Media | CHINA

MEDIA / INTERNET

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NOMURA
NOMURA INTERNATIONAL (HK) LIMITED

NEW THEME

ANCHOR REPORT

Surprising appetite

We have been surprised by the strength of Chinese media. While we retain our short-term preference for gaming within the wider Internet/media space, we returned from a recent tour of media businesses in China with the conviction to raise our 2011 media revenue growth target to 33% from 25% earlier. We see new advertisers and sectors that really did not advertise in the past starting to ratchet up spending this year. Companies in e-commerce, travel and education are increasing their ad spend by 50-150% y-y, on our checks. Meanwhile, we believe the mainstay auto advertising will remain resilient, thanks to new model launches, with a projected 40% growth in ad spend in 2011F. While participants in this story are many, we think the purest plays are Youku.com, Focus Media and Baidu. We initiate coverage of Youku with a BUY for its very strong revenue growth outlook supported by our projected 70%-plus CAGR in online video advertising over 2010-2013F, upgrade Focus Media to BUY as a beneficiary of pricing inflation, and raise our price target on BUY-rated Baidu.

① **New segments driving growth**

② **Auto advertising resilient**

③ **Skewed media price inflation**

④ **Not so traditional medium**

⑤ **Direct beneficiaries: Youku, Focus Media, Baidu**

Nomura Anchor Reports examine the key themes and value drivers that underpin our sector views and stock recommendations for the next 6 to 12 months.

Stocks for action

We initiate coverage of Youku.com with a BUY as we believe it will benefit from the transition from traditional TV to online TV in China. We upgrade Focus Media to BUY from Neutral due to stronger ad demand.

Stock	Rating	Price ($)	Price target
Youku.com (YOKU US)	BUY*	US$48.84	US$65
Focus Media (FMCN US)	BUY↑	US$30.98	US$36
Baidu (BIDU US)	BUY	US$143.11	US$165

* Initiating coverage ↑ Upgrading from Neutral
Pricing as of 4 Apr 2011.

Analysts

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Action

We have turned more positive on the outlook for China digital advertising in 2011F, following the conclusion of our China media tour and meetings with representatives from leading media agencies. We initiate on Youku.com with a BUY as we believe it will benefit from the transition to online TV from traditional TV in China. We also upgrade Focus Media to BUY from Neutral on stronger-than-expected demand.

Catalysts

Continued growth of the advertising market should further benefit the sector in 2011F.

Anchor themes

The Internet/media run in China still has room to advance further, in our view, with growth momentum expected to accelerate on a strong rise in user base expansion and increased utilisation. Among the sub-sectors, we see digital advertising, at this stage of the industry lifecycle, as the major potential beneficiary.

Stocks for action

We believe leading pure advertising plays such as Youku.com, Focus Media and Baidu will benefit the most from stronger-than-expected advertising demand in 2011F.

Stock	Rating	Price ($)	Price target
Youku.com (YOKU US)	BUY*	US$48.84	US$65
Focus Media (FMCN US)	BUY↑	US$30.98	US$36
Baidu (BIDU US)	BUY	US$143.11	US$165

* Initiating coverage
↑ Upgrading from Neutral
Pricing as of 4 Apr 2011.

Surprising appetite

① New segments driving growth

We are more positive on the advertising outlook as we continue to see new advertisers and sectors that historically did not advertise starting to ratchet up spending in the current year. Companies in e-commerce, travel and education are increasing their advertising spend by 50-150% y-y, in our view, based on our conversations with ad agencies and advertisers in China.

② Auto advertising

We expect automotive advertising to remain resilient despite government intervention as we expect the sector to spend an additional 40% in 2011F.

③ Skewed media price inflation

Media inflation is not evenly spread across different mediums. Our meetings with agencies suggest that pricing inflation is being skewed to the largest platforms, implying to us that Sina, Sohu, Tencent and Focus Media should see the greatest pricing leverage during 2011F.

④ Not-so-traditional medium

We estimate that online video advertising can grow 100% in 2011F, with a 2010-13F revenue CAGR of 72.7%, due to the shift from traditional TV to online TV.

⑤ Weibo

Many of the agencies we visited did not see Weibo as a significant revenue driver this year, as companies such as Sina are more focused on growing their user base. However, we expect advertisers to follow users in the not-so-distant future.

⑥ Direct beneficiaries

We initiate on Youku with a BUY and upgrade Focus Media to BUY from Neutral, given the strong digital advertising momentum in China. We like Youku, Focus Media and Baidu as pure advertising plays in China. While Tencent, Sina and Sohu should all likely benefit, we think the beneficial impact for them may be less as their respective social media businesses overshadow their advertising business.

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Contents

Key takeaways from our recent media tour

More optimism on ad growth

We have turned more positive on the outlook for digital advertising demand in China in 2011F

Mirroring the Chinese economy, media spending in China experienced a V-shaped recovery in 2010, growing by 12.5% y-y led by Internet and digital advertising, which saw the greatest gain in share increasing 55% from trough levels in 2009. We believe the 2010 gains were largely due to the low base impact of 2009 as a result of the financial crisis, as well as incremental new spending in advertising in concert with one-time events such as the World Cup and World Expo.

Looking ahead to 2011, in our anchor report last October, *Back in the Game* (5 Oct 2010), we advised investors to focus on the Chinese online gaming sector as we expected a recovery amid anticipated new game launches across-the-board. We felt that digital advertising might slow in 2011, as it was coming off a much higher base in 2010. Moreover, with no one-time events such as the World Cup or World Expo adding fuel to growth, we expected advertising momentum to slow in 2011.

Following our recent meetings with various media agencies in China — including global agencies such as WPP, Publicis Group, IPG, Omnicom, Aegis and Dentsu, among others — we conclude that digital advertising momentum has not faded in the 2011 and that spending has in fact remained robust, with a positive outlook for the rest of the year. Media spending is not only a function of a vastly expanding consumer economy, but also is aided by intense competition in sectors that are trying to gain brand share. Many of the companies in China are considered first-generation brands; even legacy products such as Coca-Cola or McDonalds are not multi-generational brands where grandmothers and grandfathers in China have grown up and used these brands. Furthermore, new and emerging business segments such as e-commerce, travel, education, and even insurance are starting to spend on digital advertising, up from virtually no spending in the past, to gain brand share in a market where there is no defined long-established leader.

