

Yahoo! Inc. (YHOO) – Buy

YHOO: Yahoo! May Regret Not Paying Up For Facebook

Based on press reports and our industry contacts, Yahoo! made attempts last year to purchase leading social networking site Facebook. These negotiations failed in part due to valuation, according to these sources. It appears that since then Facebook has far exceeded the assumptions Yahoo! supposedly used to value Facebook. We believe Yahoo! must take steps to gain a more meaningful leadership position in social networking or risk not participating in what could be one of the fastest growth segments in the consumer Internet sector over the next five-plus years. Despite our concern that Yahoo! may not fully participate in social networking's growth, we continue to like the company's positioning in other segments of consumer Internet and media and believe an improved search marketing platform could drive our estimates higher. Maintain Buy.

- **Based on press reports** and industry contacts, Yahoo! made attempts last year to purchase leading social networking site Facebook. These negotiations failed in part due to valuation, according to these sources.
- **Facebook has far exceeded** the assumptions Yahoo! supposedly used to value Facebook. Facebook recently surpassed 21MM registered users, which are generating 1.5BN pageviews daily.
- **We believe Yahoo!** must take steps to gain a real leadership position in social networking or risk not participating in what could be one of the leading sources of growth in the consumer Internet sector over the next five-plus years.
- **Despite our concern** that Yahoo! may not fully participate in social networking's growth, we continue to like the company's positioning in other segments and believe an improved search marketing platform could drive our estimates higher. Maintain Buy.

Company Update

Market Data	
Price (04/03/07)	\$31.72
12-Month Price Target	\$30.00
52-Week range	\$33.54-22.99
Shares Out. (MM)	1,419.1
Market cap (MM)	\$45,015.2
Avg. daily volume (000)	22,682.8
Financial Data	
Total Debt./Cap.	7.5%
Price/LTM Rev.	7.0x
Tangible BVPS	\$4.08
Cash Per Share	\$3.15

Yahoo! is one of the world's largest providers of Internet services to users and businesses. It offers an array of communications services (mail, messenger, etc.), commerce services (shopping, auctions, etc.), content and media programming services (sports, music, etc.), wireless services, services for businesses and enterprises (Corporate Yahoo!, Yahoo! Broadcast Services, etc.), and Yahoo! Fusion Marketing (search marketing, banner, rich media advertising, etc.).

	FY	FY		FY	
	12/31/06 A	12/31/07 E		12/31/08 E	
		Old	New	Old	New
Rev. (MM)	\$6,425.7	\$7,556.8	\$7,556.8	\$8,816.3	\$8,816.3
Growth	22.2%	17.6%	17.6%	16.7%	16.7%
Op. Mar.	14.6%		11.5%		11.8%
EPS: 1Q	0.20	0.21	0.21		
EPS: 2Q	0.21	0.24	0.24		
EPS: 3Q	0.23	0.24	0.24		
EPS: 4Q	0.26	0.28	0.28		
EPS: Year	0.71	0.79	0.79	0.90	0.90
Growth	16.6%	12.5%	12.5%	13.0%	13.0%
P/E Ratio	42.4x	39.9x	39.9x	35.3x	35.3x

Note: Pro forma earnings estimates displayed above do not include one-time items or any stock compensation expenses.



Disclosures applicable to this security: B, G.
Disclosure explanation on the inside back cover of this report.

Background on Yahoo!'s Reported Interest in Facebook

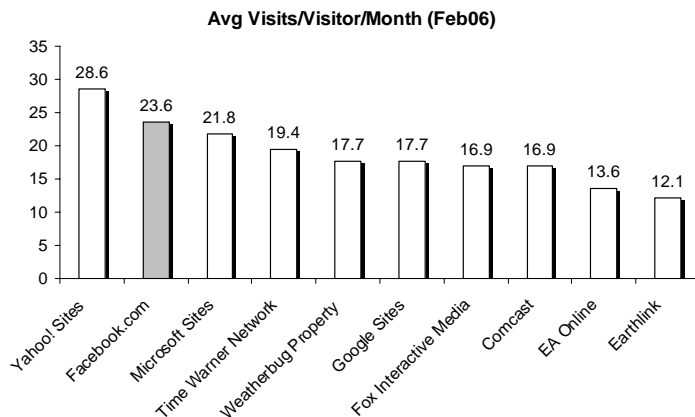
Yahoo! Supposedly Made Offer(s) Ranging from \$750MM to \$1.6BN

