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**Qihoo's entry into search puts SOHU in play. How much will the bidder pay?**

**Why the move in QIHU proves that SOHU should be over \$75 a share.**

With the recent move up in QIHU's share price, fueled by the market perception that it has entered into the search business on the Chinese internet, Citron has been bombarded with questions as to our opinion on its recent corporate announcements and events.

We are not going to take this opportunity to analyze Qihu's business in detail yet again. Citron, as well as a chorus of others, have warned the investing public about investing in QIHU. So anyone who buys the stock now should be well aware of its corporate reputation, management track record, and business ethics; most of all its soiled reputation in the Chinese internet business community. But beyond that, we are willing to look at a potential search product with fresh eyes.

And this is what we think.

The speculative move in QIHU is based, at best, on a "soft launch" of a search product with no real infrastructure in place to monetize it. But it does show that dominance in the Chinese internet is still up for grabs. This makes even more compelling the valuation case for SOHU, and forces investors to reconsider that the genuine competitive threat to BIDU is **not** QIHOO 360 – but rather SOHU – at less than half the price.

**It is Citron's opinion that SOHU represents the most compelling investment of any China technology company trading in the U.S.**

It is rare when you can find a company whose **sum-of-the-parts analysis yields a price more than 50% higher** than its current stock price – and that is according to conservative estimates from JP Morgan. This is especially true for companies in a high growth industry, but here is one in plain sight.

In Sohu, Citron sees:

- a growing search engine property
- a dominant video platform
- a monetized mobile wireless strategy
- ownership interest in one of the largest publicly traded internet games publishers in China
- and a war chest of cash

**SOHU is right now what QIHU wants to be in 2 years.**

**“You're not going to be a SOHU — they have way too long of a lead time and diversification in their business -- that makes you a minnow in their ocean”**

*-- Bernie Lo, anchor of CNBC Asia, interviewing QIHU CFO Alex Xu*



So lets see how SOHU stacks up to QIHU -- and yes, we will include a comparison of search.

(in millions, USD or as stated)	SOHU	QIHU
Revenues MRQ	256.0	72.8
Search Revenue MRQ	30.0	0.0
2013 Search Revenue Estimate *** SOHU by JPM, QIHU by Stifel	157.0	100.0
Mobile Revenue	15.6	0.0
Games ARPU **	\$14.65	** \$63.50
		** Needs a serious reality check
History of filings	12 consecutive years 10-K's without auditor warnings	1 year's 10-K with an auditors warning

## But what about web traffic?

For those of you who believe QIHU has more traffic than Sohu, we refer to a report from **this week's** iResearch weekly showing that the SOHU portal has 40% more traffic than the QIHU directory / navigation page:

<b>Company</b>	<b>Category</b>	<b>Weekly UVs(M)</b>
Tencent	Portal	281.02
Baidu	Search	269.91
Sina	Portal	203.84
<b>SOHU</b>	<b>Portal</b>	<b>185.28</b>
NetEase	Portal	137.61
<b>Qihoo 360</b>	<b>Navigation</b>	<b>131.01</b>
Youku	Online Video	126.31
Renren	SNS	60.17
Ctrip	Online Travel	7.06
58.com	Classified Ads	30.87
360buy	E-commerce	17.72
Lashou	Group Buying	8.21
Vancl	E-commerce	4.16
Qunar	Online Travel	10.67

Needless to say, the investing public can also validate SOHU's web traffic statistics in Alexa and Comscore. Using any metric or methodology of your choice, you can confirm SOHU's portal traffic and SOGOU's search penetration.

