

Upgrading to Buy 2 based on Five Near-Term Positive Factors

■ Five near-term positive factors

The five key reasons for our upgrade are: 1) valuation, 2) branded advertising strength, 3) search monetization potential, 4) 1Q "beat and raise" track record, and 5) partnership potential.

■ Longer-term concerns remain

Longer term, we still have several concerns about Yahoo's strategy and competitive position. Among our primary concerns are: 1) Search share, 2) Yahoo Media strategy and execution (three types of content), 3) International trends, and 4) Search partner quality.

■ Still pitfalls, but near-term upside potential greater than downside

The bottom line is that, despite some longer-term issues, we think weak industry sentiment combined with some valid company specific concerns have pushed the stock lower than is justified. We believe the near-term positives outweigh the near-term risks. In the note, we discuss these positives and negatives in more detail.

■ Valuation: Buy 2 and \$39 12-Month PT

Target is based on a triangulation of relative metrics and our DCF. It implies approximately 20x our '07 EV/EBITDA estimate.

Highlights (US\$m)	12/04	12/05	12/06E	12/07E	12/08E
Revenues	2,590	3,696	4,780	5,828	-
EBIT	679	1,108	990	1,290	-
Net income (UBS)	510	848	710	891	-
EPS (UBS, US\$)	0.35	0.57	0.46	0.59	-
Net DPS (UBS, US\$)	0.00	0.00	0.00	0.00	-
Profitability & Valuation	5-yr hist. av.	12/05	12/06E	12/07E	12/08E
EBIT margin %	-	30.0	20.7	22.1	-
ROIC (EBIT) %	-	33.1	28.5	42.6	-
EV/EBITDA x	-	23.6	15.3	12.0	-
PE (UBS) x	-	62.1	66.5	51.8	-
Net dividend yield %	-	0.0	0.0	0.0	-

Source: Company accounts, Thomson Financial, UBS estimates. UBS adjusted EPS is stated before goodwill-related charges and other adjustments for abnormal and economic items at the analysts' judgement.

Valuations: based on an average share price that year, (E): based on a share price of US\$30.75 on 22 Mar 2006 19:41 EST

Benjamin A. Schachter

Analyst

ben.schachter@ubs.com

+1-212-713 9310

Global Equity Research

Americas

Internet Services

Rating **Buy 2**
Prior: Neutral 2

Price target US\$39.00
Unchanged

Price US\$30.75

RIC: YHOO.O BBG: YHOO US

23 March 2006

Trading data

52-wk. range	US\$43.42-30.07
Market cap.	US\$41.4bn
Shares o/s	1,347m
Free float	60%
Avg. daily volume ('000)	24,939
Avg. daily value (US\$m)	864.2

Balance sheet data 12/06E

Shareholders' equity	US\$8.29bn
P/BV (UBS)	5.0x
Net cash (debt)	US\$2.94bn

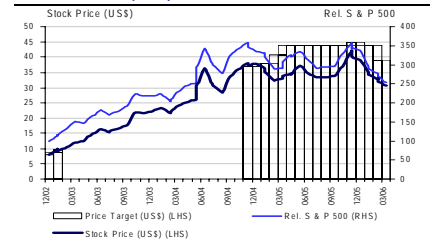
Forecast returns

Forecast price appreciation	+26.8%
Forecast dividend yield	0.0%
Forecast stock return	+26.8%
Market return assumption	9.7%
Forecast excess return	+17.1%

EPS (UBS, US\$)

	12/06E		12/05	12/08E
	From	To	Cons.	Actual
Q1E	-	0.09	0.11	0.13
Q2E	-	0.11	0.12	0.13
Q3E	-	0.11	0.13	0.15
Q4E	-	0.14	0.17	0.16
12/06E	-	0.46	0.54	-
12/07E	-	0.59	0.73	-

Performance (US\$)



Source: UBS

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ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 6

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The Bottom Line

We do not recommend shares of a company simply because we think they look cheap. While it is certainly true that based on historical EV/EBITDA multiples, Yahoo is trading at the low end of its range, and thus valuation is among the catalysts we see, we also see other significant catalysts as well: strength in branded advertising, search monetization improvements, and a solid 1Q “beat and raise” track record. While many of our longer-term strategic concerns remain, we simply believe the near-term positives outweigh the near-term risks. Below we go through our positives and negatives in more detail.