Based on press reports¹ and our industry contacts, privately held Facebook has been courted by potential buyers since not long after it launched in February 2004. According to these same sources, the deal that came closest to happening was the acquisition of Facebook by Yahoo! last year, a project that is/was reportedly referred to internally at Yahoo! as "Project Fraternity". According to reports, sometime during 1Q06 Yahoo! made an offer to acquire 5% of Facebook for \$37.5 million – implying a \$750 million valuation. Facebook supposedly rejected this offer. Yahoo! reportedly became more aggressive in the middle of last year when it proposed to acquire the entire company for \$1 billion (we assume all in cash). These same sources also reported that Facebook rejected the \$1 billion offer, believing that the valuation was too low. Supposedly, Yahoo was prepared to pay up to \$1.62 billion, but negotiations broke off before the offer could be made. In fact, a PowerPoint slide was published on the Web that was supposedly prepared by Yahoo! and provides detailed assumptions used to derive the \$1.62 billion valuation (more on those assumptions below).

Yahoo! May Have Underestimated Facebook's Growth/Potential

Facebook is a force in the online world

Facebook is no doubt one of the most important Internet companies to have been created in the last five years. In just three years since launch the property has attracted 21 million registered users. More phenomenal, however, is that an estimated 93% of those 21 million users are "active", or log on at least once a month, 85% at least once a week and 60% at least once a day. In addition, average daily usage is reported to be nearly 20 minutes per day per user. According to comScore, Facebook.com ranked as the 36th most-visited site on the Web in February 2007 with 16.7 million unique visitors, and was also the second-most "engaging" site with 23.6 average visits per visitor during the month (see figure below). Facebook has also been ranked as the number one site for photos, ahead of Yahoo!'s Flickr, with over 6 million photos uploaded daily. In a survey conducted last month, eMarketer found that Facebook was the most viewed site by females in the United States (69%) ages 17-25 and also the most viewed website by males (56%). In a survey conducted last year by Student Monitor, Facebook was named the second most "in" thing among undergraduates, tied with beer and after only the iPod. Those sorts of usage statistics are nearly unheard of, and make Facebook one of the largest and stickiness media properties around.



Source: comscore, March 14, 2007

Facebook is exceeding Yahoo!'s reported assumptions

Facebook's growth continues to exceed expectations. It was reported last week that Facebook has now surpassed 21 million registered users and is generating an

¹ Techcrunch.com has reported extensively on the supposed Yahoo!/Facebook negotiations

average of 1.5 billion pageviews per day. These figures suggest that Yahoo! management may have underestimated Facebook's growth and potential during its negotiations last year – assuming that the published PowerPoint and analysis therein in fact came from and was used by Yahoo! management. Simply put, the assumptions/metrics used in this analysis have proved too conservative. For instance, the analysis assumed 22.0 million registered users in 2007 and total pageviews per active user per month of 1,061. Based on press reports and on our industry contacts, we believe Facebook recently surpassed 21 million registered users (with a 90%+ monthly active rate) and is generating 1.5 billion total pageviews per month. That would imply 2,329 average monthly pageviews per active user – more than double Yahoo!'s reported assumption of 1,061. In addition to higher user engagement (or stickiness) at Facebook, the site also appears on track to exceed Yahoo!'s user forecast as well. With Facebook supposedly adding 120,000 new registered daily, the site is on pace to far exceed Yahoo!'s assumption of 22 million registered users by year-end 2007.