As for multi-national corporations, not only are we seeing traditional advertisers such as McDonalds, Coca-Cola and Samsung continue to increase their overall budgets in China, but also many of these companies are starting to go more online — where Internet and digital spending is increasing. In fact, Samsung suggested its advertising budget will increase by as much as 40% for digital initiatives in the first half of 2011, compared with an overall ad budget increase in the high teens. Our conversations with various Samsung marketing specialists suggests more emphasis is being placed on social media advertising, video and digital outdoor as the Internet has increasingly become a more mainstream marketing medium. This is largely due to more targeted and segmented advertising chasing direct demographics, while the cost of advertising or CPM for digital advertising via banner ads, outdoor digital, or online video may be 50-70% less than that of traditional television.

We highlight five takeaways on the key trends in digital advertising in China from our media tour:

- **New segments driving growth:** Despite a strong 2010, when Internet adverting grew 55% according to GroupM, we are anticipating that the positive momentum will continue to carry over in 2011. We look for Internet advertising to grow 33% y-y in 2011 and remain positive on the advertising outlook as we continue to see new advertisers and sectors that did not advertise in the past starting to ratchet up spending in the current year. Companies in e-commerce, travel and education are increasing their advertising spend by 50-150% from 2010 levels. Why the sudden need to advertise? In our view, these sectors tend to be very fragmented, where companies are trying to grab brand share. In the case of online travel, Ctrip is considered the largest player in the industry, but it garners less than 5% of industry revenues. In e-commerce, despite Taobao's market share of 70%+, with so many recent IPOs and more in the pipeline, companies like 360BUY are forgoing near-term profits to gain buyers' attention and brand share. Furthermore, these new segments are targeting Internet as a primary medium of advertising, given its targeted demographics, as well as lower cost; Internet and outdoor digital advertising can be as much as 50-70% less expensive on a CPM basis than traditional television ads.

- **Auto advertising:** Despite government regulations limiting the number of license plates in key cities such as Beijing and Shanghai, we expect automotive advertising to remain resilient as we expect the sector to spend an additional 40% in 2011F on digital brand advertising. Auto companies constituted the largest share of Internet and digital advertising at approximately 25% of the entire market in 2010. Last year was a very strong year, with auto advertising up 88% y-y from 2009 based on about 50 new car models, given that auto advertising depends heavily on new car launches. For 2011, we estimate that about 45 new models will be introduced industry-wide, again contributing to new growth. We expect auto advertising to transition more to SNS (social network service) sites and online video sites over the next 12-18months. Our conversations with leading auto manufacturers in China, as well as media agencies there, suggest that given the higher educated user base of online video, coupled with the target age and demographics, auto companies are increasingly keen on developing an online video strategy. We believe that brand advertising growth for auto advertising will decrease to 40% in 2011F, as auto companies look to spend more on video. We estimate that auto advertising for online video could increase 100-150% y-y, making it the largest revenue contributor to online video at approximately 20% of forecast total online video advertising spending in 2011.

Media price inflation is skewed towards the largest platforms

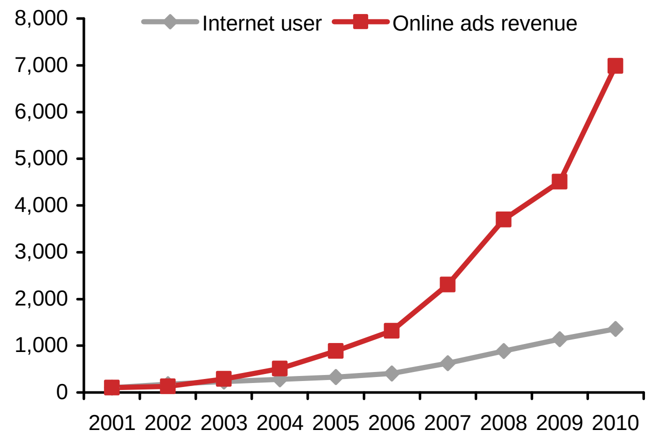
- **Skewed media price inflation:** Media price inflation is the actual cost of reaching the same number of viewers. This largely occurs as new advertisement medium emerge, such as online, outdoor, print and broadcast, and many sub-sectors in between. Our panel of media specialists in China pointed out that relative to 3-4 years ago, advertisers spend 10-15% more today to reach the same number of people, largely due to an expanded base. Advertisers in all media are spending more to capture the same audience through greater utilization of advertising, coupled with increased costs; hence, the return on investment in advertising continues to slide. Media proliferation is a double-edged sword as this keeps media inflation in check, however having too many options also lowers ROI and cost per viewership in existing mediums also increase.

  However, media inflation or pricing is not evenly spread across different mediums. Our meetings with various agencies suggested that pricing inflation is being skewed to the largest platforms, implying that Sina, Tencent and Focus Media are seeing the greatest pricing leverage. One of our panelists pointed out that the lack of inventory in China digital advertising is impacting the largest players — positively. For example, if a company wants to advertise in magazines, most advertisers are increasingly going for inventory in the top three magazines; hence, pricing for those top magazines is seeing a significant increase. The same is happening with digital advertising; with new sectors coming on and ramping up advertising spending, inventory levels in key mediums are in shortage. Hence, we expect very strong pricing from Sina, Sohu, Tencent and even Focus Media. We estimate that Sina's brand advertising business will grow 29% y-y in 2011F and that Focus Media will grow its traditional business 29% y-y, of which 40-50% of expected 2011 incremental growth will be from pricing increases. However, when we look at smaller players such as AirMedia (AMCN US; BUY) or Vision China (VISN US; not rated), we expect pricing to contribute 5-8% of 2011 growth, almost half that of larger scalable players.