Investment positives

- (1) **Valuation** – We do not think this is a valuation trap. Often stocks look cheap because estimates are trending down; we do not think that is the case here. While we do have some longer-term concerns (which we outline below), we generally expect branded advertising to provide strength and visibility when 1Q06 numbers are released on April 18th. At about 14x EV/'07E EBITDA (exl. Stock), the stock is currently trading at a multi-year low valuation. While it does appear more expensive at about 40x both '07E P/E and P/FCF (fully taxed), both of these multiples are also near multi-year lows. Finally, we note that if we include stock comp charges, Yahoo is actually trading at less than 12x EV/'07E EBITDA. The bottom line is that as we move towards '07, we expect investors to give Yahoo credit for growing EBITDA 25%-30%. This should help the company bounce off these recent lows.
- (2) **Branded Strength** – We continue to believe that large companies are actively shifting more advertising dollars online. We expect total U.S. online advertising to grow 25%-30% for the foreseeable future. In our view, at the boardroom level, decisions have been made to shift a meaningful percentage of ad spend online. However, when it gets down to the operational level, it can be difficult to spend those dollars efficiently. Often there is limited quality inventory available, but we think that Yahoo offers advertisers one of the most attractive and professional sales channels available online. This should allow it to continue to gain share and grow its branded business faster than the overall market. Additionally, while search has received much attention over the past year, we continue to point out that it is difficult to efficiently spend very large sums on search. You just cannot force a user to search for a particular term. Yahoo offers many non-search advertising options to the advertisers that still want to spend online.
- (3) **Search monetization potential** – Two issues here: 1) we think the monetization efforts will work; and 2) we think the stock will react positively before they execute on it. On the first part, we expect the company to refocus its sponsored search on relevancy. While this will not directly copy Google's methodology, it should have similar elements and

results (i.e., better relevancy, and thus, higher click-through-rates). We think the company is on track with its plan, and expect to see its rollout in 2H06. Our second point is that, as long as the company states during its 1Q earnings call that monetization improvement efforts are tracking according to plan, the stock should react positively – i.e., the stock should move before the monetization efforts truly have to show results. One bit of caution, while we think the monetization efforts will work to improve click-throughs and relevancy, this may not directly lead to usage share gains or even share stabilization.

- (4) **1Q track record** – Yahoo has “beat and raised” estimates after 1Q each of the past three years, and the stock has responded accordingly (see Table 1 below). While we are not necessarily pounding the table on 1Q results, we do see it as in line or better. Importantly, we also think that given strength in branded advertising, Yahoo will likely have increased visibility into full year guidance versus previous 1Q results. This should allow it to confidently increase guidance. Various industry contacts have indicated that advertising campaigns are being planned and purchased earlier on in the year.

Table 1: Historical Yahoo 1Q Earnings and Post Earnings Stock Performance

Reported Quarter	Actual EPS	Consensus	Surprise Amount	Stock % Chg day after earnings	Stock % Chg week after earnings	Guidance
Mar-05	\$0.13	\$0.11	\$0.02	4%	5%	Raised guidance
Mar-04	\$0.07	\$0.05	\$0.02	16%	13%	Raised guidance
Mar-03	\$0.04	\$0.03	\$0.01	6%	8%	Raised guidance

Source: FactSet

Table 2: Historical Yahoo Guidance, Pre and Post 1Q

	2003		2004		2005		2006
	Pre-Q1	Post-Q1	Pre-Q1	Post-Q1	Pre-Q1	Post-Q1	Pre-Q1
Rev (ex-tac)	\$1,145-1,215	\$1,220-1,280	\$2,120-2,250	\$2,405-2,520	\$3,365-3,565	\$3,565-3,715	\$4,600-4,850
OIBDA	--	--	\$710-800	\$890-970	\$1,390-1,490	\$1,500-1,575	\$1,915-2,055

Source: Company reports

- (5) **Partnership potential** – We have written previously that we think Yahoo and Microsoft could form some sort of partnership to more effectively contest the European search market, given our belief that Google is continuing to dominate the search market in Europe in particular. We tend to think that Microsoft is likely to give its new AdCenter and Vista time to make gains versus Google, Yahoo, and others, but if those efforts fail, we think a form of Yahoo/Microsoft partnership in this area could make sense. Combining their search efforts would clearly bring gains in terms of increasing share versus Google. Additionally, MSN and Yahoo both provide excellent branding opportunities, and combining efforts could certainly lead to efficiencies for advertisers across the networks. Also, the

engineering talent and infrastructure of a partnership might counter Google's strengths more effectively. Finally, internationally (and in Europe in particular) we think a combined effort would be more effective in chipping away Google's share.

Investment Negatives

- (1) **Search share** – Nothing new here, but Yahoo's search share has been declining. In fact, Google is taking share from all major engines. We think the monetization efforts will work to help increase revenue per search, but in order for it to really help overall numbers, we think Yahoo needs to at least stabilize the share loss.

