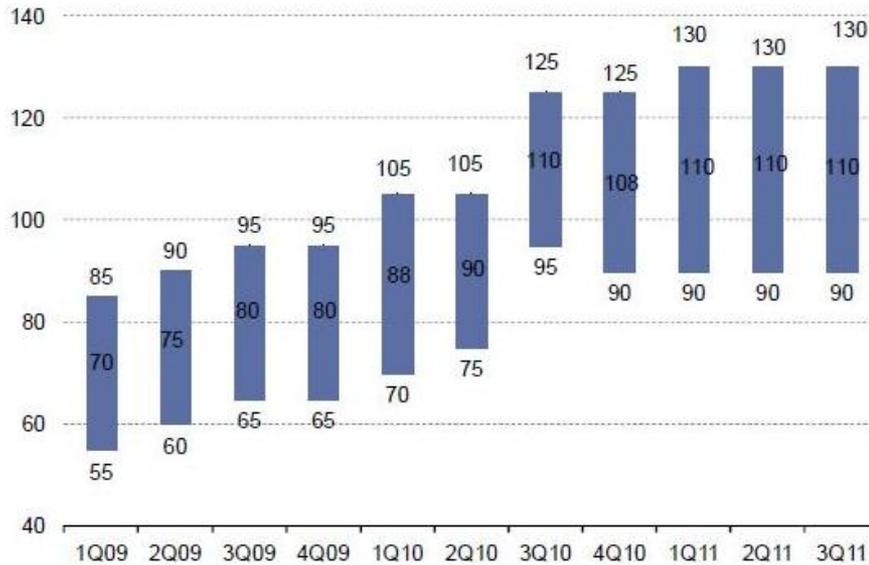
- According to China Construction Bank International Securities and iResearch, internet advertising in China is a 48 Billion RMB marketplace in 2011.
- Of that, approximately 1% is spent on text links (approximately 480m RMB, or \$80m USD).
- There are hundreds of directory sites which directly compete with Qihoo's hao.360.cn for a share of this revenue.
- Yet Qihoo claims to be deriving ad revenue at a run rate in excess of \$110m USD.... All of which is from text links!

Simply impossible!



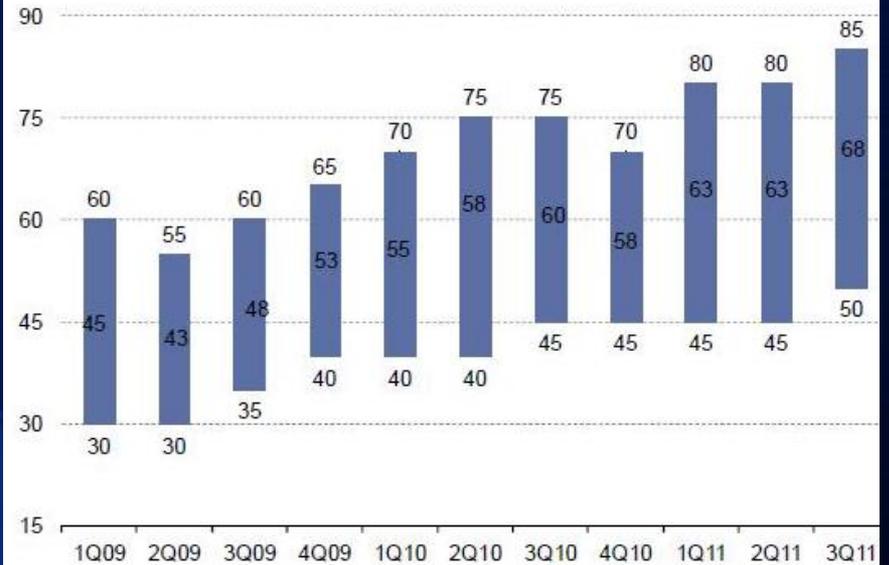
# Is Tencent Wrong ?

**Exhibit 4: Tencent has increased MMO games ARPU**  
Quarterly ARPU range and averages (Rmb)



Source: Company data.

**Exhibit 5: Casual games ARPU have also increased**  
Quarterly ARPU range and averages (Rmb)



Source: Company data.