- **Not-so-traditional medium:** We have seen an aggressive push towards online video portals from traditional portals such as Sina and Sohu, as well as new entrants such as Baidu's Qiyi. The opportunistic land grab we are seeing in video is largely related to the potential shift from traditional TV to online TV as content and advertising regulations are allowing online video to be more accessible from a user's perspective. We estimate that online video advertising can grow 100% in 2011F, with a 2010-13F advertising CAGR of 72.7%. However, we believe that profitability from this business will be muted in the near term, as none of the video sites on a standalone basis is making money — not even YouTube. This is a high-fixed-cost business where current players are expanding content library and bandwidth capacity and, in our view, will take at least 18-24 months until some of these businesses will turn profitable. Nevertheless, we believe that advertisers are increasingly targeting online video as a viable medium, given the strong reach, growing user base and targeted demographics as online video users are at a distinct education and age level. Our panel of media experts noted that online video advertising is a very small incremental cost; it provides a new medium to broadcast while extracting the same TV advertisement to the Internet. Furthermore, advertisers, particularly those that did not participate much in CCTV auctions, find online video advertising as an affordable method to reach to the same demographics; hence usage from segments such as e-commerce, education, travel and health/beauty are expected to continue to increase. We are optimistic on the prospects of online video advertising in China as we saw a similar case in the past: Internet user growth was faster than online ad revenue growth back in 2002, but online ad revenue in China soon ramped up and has outgrown the pace of Internet users ever since.

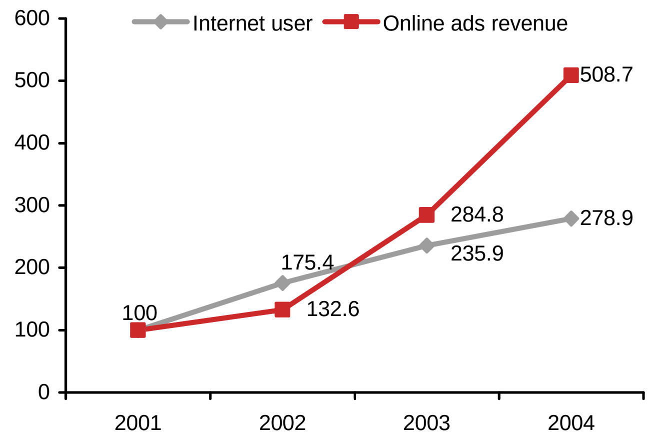
We expect online video advertising to grow 100% y-y in 2011F

Exhibit 1. Internet user vs. online ad revenue (2001-2010)



Source: iResearch and Nomura research

Exhibit 2. Internet users vs. online ad revenue (2001-2004)



Source: iResearch and Nomura research

- **Weibo:** While Sina and Tencent, the two leading Weibo sites in China with over 100mn registered users, both claimed that monetization for their respective Weibo platforms will not be material in the near term, given sheer user growth (Sina's platform is adding 10-12mn new users each month), the potential for monetization can be enormous, in our view. We do not believe that Weibo in China will monetize any differently than how Twitter generates revenues. Twitter typically does not have many brand or display ads; however, it generates revenues as follows: 1) search engines pay Twitter to display live feeds in web search results; and 2) advertisers pay for promotional tweets such that when users query related products, paid advertisers show up first. Advertisers also have promo accounts where companies like Starbucks will promote their brands through the site. We expect Sina to monetize in a similar manner, where companies can create corporate accounts to promote their brands or offer coupons to its followers, and Sina will charge based on how many times it gets "retweeted". However, while monetization of this platform will take time, certainly we estimate that advertisers will take on this medium due to its direct marketing advantages, as well as its scale that allows for significant reach. Many of the agencies we visited did not see Weibo as a significant ad revenue generator this year, given that companies like Sina are more focused on growing their user base; however, they expect advertisers to follow users in the not-so-distant future.

We initiate on Youku with a BUY and PT of US$65, upgrade Focus Media to a BUY with increased PT of US$36 and lift Baidu's PT to US$165

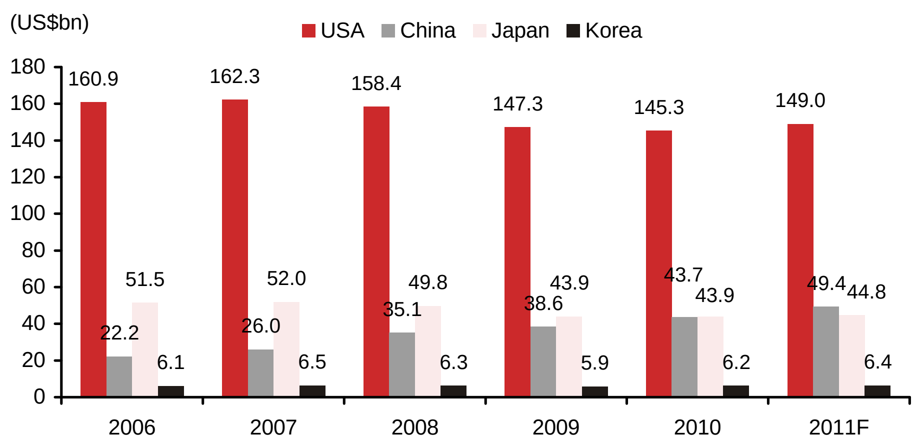
- **Direct beneficiaries:** We initiate on Youku.com with a BUY rating and a price target of US$65, representing 33% potential upside from current levels. Youku is currently trading at 41x FY11F price-to-sales, and given that revenues are ramping 110% and 65% for FY11F and FY12F, respectively, on our estimates, we believe that P/S will significantly decrease in the near future. Given the high fixed costs and scalability of the business model, we believe that the company will not turn profitable until 2H12F. However, we expect the momentum of viewership moving from TV to online video to remain strong in the near term, as bandwidth capacity and online content continues to improve. Youku should not only benefit from this structural shift, but also from the networking impact of social media and online video, in our view. We believe there is a networking impact and online video cycle — when a site has a large content library, it will attract more users; the more users it attracts, eventually the advertisers will catch on; and when advertisers come on board, the company will have revenues to generate and buy more content and the cycle continues. Given the strong digital advertising momentum in China, we like Youku, Focus Media and Baidu as pure advertising plays that should benefit from the ad growth outlook. While Tencent, Sina and Sohu will all likely benefit as well, we believe the beneficial impact may be less as the advertising business for those companies is overshadowed by their respective social media businesses.