Table 3: U.S. Search Share (by volume of searches)

	Q1:05	Q2:05	Q3:05	Q:405
Google	51.9%	56.5%	57.3%	60.0%
Yahoo!	24.9%	22.5%	21.4%	20.5%
MSN	12.5%	11.1%	11.4%	10.0%
Time Warner	5.1%	5.3%	5.1%	4.9%
Ask Jeeves	5.6%	4.6%	4.8%	4.6%

Source: ComScore, UBS estimates

- (2) **Yahoo Media strategy and execution (three types of content)** – Yahoo often discusses three types of content: Yahoo generated, partner generated, and user generated. Each of these concerns us. With Yahoo generated content, initial efforts – while interesting – have not done much to really move the revenue needle, in our opinion. Examples such as personal finance writers, Kevin Sites, and others are interesting, but we don't think they have the scale to be meaningful. On partner generated content, we would intuitively think that this is where Yahoo, and in particular, Terry Semel's strengths would lie. We would have expected many more and larger content partnerships to have been announced by now. A part of the disappointing results from both Yahoo and partnership generated content is the confusion regarding Lloyd Braun's efforts, in our view. Finally, we are concerned that the MySpace and Facebook generation is not looking to Yahoo as a provider of choice in user generated content. All three of these areas remain concerns for user generated content.
- (3) **International trends** – International growth has been disappointing. The numbers tell the story. From 1Q05-4Q05 the percentage of revenue from international has remained flat at about 25%. We are most concerned about the lack of a clear strategy for share gains in Europe. The bottom line here

is that we are not optimistic that Yahoo can right the ship in Europe. In our opinion, it will need to partner with Microsoft in order to compete effectively against Google throughout most of the major European countries. However, we continue to believe that the investment strategy in Yahoo Japan and with Alibaba is appropriate, though underappreciated by The Street.

- (4) **Search partner quality** – We remain concerned over the quality of traffic from some of Yahoo’s search partners. Anecdotally, we tend to see Overture more often than Google syndication on sites where we question either the traffic quality or the appropriateness of content, or both. This includes certain domain parking sites that, while legal, seem like a grey area to us in terms of quality. Additionally, we refer investors to the work done at benedelman.org, which highlights specific examples of questionable activity linked to Yahoo keyword ads. We would like to see Yahoo supply more data on who is in its partner network and make efforts to clear up this issue.

Still Neutral on Google

While this is not a Google note, we thought it appropriate to update investors on where we are on Google. Given that we are upgrading Yahoo, a fair question to ask is, why not upgrade Google? Our basic position on Google has not changed much. Our call is that we currently have lower confidence in our and The Street’s collective ability to accurately estimate revenue, and that we tend to think that consensus operating expense estimates remain low (in part because of concern over near-term costs from Dell and other distribution arrangements). The bottom line is that we remain positive on the long-term future of Google, driven by innovation and its infrastructure and talent. In the near-term, we simply think there is not enough visibility into top-line growth for us to recommend the shares with any conviction. We continue to believe that until the Dell deal is struck and announced, there is risk that it will surprise investors.

■ **Yahoo Inc.**

Yahoo was started as a hobby by two Stanford Ph.D students, David Filo and Jerry Yang, in 1994. It quickly became a major venue for finding information on the Web. Today, the company offers services and tools for individuals and businesses throughout the world. It has over 7,000 employees and over 325 million unique users. It serves more than 2.7 billion pages per day, making it the number-one destination on the Web.

■ **Statement of Risk**

Yahoo and Google generate the majority of their revenue from online advertising. Online advertising is a relatively new industry. There is risk that the industry could fail to grow for a variety of reasons. Yahoo and Google's businesses could suffer if the online advertising industry were to become depressed.

Yahoo and Google face significant competition from a large number of other companies, including Microsoft. They also face competition from smaller start-ups that are developing new competing technologies. Yahoo and Google's share of online advertising dollars could fall because of this competition. Additionally, various legal issues remain concerns that will not likely be decided for many years.