Goldman Sachs report on Tencent, company data

MMORPG games out-earn web games on ARPU basis  
by nearly 2 to 1



# Is Tencent Wrong ? (cont'd)

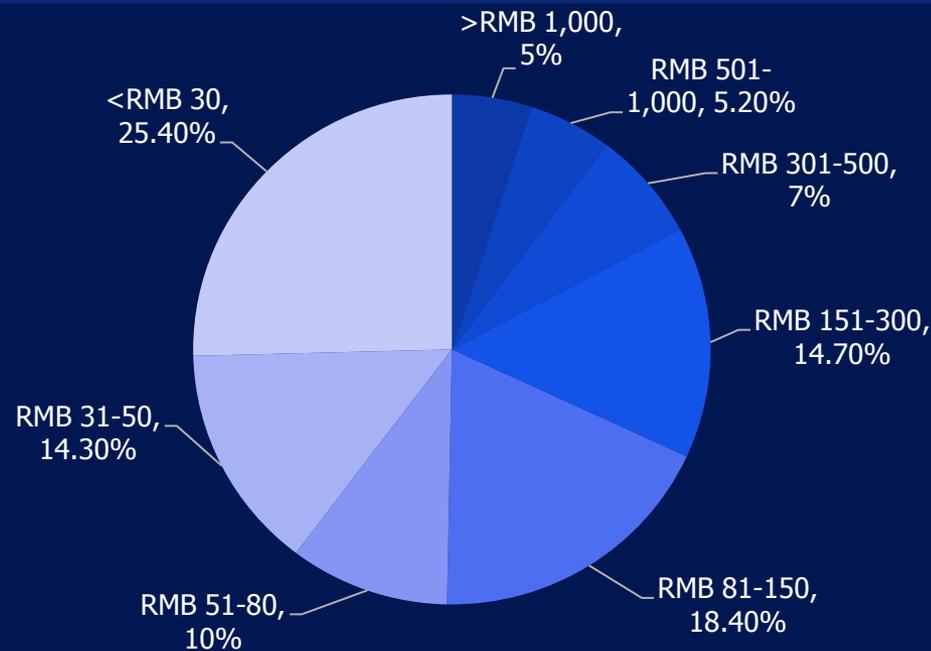
Qihoo explained its outlier ARPU claims for its web games platform as follows:

- “Typically, web games have shorter life cycle and higher ARPU than traditional MMORPG games. Qihoo 360's gaming ARPU is not comparable to that of other publicly listed Chinese gaming companies because almost all of them are focusing mainly on MMORPG games.”

BUT — Tencent, China's dominant games platform, discloses :  
MMORPG games out-earn web games by nearly 2:1  
on ARPU basis



# Is China's Ministry of Information Wrong ?



Source: CNNIC data in CCBIS report.

- The China Ministry of Information's CNNIC claims that only 17% of China's paying game players spend more than RMB 300 a month on games ...
- Yet, Qihoo claims that their stated ARPU of RMB 380 a month is well within the norm of the Chinese gaming market

# Is Amazon Wrong ?

Amazon's Alexa subsidiary ranks 360.cn no higher than the 30th most popular website in China. [www.alexa.com](http://www.alexa.com)

Qihoo explains this by saying:

- "One of the key features of a security product is to erase unnecessary plug-ins that may impact a user's on-line experience. Few of our users have Alexa plug-ins on their computers. Alexa has therefore under-estimated 360.cn's traffic."

Ridiculous — If that was the case than Alexa couldn't measure traffic at any web site in China due to Qihoo's 85% penetration for security products in China.

No other web operator has ever identified this issue as a problem.

The irony is that even Qihoo themselves reference Alexa to qualify their own link exchange partners.



# Is Alibaba Wrong ?



IE  
Outranks  
360  
Browser  
by 2:1  
(54% to  
27%)

[data.cnzz.com](http://data.cnzz.com)

Qihoo claims their browser has the largest market penetration in China:

- “we have a browser that is very popular in China with ... around 57% market penetration”

Alibaba’s subsidiary CNZZ.com reports a completely different reality: Half the usage of IE and flatlining in recent months.



# So who is Wrong ?

- Every attempt to reconcile Qihoo's business metrics with the largest and most credible information sources in the internet space result in gross inconsistencies from Qihoo
- Qihoo does have a significant presence in China with its anti-virus software, web browser and web page hao.360.cn
- There is no doubt does that Qihoo generates some revenues from these sources
- However, the financials as presented are grossly inflated and have a slim chance of passing an audit or avoiding an SEC investigation



# Fraudulent Financials

## Revenue Per Link is Not Credible

- Qihoo claims monthly revenue per link of appx. RMB 325,000 to 350,000, with 130 paid links on its front page
- Advertisers with two links are not paying twice [www.thestreet.com](http://www.thestreet.com)
- Independent channel checks fail to verify more than a small fraction of total revenues

## No transparency in entire commerce chain

- No agencies, no published rates, no media kit, no straight answers from two person sales dept. -- an entire revenue model cloaked in secrecy.