Backdrop

The basics

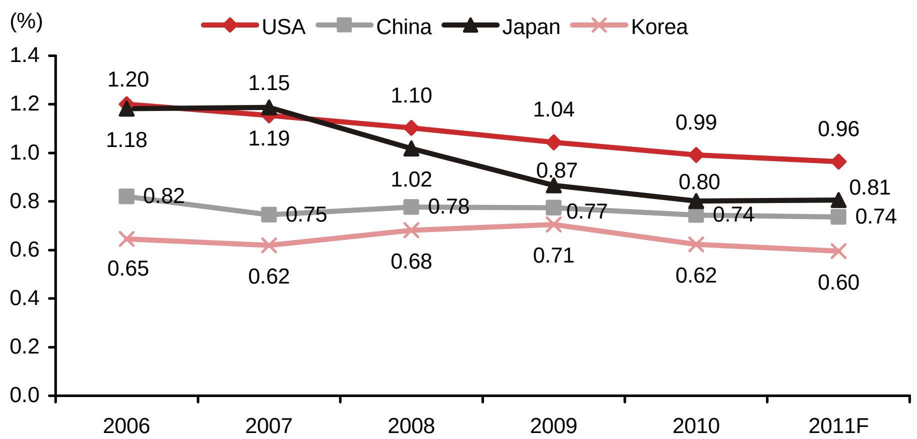
Traditionally, advertising growth for both mature and emerging markets has largely mirrored GDP growth; hence, visibility into advertising growth has been rather good. The Chinese advertising market's correlation is no different. The advertising industry in China had total spending of US$43.7bn in 2010, up 12.5% from US$38.6bn in 2009, according to GroupM. This figure in 2010 takes about 0.74% of China's nominal GDP, compared with the US at 0.99% of GDP, Japan at 0.80%; and Korea at 0.62%. We expect China's advertising market to grow 10.1% in RMB terms (12.9% in US$ terms) in 2011F, while digital and Internet should remain the largest gainer at 33% y-y growth. Compared with other countries such as the US, Japan and Korea, the growth rate for China advertising spending is higher, given consumption expansion as well as companies positioning for brand share. We expect sectors such as e-commerce, education and travel to contribute materially to incremental growth as many of these companies are new to online digital advertising. These three sectors combined could account for 12% of all digital advertising expenditure in 2011F, up from a combined 6% in 2010, on our estimates.

Exhibit 3. Total ad spending (US$bn)



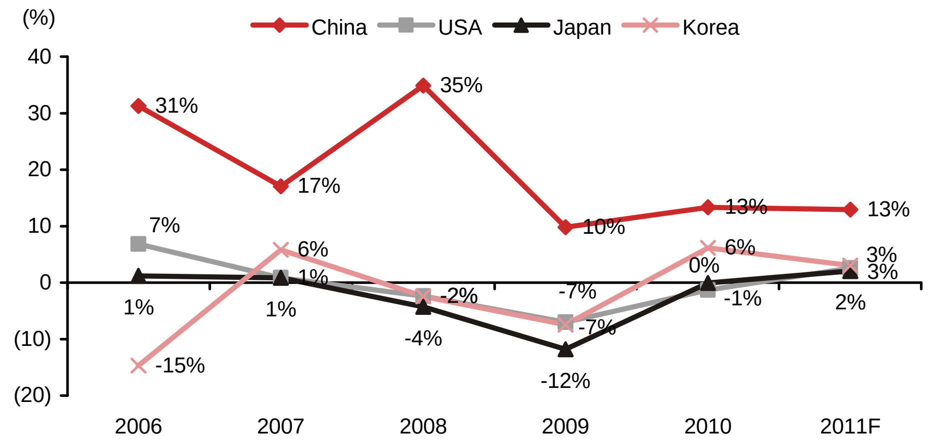
Source: GroupM and Nomura estimates

Exhibit 4. Total ad spending as a % of GDP



Source: GroupM and Nomura estimates

Exhibit 5. Total ad spending growth rate (%)



Source: GroupM and Nomura estimates

Exhibit 6. Nominal GDP vs ad spending growth %

Growth (%)	China		USA		Japan		Korea	
Year	**GDP %**	**Ads %**	**GDP %**	**Ads %**	**GDP %**	**Ads %**	**GDP %**	**Ads %**
2004	17.7	26.9	6.5	10.9	8.9	3.9	12.1	(3.8)
2005	16.8	27.9	6.5	4.3	(1.2)	8.8	17.0	2.0
2006	20.2	31.3	6.0	6.9	(4.2)	1.2	12.7	(14.7)
2007	28.8	17.1	4.9	0.9	0.4	0.9	10.2	5.8
2008	29.4	34.8	2.2	(2.4)	11.6	(4.2)	(11.2)	(2.4)
2009	10.3	9.8	(1.7)	(7.0)	3.7	(11.8)	(10.6)	(7.5)
2010	17.9	13.3	3.8	(1.3)	8.0	0.0	20.1	6.2
2011F	14.1	12.9	5.4	2.5	1.5	2.0	7.9	3.0
03-11F CAGR	**19.2**	**21.4**	**4.2**	**1.7**	**3.5**	**(0.1)**	**6.7**	**(1.7)**

Note: All GDP and ad spending growth are based on US$

Source: GroupM and Nomura estimates

Exhibit 7. Top sectors of online ad spending

(RMBmn)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F	01-11F CAGR (%)	09-11F CAGR (%)
Auto/Transport	13.0	32.6	97.0	230.0	259.1	549.6	966.8	1,409.9	1,488.4	2,801.0	3,921.4	77	62
IT Products	89.0	120.0	248.2	382.4	552.8	686.9	930.8	1,207.7	1,892.4	2,346.1	2,745.0	41	20
Network Services	54.6	54.2	145.0	310.4	428.3	423.5	628.0	1,178.8	1,066.3	1,138.5	1,184.0	36	5
Real Estate	5.4	8.5	58.6	174.2	457.5	538.3	720.3	972.9	816.8	1,687.1	2,328.2	83	69
Clothing	4.3	7.8	16.1	23.7	39.7	77.1	135.8	554.4	657.2	812.0	990.6	72	23
Financial Services	12.8	21.6	22.2	41.1	70.1	122.5	243.5	467.2	424.8	587.2	757.5	50	34
Post & Telecom	41.2	75.1	180.9	258.7	203.9	268.0	348.9	426.9	412.1	492.8	591.3	31	20
Food & Beverages	15.1	19.6	23.8	27.5	39.9	129.4	231.3	411.3	521.6	780.7	1,132.0	54	47
Consumer Electronics	27.7	25.3	54.9	118.5	140.3	177.9	268.7	343.0	373.8	585.9	849.5	41	51
Retail & Service	8.2	9.4	7.5	25.1	39.1	49.0	180.5	347.1	364.9	467.5	584.4	53	27
Total top10 sectors	**271.3**	**374.0**	**854.1**	**1,591.7**	**2,230.7**	**3,022.3**	**4,654.6**	**7,319.3**	**8,018.4**	**11,698.7**	**15,083.9**	**49**	**37**