## What is SOHU worth today and in 12 months?

The following table summarizes a sum-of-the-parts analysis based upon data in a credible analyst report from JP Morgan, adjusted for a few subsequent changes:

What SOHU is worth today:

<b>(million USD)</b>	<b>JPM Sum of parts</b>	<b>JPM Comments</b>
Cash	640	Includes SOHU's portion of Changyou's cash, some of which was distributed via \$201m special cash dividend last week.
Portal – "Branded ads"	650	(Somehow this is low compared to SINA and Soufun – midpoint of 10x and 15x multiple
Online Video	200	(Very low by any comparative measure)
Games	705	(Changyou, based on midpoint of 3x to 5x multiple
Search	250	JPM quotes 216m based on SOHU 63% ownership. Actual ownership is now 73%.
<b>Total</b>	<b>2,445</b>	
Shares Outstanding	38.01	
<b>Implied Price per share</b>	<b>64.32</b>	Per ADS

Now we need to re-evaluate the Sum-of-the-Parts for these two important new considerations:

- How does Qihoo's entry into search change the value of Sogou.com?
- How does the Yoku/Tudo merger change the value of Sohu's video platform?

## 🟡 Sohu's search business compared to Qihoo 360: Mature and Proven vs. the Unknown

(For those unfamiliar with the product, Sogou.com is a popular Pinyin search engine in China. It is 73% owned by SOHU.) <http://en.wikipedia.org/wiki/PinYin>

Why Pinyin matters: Sogou Pinyin is software that allows users to type Chinese characters using a standard QWERTY keyboard. It is the most widely used software in China with over 83.6% penetration rate.

[http://en.wikipedia.org/wiki/Sogou\\_Pinyin](http://en.wikipedia.org/wiki/Sogou_Pinyin)

Sogou's entire search methodology is based on PinYin, and it indexes over 10 billion web pages. It has earned its penetration rates in China by careful and methodical incremental development over the last six years. Its search business has been 100% home-grown, and it continues to gain market share against Baidu because it fulfills a legitimate market need.

In fact, in 2007, Sogou threatened to sue Google over an infringement claim – Google's Pinyin dictionary contained Sogou's employee names. (oops!) Google quickly issued a new Pinyin database.

Now let's consider the value the market bestowed on search, based on QIHU's share price increase since it announced its entry into the search business.

QIHU is up appx 7 points since breaking the story it was starting to demo its own search results. (As commented above, this demo is a long and expensive journey away from a real search business, but setting aside the market's over-enthusiasm for a moment...)

How do we compare the market's valuation of Qihoo 360's search to Sogou?

It must be noted that profitability in internet search **is not as easy as turning on a switch:**

**“We think this will be difficult for QIHU, as the company does not have any experience with large sales teams and distributor channel management. It took Sogou almost 5 years to become profitable on its search business.”.**

*-- Wedge Partners, bullish on Qihoo*

“SOHU: Sogou continues to focus on Technology. In the 1H12 company recruited a few hundred more engineers to R&D team (now 82% of total head count). “

*-- JP Morgan comments, earlier this year.*

Sohu has accomplished its heavy investments in search technology, and has already turned the corner to profitability, while Qihoo is just embarking down this road.

The reality is that as a business, search requires significant infrastructure, including semi-automated ad receipt systems, a bid system for keywords, real-time results reporting technology for customers, for and an enormous and well-trained staff for sales and customer service.

It should be noted that while Qihoo search is still in "demo" mode, Sogou has launched over 25 updated versions of Sogou since beta over the last six years, and is still consistently improving its technology. This is the only course of action for a true competitor in the search business.

“If the company manages to successfully build up its own sales team and distributor network in the next 2-3 years, its monetization ability should be comparable to, or slightly better than, Sogou.com.”“

*-- Wedge Partners, bullish on Qihoo.*

There are many reasons to value Sogou's search asset **far higher** than Qihoo's:

	<b>SOHU (Sogou.com)</b>	<b>Qihoo 360 search</b>
Technology and competitive position	Truly innovative Pinyin search engine, doesn't compete directly with Baidu	Technology unknown, possible legal challenges from Baidu due to a history of competitive conflict
Market share	Gaining from Baidu due to its popularity with China internet users	Absence of independent measurement of Qihoo's market reach or penetration
Product maturity	Polished and incrementally improved product, evolved through numerous versions over six years	Demo only. Brand new.
Transparency in internet metrics	Comscore and Alexa confirm Sohu's competitive position	Qihoo relies only on iResearch for its reach and penetration disclosures
Current Revenue	Current revenue run rate \$30 million USD per quarter	Non-monetizing at this time.
Capex	Existing product is paid for – company investing in more improvements	Technology platform not yet established, costs to be expensed in the future
Expense model	In current operations	No significant expenses yet for sales and customer relations teams
Analyst estimated Revenue	\$157 million USD for FY 2013	\$100 million USD for FY 2013
Impacts to company's current revenue model	None	Displaces 4.5 m USD revenue per quarter from Google search referral

Investors are free to apply either a discount or a premium to Sogou.com's search business compared to Qihoo's search....demo.

But if we take a conservative approach and assume despite the above comparison that Sogou.com is **merely of equal value** to the increment the market has given Qihoo search after just its first four days of operation, the sum-of-the-parts should be increased by \$9.07, **to \$73.39**. [Sensitivity Analysis for Search Business Value \(Sogou.com\)](#)

## 🟡 Sohu's video business vs Youku/TUDO

Sohu has a credible video business. The numbers below document its #2 position in China's internet video market.

<b>SOHU Competitive Analysis for Video</b>				% SOHU > TUDO
<b>Video Websites -- Unique Visitors</b>	<b>April-12</b>	<b>May-12</b>	<b>June-12</b>	
YOUKU.com	106,981	102,592	107,822	
<b>SOHU.com</b>	<b>83,530</b>	<b>89,732</b>	<b>94,600</b>	<b>11.97%</b>
Tudou Sites	96,009	80,186	84,486	
QQ.com Video	83,123	80,228	58,904	
SINA Video	46,955	48,746	55,359	
QIYI.com	45,949	42,642	49,709	
<b>Video Websites -- Average Daily Visitors</b>	<b>April-12</b>	<b>May-12</b>	<b>June-12</b>	
YOUKU.com	14,102	12,619	13,316	
<b>SOHU.com</b>	<b>10,027</b>	<b>10,848</b>	<b>11,310</b>	<b>25.57%</b>
Tudou Sites	11,847	8,742	9,007	
QQ.com Video	10,130	9,390	6,326	
SINA Video	4,504	4,629	5,430	
QIYI.com	5,314	4,440	5,101	
<b>Video Websites -- Total Minutes</b>	<b>April-12</b>	<b>May-12</b>	<b>June-12</b>	
YOUKU.com	2,028	1,913	2,159	
<b>SOHU.com</b>	<b>1,526</b>	<b>2,105</b>	<b>2,116</b>	<b>14.01%</b>
Tudou Sites	1,709	1,676	1,856	
QQ.com Video	575	602	682	
QIYI.com	895	714	603	
56.com	347	404	425	
<b>Video Websites -- Total Page Views</b>	<b>April-12</b>	<b>May-12</b>	<b>June-12</b>	
YOUKU.com	2,513	2,449	2,089	
<b>SOHU.com</b>	<b>1,194</b>	<b>1,461</b>	<b>1,634</b>	<b>18.23%</b>
Tudou Sites	1,931	1,735	1,382	
QQ.com Video	926	884	829	
QIYI.com	691	592	642	
CNTV.com	504	315	523	

\* Source JP Morgan analyst .

Youku and Todou

In March 2012, [Youku acquired Tudou](#), creating China's "biggest online video company". Unlike most mergers, this one actually caused the shares in both issuers to rise. Clearly the market regarded the news as highly bullish for the sector. This merger was [approved by shareholders this week](#). TUDO shareholders get 1.595 shares of YOKU for each share of TUDO.

Here is the merger valuation math:

Conversion rate (YOKU for TUDO ADS's	1.595
Current YOKU Price per ADS	17.75
TUDO ADS's outstanding	28.9
TUDO valuation (millions, USD)	818.2
TUDO cash and receivables (millions, USD)	139.0
TUDO enterprise value (millions, USD)	<b>679.2</b>

Citron notes that in all four of the above metrics, SOHU outranks TUDO by 10% to 20%. So isn't SOHU now worth more than the \$200 million valuation pegged by JP Morgan's sum-of-the-parts? How much more?