## Related Party Transactions

- Auditor will see numerous advertising and gaming revenue transactions with related parties which are significantly higher than market-comparable rates



# Fraudulent Financials cont'd

## Interviews with Relevant Parties and Competitors

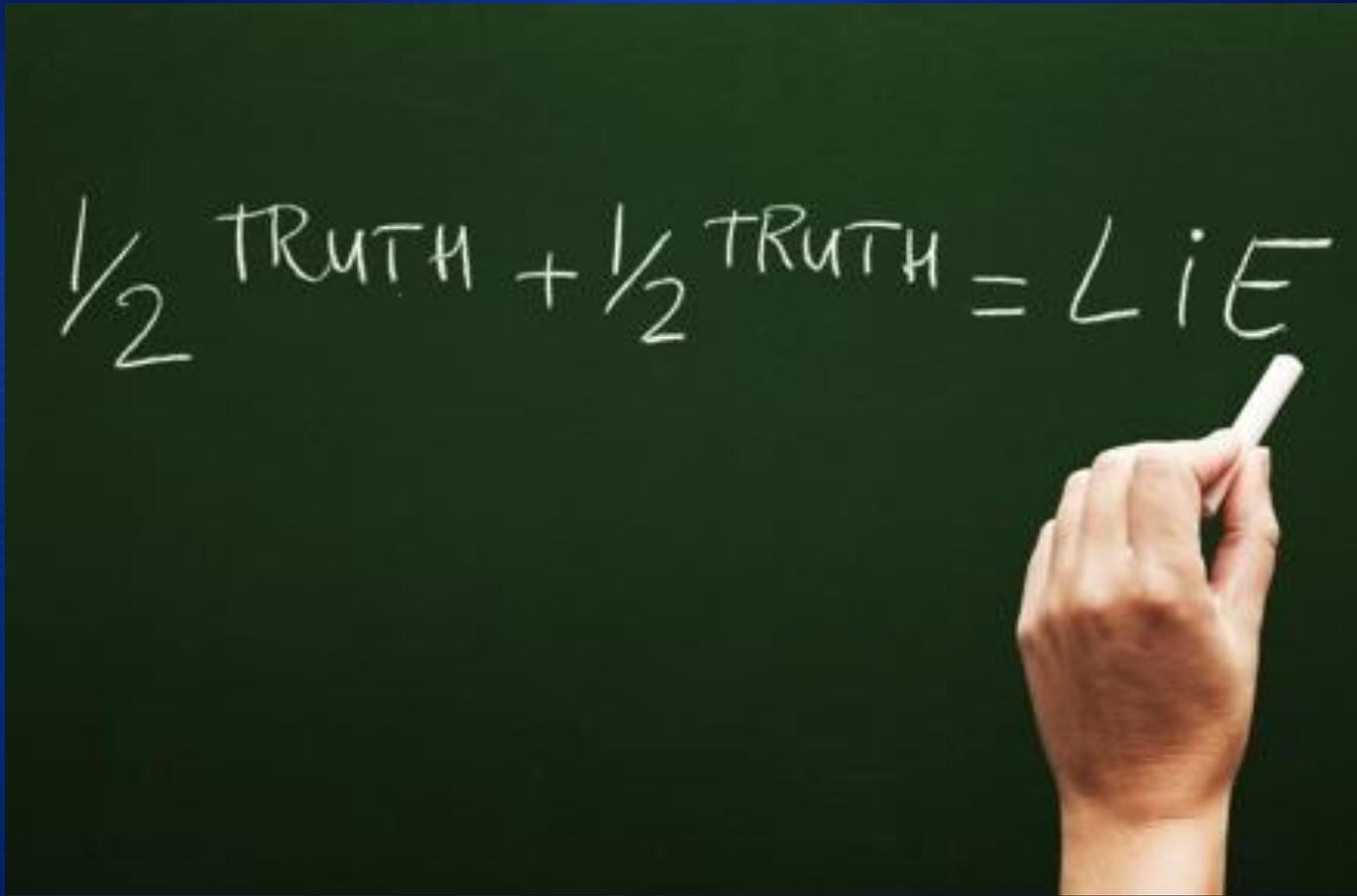
- Direct competitor 2345.com can only sell 40% of their links
- Relevant party interviews at Qihoo reveal “ghost links” and over-reporting of revenues by 40%

## Gaming ARPU Wildly Out of Scale with Publicly Listed Competitors

- Qihoo claims ARPU of RMB 380 per month while similar web games from publicly traded competitors earn less than RMB 100 per month



# So Who is Lying ?



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