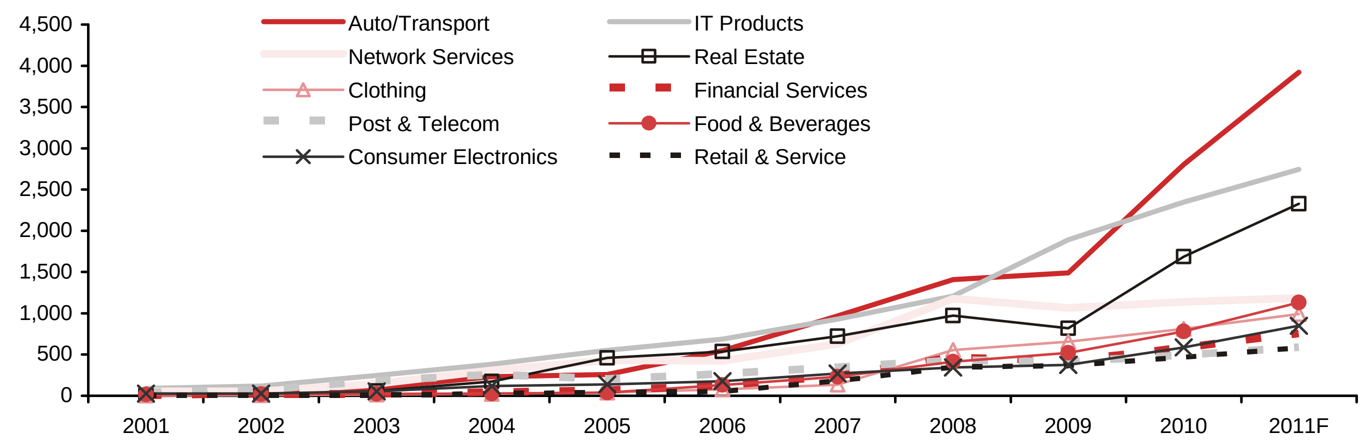
Source: iResearch

Exhibit 8. Top sectors of online ad spending growth

Growth (%)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011F
Auto/Transport	150	198	137	13	112	76	46	6	88	40
IT Products	35	107	54	45	24	36	30	57	24	17
Network Services	(1)	168	114	38	(1)	48	88	(10)	7	4
Real Estate	57	591	197	163	18	34	35	(16)	107	38
Clothing	80	107	47	67	94	76	308	19	24	22
Financial Services	69	3	85	70	75	99	92	(9)	38	29
Post & Telecom	82	141	43	(21)	31	30	22	(3)	20	20
Food & Beverages	30	21	15	45	225	79	78	27	50	45
Consumer Electronics	(8)	117	116	18	27	51	28	9	57	45
Retail & Service	15	(20)	234	56	25	268	92	5	28	25
Total top10 sectors	**38**	**128**	**86**	**40**	**35**	**54**	**57**	**10**	**46**	**29**

Source: iResearch

Exhibit 9. Top sectors of online ad spending



Source: iResearch

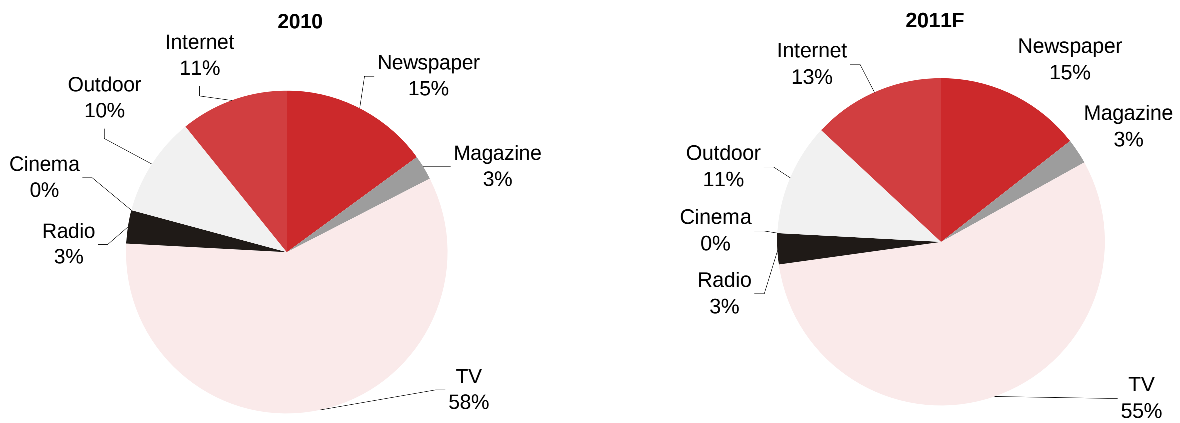
Digital advertising as a growing trend

In 2010, Internet advertising accounted for 10.8% of total ad spending in China versus 7.9% in 2009, according to GroupM. While 2011 is poised for stronger growth on the heels of growing Chinese consumption and further acceptance of digital media, we believe that these trends will be incrementally positive for advertising expenditures, as we believe that there is a continued structural shift from traditional media to digital media, and greater acceptance and use of the Internet from online gaming to video, etc. Hence, while we saw a V-shaped recovery in advertising, from its low points in 2008 and 2009, it looks like digital advertising will continue to gain a significant share in 2011, growing at 33% compared to that of the overall media at 10.1% in RMB terms (12.9% in US$ terms), on our numbers, as a wider selection of sub-categories of digital advertising continues to evolve from display and search, to now with social media and online video. While these special categories should provide a marginal lift to the sector in the near term as revenue contributions continue to ramp, we believe that the bulk of increase in revenue will come from the Chinese consumers. Looking at what was hot in advertising for 2010, the highest increases came from consumer-oriented sectors, with retail and apparel and food and beverage taking top honors for growth. While the theme for 2011 remains largely the same as Chinese consumer-related segments remain key drivers, we believe new mediums such as online video and social media will not cannibalize revenues from legacy mediums like portals and search, but contribute incrementally to growth.