Facebook User & Usage Metrics

YHOO Estimates for CY2007		Actuals (as of March 2007)	
Total users (MM)	22.0	Total Users (MM)	21.0
x active users %	92%	x active users %	92%
= Active users (MM)	20.0	= Active users (MM)	19.0
Daily pageviews (MM)	716	Daily pageviews (MM)	1,500
Monthly pageviews (MM)	21,475	Monthly pageviews (MM)	45,000
Monthly pageviews per active user	1,061	Monthly pageviews per active user	2,329
x months in year	12	x months in year	12
= Annual pageviews per active user	12,732	= Annual pageviews per active user	27,950
x Active users (MM)	20.0	x Active users (MM)	19.0
= Total annual pageviews (MM)	257,696	= Total annual pageviews (MM)	540,000

Source: Needham & Company, Techcrunch.com and press reports

Did Yahoo! Miss Another Opportunity?

Like in search, will Yahoo! look back and wish it was more aggressive?

Social media/networking is arguably one of the most important trends shaping the consumer Internet and Internet media world today, eclipsed only by search/Google. And News Corp's MySpace and privately held Facebook are arguably the most relevant social media/networking companies out there, particularly in the U.S. While Facebook has attracted a substantial user base in just its first three years of operation and has gained phenomenal traction/engagement with its users, we recognized that the business is still young and under-monetized, and much execution remains until we can say for sure that it will be success with both its users and its investors/owners. That said, Yahoo! may have underestimated the growth and potential of Facebook and, as a result, missed out on acquiring a/the leading company in the social media space.

Why is it important for Yahoo! to have a more meaningful presence in the social media/networking space?

1. The demographic – the college students of today are not only “the future leaders of tomorrow”, they also tend to be early adopters, more willing to shop online, and the most activity online demo.
2. Growth – This is where the growth in online media is right now. Social media/networking sites are some of the fastest growing on the Web, and their user engagement stats suggest they are incredibly sticky and viral properties. Yahoo! has been one of the main evangelists of “user engagement” as the main benchmark of Internet media success.
3. Monetization – While monetization of social media/networking sites is still in its infancy, the ability to personalize/target content and ads is very powerful with these sites because they combine registration databases with massive amounts of behavioral surfing and interaction data. Some of the work that Facebook is doing with their API and tying into other online e-commerce

and media properties provides some hints as to the power of social recommendation for e-commerce.

Why Yahoo! should buy (Facebook) rather than build

1. The network effect is hard to unravel – Our experience and observations suggest that it is nearly impossible to break into a virally-based online business segment that benefit from the network effect after a company has already gained critical mass. We believe this is the case in the social networking space, with MySpace and Facebook the clear leaders in the U.S. market. eBay is probably the best example of the networking effort at work, and Yahoo! Auctions and many others are the examples of failed attempts at competing in this type of market.
2. Other attempts have failed – Yahoo! should have bought into the social networking space because its previous attempts, namely Yahoo! 360, have failed to catch on with consumers. While Yahoo! Answers, Flickr and del.icio.us are all examples of successful online socially-oriented services, we consider them point applications and not core destinations. Given our expectation that the social media/networking space will be one of the key growth drivers of the consumer Internet sector in the years ahead, we believe Yahoo! needs to gain a more meaningful leadership position in social media/networking.
3. Shot in the arm – We believe Yahoo!'s corporate moral could use a major shot in the arm. Acquiring a dynamic, fast growing, cutting-edge property like Facebook and/or a handful of the other more international properties could go a long way to reinvigorating both the Yahoo! brand and its employees – in our opinion.

The risk of not taking at least a few big bets on the future, not having the foresight and/or just being too conservative can have long term ramifications. Yahoo!, for instance, is reported to have had an opportunity to buy Google back in 2001 for \$1 billion in order to solidify its position in search. However, Yahoo! management did not see the importance that search would have on consumer navigation and on direct marketing. Yahoo! missed that opportunity and ultimately had to settle a year later by buying Inktomi (December 2002) and Overture (July 2003) in order to patch together a competitive search offering. Yahoo must take steps to gain a real leadership position in social networking or risk not participating in what could be one of the leading sources of growth in the consumer Internet sector over the next five-plus years. As the Internet's largest community and communications company, the fact that Yahoo is not a leader in social networking could represent one of the biggest missed opportunities.

Investment risks include: 1) stiff competition for online consumers from Google, MSN and others; 2) uncertain returns from new investments such as Project Panama; among others; 3) management expectations for declining gross and operating margins, and 4) uncertain ability to benefit from emerging trends like video and social networking, among other things.