Again, to remain conservative, we've assumed a valuation of SOHU's video **matching** TUDO (even though it significantly beats TUDO in all usage metrics):

With that equivalency, the sum-of-the-parts would increase by \$12.61, **to \$76.93**. [Sensitivity Analysis for Video Business Value](#)

## Sum-of-the-parts summary and conclusion:

And if you add the incremental valuations **for both search and video** to the sum-of-the-parts analysis, (10.80 for search and 12.61 for video) **you get \$86.00**.

## Innovator vs. Imitator

Beijing News reported yesterday that BIDU is having Qihu's new search function investigated to see if it is "stealing" queries.

<http://www.bjnews.com.cn/finance/2012/08/23/218366.html>

This would not be the first legal tangle between the two companies. In a prior legal settlement with BIDU, Qihu consented not to "hijack" Bidu search requests or present Bidu's search results as its own. This comes on top of a debacle last month where Qihu was accused widely in the Chinese press of faking a Microsoft security patch in order to trick users into installing Qihoo's software.

<http://www.eeo.com.cn/ens/2012/0820/232209.shtml>

Compared to this debacle, Sohu is in exactly the opposite situation – having successfully defended its Pinyin database from Google's infringement. In 2007, Google, yes the mighty Google, admitted to infringing on Sogou technology while trying to develop a Pinyin based search.

[http://en.wikipedia.org/wiki/Google\\_Pinyin#Copyright\\_infringement\\_allegations](http://en.wikipedia.org/wiki/Google_Pinyin#Copyright_infringement_allegations)

## Sogou Is the Real Competitive Threat to BIDU

What makes the Sogou search product unique is that it does not compete head-to-head with Baidu. Designed around a PinYin-based search, a phonetic homonym system which is much easier for many tens of millions of Chinese to type spontaneous searches with. Therefore, they do not have to compete on Baidu's turf and beat them at their own game. Sogou can actually maintain its own unique identity and continue to win significant market share – they already have demonstrated their track record in doing so. **This was actually acknowledged by BIDU, when they met with Sogou's management to explore a takeover earlier this year, thereby acknowledging the competitive threat.**

<http://www.techinasia.com/baidu-sogou-buyout-rumor/>

<http://roll.sohu.com/20120607/n344995505.shtml>

## Future catalysts for SOHU:

SOHU is easily worth \$75 today but any of these catalysts could take the stock higher in short term.

- The IPO of 7Road, which has already been announced by Changyou
- The potential IPO of SOGOU, which we believe, is probable in order to retain key employees
- Management buyout of SOHU, which would be an easy deal considering the 20% management stake and its strong cash position.
- Most likely a buyout by a strategic partner in order to own a viable competitor to Sina, Baidu, and Yoku. This could be a player in search and/or video. In that scenario SOHU could easily fetch over \$80 a share. The buyer could easily be Tencent or Baidu

So giving Qihoo its fair consideration, if it fires on all cylinders and executes according to its analysts models, it can be worth \$30 in 2 years, or you can buy

Sohu, whose business is conservatively valued at \$65, without any takeover premium ... your choice.

So take your choice: Questionable management for a highly future-loaded \$3 billion valuation, or buy a mature internet competitor with diversified, quantifiable business streams, and a 12 year track record of filing SEC-10-K's for \$200 million plus cash and securities. Really it's no choice at all.

## Conclusion

 Is this a new, kinder and gentler Citron? ... Nah. 

The most recent move in Qihoo simply highlights how undervalued SOHU is. Maybe Sohu's management is just too conscientious – they don't know how to spin a wildly exaggerated promotional story for the markets. We really don't care because long term, good products that are vertically integrated in the Chinese internet space will be the winners, Citron commentary notwithstanding.

 Cautious investing to all.