On outdoor digital advertising, we still believe that this segment of advertising will be the last to turn positive in a business up-cycle and the first to turn for the negative in a cyclical downturn as it poses the lowest ROI and reach among all major categories. However, given the relative fragmentation of the industry, we believe that only Focus

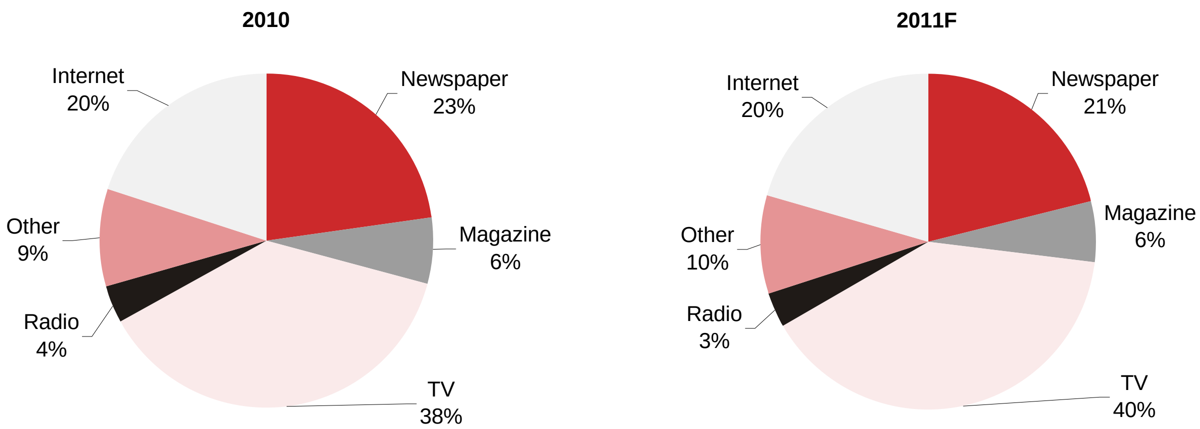
Media will continue to see strong cyclical strength given that inventory in key mediums with scale remains scarce and pricing is at a premium. We expect Focus Media to be the only outdoor digital company to command double-digit pricing growth (after discount), while many of its peers, including AirMedia and Vision China, are unlikely to see such strength. While outdoor advertising will not see the same demand or pricing as Internet advertising platforms as its lacks of measurability, we believe Focus Media can come closer with scale and critical mass. Furthermore, we may see a less seasonal impact on many outdoor advertisers coming from the World Cup or the World Expo, as we didn't see incremental advertisement growth from such events in 2010; the exception being AirMedia, which we believe has benefited from increased airport traffic from the World Expo. In our opinion, an inventory shortage in key digital mediums will likely benefit Focus Media the most as advertisers look for the next best thing, but overall inventory shortage and pricing growth trickling down to smaller players such as AirMedia may not be likely. We estimate that outdoor advertising will grow approximately 22% this year, after a very solid 2010 when the sector registered growth of 16.9%, coming off a very low base of -0.4% y-y in 2009, according to GroupM. We like the outdoor advertising sector because it's a scalable business. Much of the costs structure for these advertisers is fixed (rentals, depreciation and salary); hence due to top-line leverage, operating margins can grow significantly. However, on a cyclical business downturn, these companies do not fare due to high fixed costs.

Exhibit 10. China — Ad spending segments



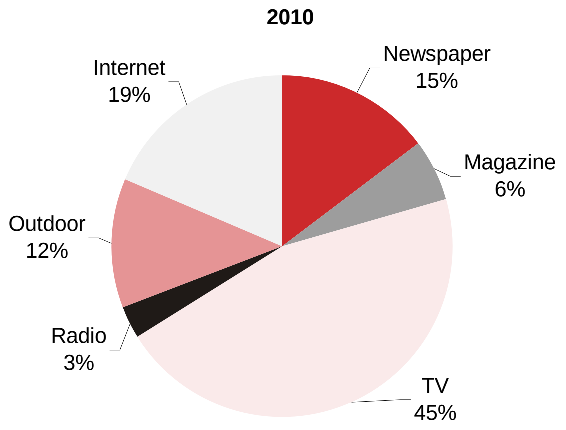
Source: GroupM and Nomura estimates

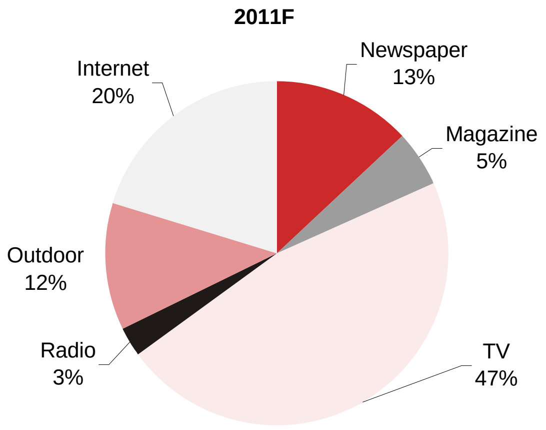
Exhibit 11. Korea — Ad spending segments



Source: GroupM

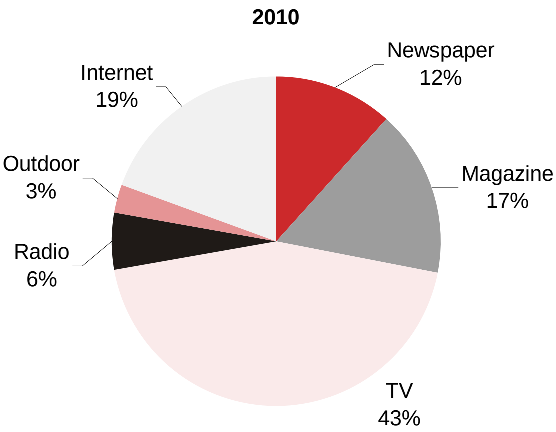
Exhibit 12. Japan — Ad spending segments