Income Statement – Historicals and Forecasts

	1Q06	2Q06	3Q06	4Q06	1Q07E	2Q07E	3Q07E	4Q07E	2005	2006	2007E	2008E
Marketing services	1,381	1,386	1,370	1,490	1,488	1,635	1,654	1,816	4,594	5,627	6,594	7,747
Fees	186	190	210	213	224	230	245	264	664	798	963	1,069
Listings	0	0	0	0	0	0	0	0	0	0	0	0
Total Revenues	1,567	1,576	1,580	1,702	1,713	1,864	1,899	2,081	5,258	6,426	7,557	8,816
YoY change	34%	26%	19%	13%	9%	18%	20%	22%	47%	22%	18%	17%
Traffic acquisition costs (TAC)	479	453	459	475	529	554	574	607	1,562	1,866	2,263	2,687
Other cost of revenues	177	191	221	215	229	255	258	288	471	803	1,030	1,177
Gross Profit (Loss)	911	932	901	1,013	955	1,055	1,067	1,186	3,225	3,757	4,263	4,952
Gross margin	58%	59%	57%	60%	56%	57%	56%	57%	61%	58%	56%	56%
Sales and marketing	292	287	289	299	320	342	339	356	1,025	1,167	1,357	1,615
Product development	180	173	164	172	189	199	215	225	547	688	828	977
General and administrative	98	108	102	112	120	126	132	135	320	420	512	589
Stock compensation	109	100	121	95	150	140	140	140	52	425	569	608
Amortization of intangibles	31	34	33	27	31	31	31	31	173	125	125	125
Total Operating Expenses	710	702	699	705	810	838	856	887	2,118	2,816	3,391	3,914
Profit (Loss) from Operations	201	230	202	308	144	217	211	299	1,108	941	872	1,038
Other income, net	35	36	50	35	38	43	48	52	1,436	157	180	238
Equity interest earnings	26	22	30	34	25	21	29	32	128	112	107	100
Minority interest	(0)	(0)	0	(0)	(1)	(1)	(1)	(1)	(8)	(1)	(2)	(2)
Income/(Loss) before taxes	263	287	283	377	207	280	288	383	2,664	1,209	1,157	1,373
Income tax (exp)/benefit	(103)	(123)	(124)	(108)	(81)	(109)	(112)	(149)	(768)	(458)	(451)	(535)
Income/(Loss) bef extraord items	160	164	159	269	126	171	175	234	1,896	751	706	838
Extraordinary items	0	0	0	0	0	0	0	0	0	0	0	0
Net income (loss)	160	164	159	269	126	171	175	234	1,896	751	706	838
Diluted wtd avg shares outstanding	1,493	1,477	1,442	1,419	1,434	1,449	1,464	1,479	1,486	1,458	1,457	1,517
Diluted EPS - GAAP	\$0.11	\$0.11	\$0.11	\$0.19	\$0.09	\$0.12	\$0.12	\$0.16	\$1.28	\$0.52	\$0.48	\$0.55
Other												
Net Revenues	1,087.7	1,122.7	1,121.5	1,227.9	1,184.0	1,310.4	1,325.0	1,474.1	3,696	4,560	5,293	6,129
YoY Change in Net Revenues	33%	28%	20%	15%	9%	17%	18%	20%	42%	23%	16%	16%
EBITDA	434.9	456.9	473.7	540.4	444.4	515.7	519.4	617.1	1,557	1,906	2,097	2,472
EBITDA Margin (net revs)	40%	41%	42%	44%	38%	39%	39%	42%	42%	42%	40%	40%

Source: company reports and Needham & Company LLC estimates

Yahoo! Inc.