■ **Analyst Certification**

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UBS rating	Definition	UBS rating	Definition	Rating category	Coverage ¹	IB services ²
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	Buy 2	FSR is > 10% above the MRA, lower degree of predictability	Buy	40%	35%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	Neutral 2	FSR is between -10% and 10% of the MRA, lower degree of predictability	Hold/Neutral	50%	31%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	Reduce 2	FSR is > 10% below the MRA, lower degree of predictability	Sell	11%	30%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 December 2005.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

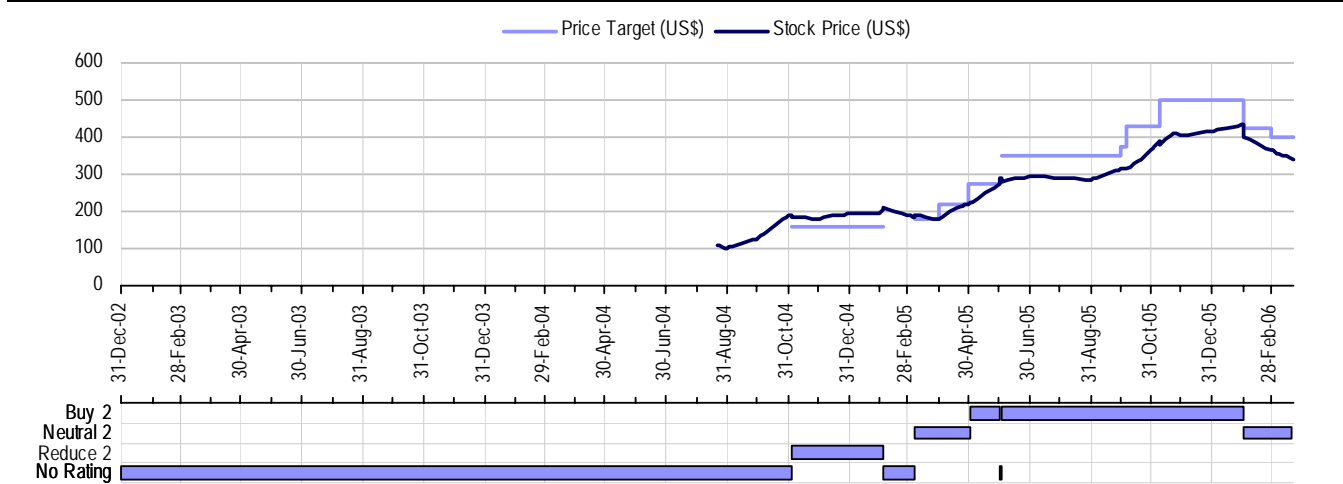
Company Name	Reuters	Rating	Price	Price date/time
Google Inc. ^{2,4,6b,18}	GOOG.O	Neutral 2	US\$340.22	22 Mar 2006 19:55 EST
Yahoo Inc. ^{6a,7,18}	YHOO.O	Neutral 2	US\$30.75	22 Mar 2006 19:55 EST

Source: UBS. EST: Eastern standard time.

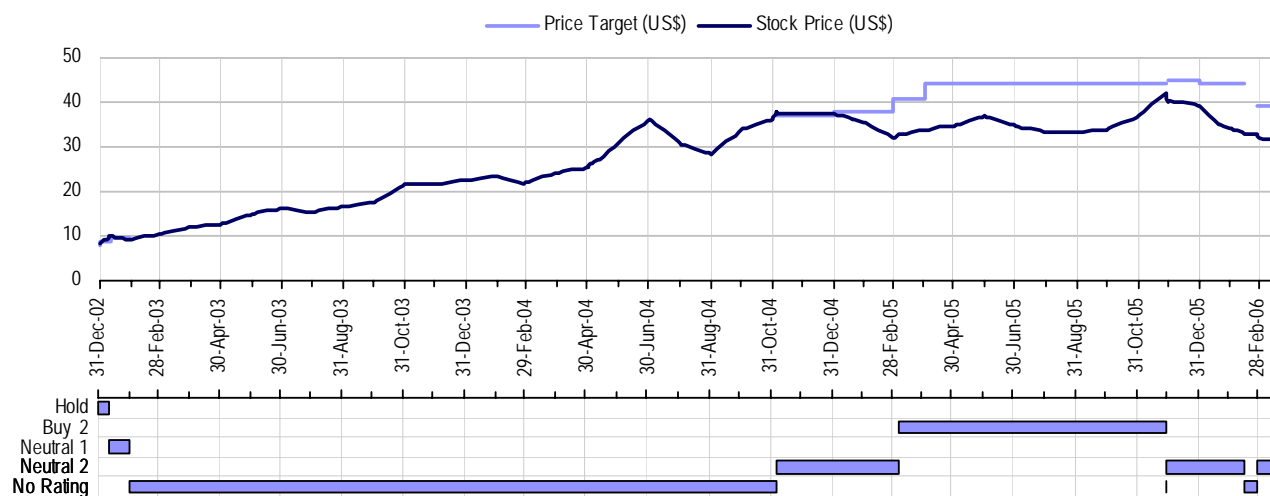
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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Google Inc. (US\$)



Yahoo Inc. (US\$)



Source: UBS; as of 22 March 2006.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

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