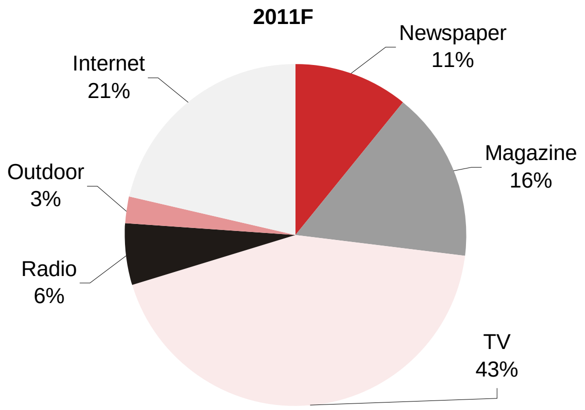




Source: GroupM

Exhibit 13. US — Ad spending segments





Source: GroupM

Exhibit 14. China — Advertising segment

(RMBmn)	2004	2005	2006	2007	2008	2009	2010	2011F
Internet advertising	**2,340**	**4,070**	**6,050**	**10,610**	**17,000**	**20,730**	**32,120**	**42,720**
% change y-y		73.9	48.6	75.4	60.2	21.9	54.9	33.0
% of total ad spending	2.1	3.0	3.5	5.4	7.1	7.9	10.8	13.1
Outdoor advertising	**11,700**	**15,400**	**23,052**	**18,229**	**25,644**	**25,531**	**29,849**	**36,416**
% change y-y		31.6	49.7	-20.9	40.7	-0.4	16.9	22.0
% of total ad spending	10.6	11.3	13.3	9.3	10.7	9.7	10.1	11.2
TV advertising	**69,473**	**86,940**	**109,554**	**127,532**	**150,492**	**165,478**	**172,709**	**181,344**
% change y-y		25.1	26.0	16.4	18.0	10.0	4.4	5.0
% of total ad spending	63.2	63.6	63.1	65.0	62.8	62.8	58.3	55.6
Magazine advertising	**1,905**	**2,408**	**3,167**	**4,320**	**5,475**	**6,174**	**7,469**	**8,216**
% change y-y		26.4	31.5	36.4	26.7	12.8	21.0	10.0
% of total ad spending	1.7	1.8	1.8	2.2	2.3	2.3	2.5	2.5
Newspaper advertising	**24,546**	**25,628**	**27,895**	**30,344**	**34,584**	**37,924**	**44,344**	**47,448**
% change y-y		4.4	8.8	8.8	14.0	9.7	16.9	7.0
% of total ad spending	22.3	18.7	16.1	15.5	14.4	14.4	15.0	14.6
Radio advertising		**2,330**	**3,874**	**5,050**	**6,615**	**7,530**	**9,754**	**9,939**
% change y-y		N/A	66.3	30.4	31.0	13.8	29.5	1.9
% of total ad spending		1.7	2.2	2.6	2.8	2.9	3.3	3.0
Total advertising	**109,964**	**136,776**	**173,592**	**196,085**	**239,810**	**263,367**	**296,245**	**326,083**
% change y-y		24.4	26.9	13.0	22.3	9.8	12.5	10.1
Advertising as % of GDP	**0.69**	**0.75**	**0.82**	**0.75**	**0.78**	**0.77**	**0.74**	**0.74**

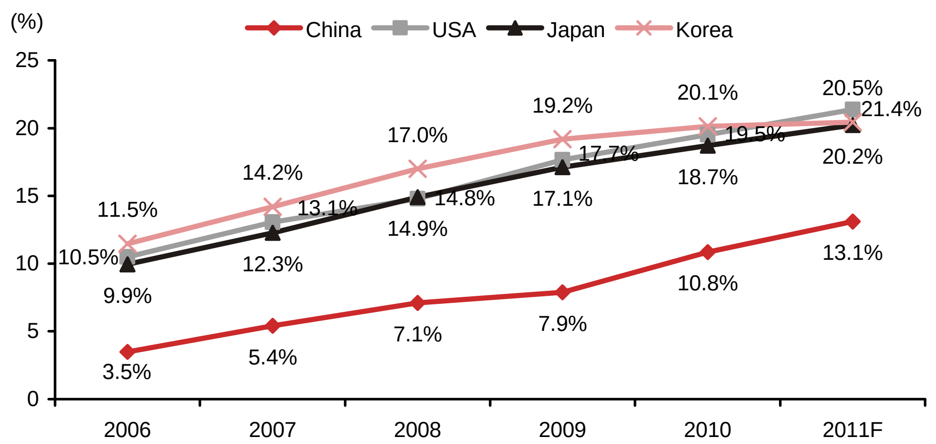
Source: GroupM and Nomura estimates

Exhibit 15. Internet advertising market

	2004	2005	2006	2007	2008	2009	2010	2011F
China (RMBmn)								
Internet advertising	2,340	4,070	6,050	10,610	17,000	20,730	32,120	42,720
% change y-y		73.9	48.6	75.4	60.2	21.9	54.9	33.0
% of total ad spending	2.1	3.0	3.5	5.4	7.1	7.9	10.8	13.1
Advertising as % of GDP	**0.69**	**0.75**	**0.82**	**0.75**	**0.78**	**0.77**	**0.74**	**0.74**
USA (US$mn)								
Internet advertising	9,626	12,542	16,879	21,206	23,448	26,027	28,370	31,859
% change y-y		30.3	34.6	25.6	10.6	11.0	9.0	12.3
% of total ad spending	6.7	8.3	10.5	13.1	14.8	17.7	19.5	21.4
Advertising as % of GDP	**1.22**	**1.19**	**1.20**	**1.15**	**1.10**	**1.04**	**0.99**	**0.96**
Japan (¥bn)								
Internet advertising	181	378	483	600	698	707	772	853
% change y-y		108.2	27.8	24.4	16.3	1.2	9.3	10.4
% of total ad spending	4.1	7.9	9.9	12.3	14.9	17.1	18.7	20.2
Advertising as % of GDP	**1.02**	**1.12**	**1.18**	**1.19**	**1.02**	**0.87**	**0.80**	**0.81**
Korea (Wbn)								
Internet advertising	393	567	779	1,020	1,190	1,243	1,385	1,450
% change y-y		44.4	37.4	30.9	16.7	4.5	11.4	4.7
% of total ad spending	5.0	7.1	11.5	14.2	17.0	19.2	20.1	20.5
Advertising as % of GDP	**0.98**	**0.85**	**0.65**	**0.62**	**0.68**	**0.71**	**0.62**	**0.60**