(\$ in MM, except per share data)

Fiscal Year Ending December 31

BALANCE SHEET

ASSETS

	Annual		Quarterly			
	FY 12/31/2005	FY 12/31/2006	Ending 3/31/2006	Ending 6/30/2006	Ending 9/30/2006	Ending 12/31/2006
Cash & Short-term Investments	3,999.8	3,537.3	3,833.5	3,964.7	3,230.0	3,537.3
Receivables	721.7	931.0	766.5	792.5	784.5	931.0
Inventory	0.0	0.0	0.0	0.0	0.0	0.0
Other Current Assets	205.6	217.8	171.9	173.7	166.1	217.8
Current Assets	3,488.2	3,750.1	3,366.9	3,654.7	3,059.6	3,750.1
Property and Equipment	697.5	1,101.4	775.0	884.0	1,049.6	1,101.4
Goodwill and Intangibles	3,430.2	3,397.9	3,427.3	3,429.3	3,383.9	3,397.9
Long-term Marketable Securities	1,439.0	935.9	1,405.0	1,276.1	1,120.9	935.9
Other Assets	1,815.6	2,351.8	1,851.3	1,946.4	2,004.0	2,351.8
Total Assets	10,870.5	11,537.2	10,825.4	11,190.6	10,618.1	11,537.2

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities	1,204.1	1,475.3	1,309.4	1,422.9	1,459.1	1,475.3
Short-term Debt	0.0	0.0	0.0	0.0	0.0	0.0
Long-term Debt	750.0	749.9	750.0	750.0	750.0	749.9
Shareholders' Equity	8,710.6	9,188.4	8,445.1	8,697.7	8,068.2	9,188.4
Total Liabilities + Shareholders' Equity	10,870.5	11,537.2	10,825.4	11,190.6	10,618.1	11,537.2

INCOME STATEMENT

Revenue	5,257.7	6,425.7	1,567.1	1,575.9	1,580.3	1,702.4
Gross Profit	3,225.3	3,756.6	910.8	931.7	900.9	1,013.2
Operating Income	1,107.7	941.0	201.2	229.6	202.3	307.8
Pretax Income	2,664.0	1,209.4	262.8	287.0	282.9	376.7
Net Income	1,896.2	751.4	159.9	164.3	158.5	268.7
Shares Outstanding	1,486.5	1,457.9	1,493.3	1,476.6	1,442.4	1,419.1

CASH FLOW STATEMENT

Depreciation and Amortization	397.1	540.0	125.1	127.5	149.9	137.5
Cash Flow from Operations	1,711.4	1,431.4	444.7	429.7	389.7	167.4
Capital Expenditures	408.9	689.1	141.7	175.1	240.8	131.6

CASH MANAGEMENT*

DSOs	41.7	46.9	42.7	44.5	44.9	45.3
Inventory Days	0.0	0.0	0.0	0.0	0.0	0.0
Days Payable	10.6	12.3	12.2	17.3	18.7	16.4
Cash Conversion Cycle	31.1	34.7	30.5	27.3	26.2	28.9

PROFITABILITY

Gross Margin	61.3%	58.5%	58.1%	59.1%	57.0%	59.5%
Operating Margin	21.1%	14.6%	12.8%	14.6%	12.8%	18.1%
Net Margin	36.1%	11.7%	10.2%	10.4%	10.0%	15.8%
Return on Assets*	19.0%	6.7%	5.9%	6.0%	5.8%	9.7%
Return on Equity*	24.0%	8.4%	7.5%	7.7%	7.6%	12.5%
Total Debt/Capital	7.9%	7.5%	8.1%	7.9%	8.5%	7.5%

PER SHARE DATA

Tangible Book Value	3.55	3.97	3.36	3.57	3.25	4.08
Cash	3.66	3.07	3.51	3.55	3.02	3.15
Net Cash	3.15	2.55	3.01	3.04	2.50	2.62
EPS (Pro Forma)	0.61	0.71	0.20	0.21	0.23	0.26
EPS (Pro Forma Including Option Expenses)	0.58	0.53	0.16	0.17	0.18	0.22
EPS (GAAP)	1.28	0.52	0.11	0.11	0.11	0.19

* Quarterly calculations reflect annualized quarterly data. Annual calculations reflect LTM data.

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I, Mark May, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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	% of companies under coverage with this rating	% for which investment banking services have been provided for in the past 12 months
Strong Buy	5	13
Buy	61	14
Hold	32	13
Under Perform	2	0
Rating Suspended	0	0
Restricted	1	33
Under Review	0	0

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