Source: GroupM and Nomura estimates

Exhibit 16. Internet Ads as % of total Ads



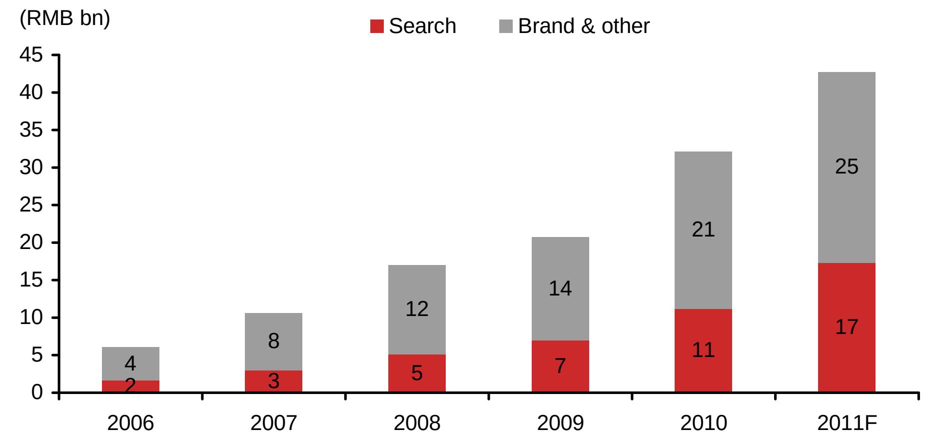
Source: GroupM and Nomura estimates

Exhibit 17. China — Online ad market

(RMBmn)	2004	2005	2006	2007	2008	2009	2010	2011F
Online search market	571	963	1,603	2,960	5,146	6,950	11,148	17,453
% change y-y		69	66	85	74	35	60	57
Brand ads/other market	1,769	3,107	4,447	7,650	11,854	13,780	20,972	25,267
% change y-y		76	43	72	55	16	52	20
Total online advertising	2,340	4,070	6,050	10,610	17,000	20,730	32,120	42,720
% change y-y		74	49	75	60	22	55	33
Internet ad market share (%)	2.1	3.0	3.5	5.4	7.1	7.9	10.8	13.1

Source: iResearch and Nomura estimates

Exhibit 18. China — Online ad market (RMBbn)



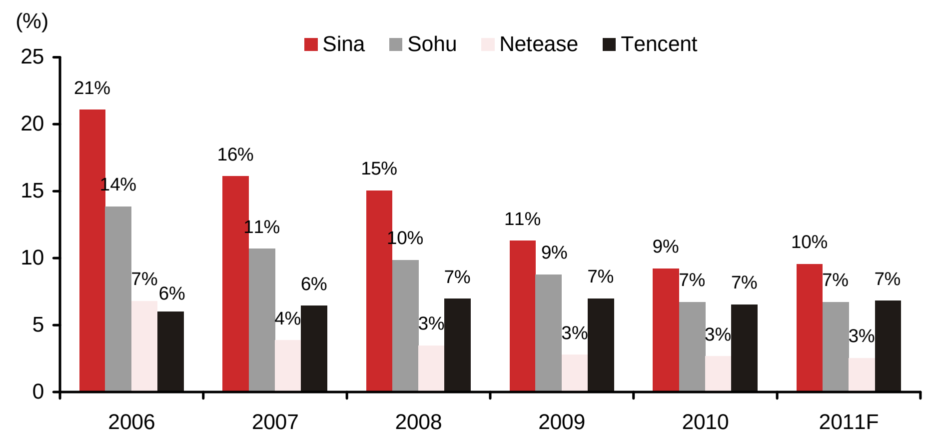
Source: iResearch and Nomura estimates

Brand ad market

Vertical portals and SNS are gaining momentum

The vertical and social networking sites are gaining momentum in Chinese Internet and taking market share from the traditional portals. We estimate that online advertising space grew approximately 55% y-y in 2010F, with traditional portals losing market share. For 2011F, we estimate that Sina's brand advertising will increase 29% y-y, compared with Sohu's 24%. Among the major portals, we like Tencent as we estimate it to gain the greatest share from its peers. Leveraging its IM platform where the company banks approximately 50% of its brand advertisement, according to our estimate, we expect Tencent's advertising revenues to increase 29% in 2011F. We believe this is going to be the case, where we see portal display advertising growing in the mid-20s%, compared to the overall digital space (including social media, search and video) of 33%. Portals are losing out to not only search, which we expect will grow 50%+ y-y, but also to social networking and video sites. These verticals portals and SNS sites offer targeted advertisement to specific demographics at average selling prices that are 30-40% less than the comparable inventory on traditional portals. Hence, as the Internet continues to expand and evolve in China, vertical portals and SNS will be very significant competitors to the traditional portals, in our view.

Exhibit 19. Brand ad market share of major players



Source: Company data, iResearch and Nomura estimates

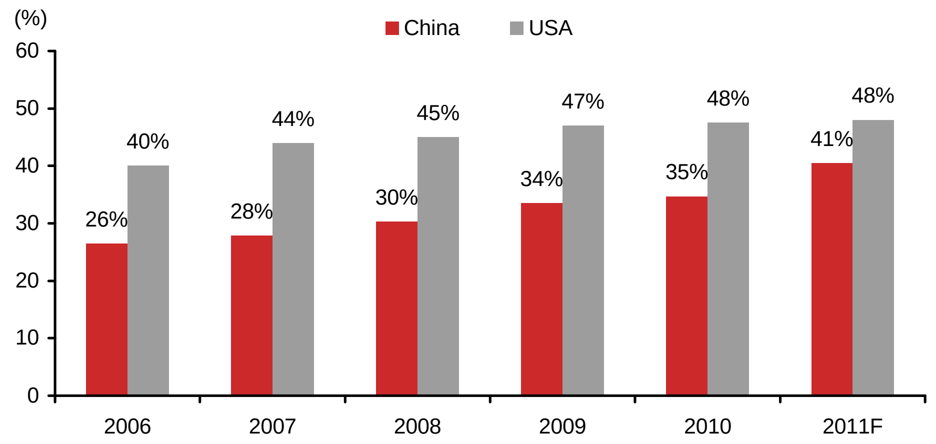
Search market

Search market is much more concentrated than brand advertising

The search market, in contrast to the brand ad segment, is much more concentrated, with Baidu and Google dominating. Like with SNS, we believe that search is a "winner takes all technology" where there is not enough room for two major competing search engines. In virtually every country, the dominant search site has more than two-thirds of the potential market share and China is no different. We believe the shutdown of google.cn does not change the imbalance of the industry. The windfall of market share and revenues expected for Baidu — with its closest rival closing shop in China — is largely overdone, in our view. We believe that Google will remain competitive in China, as the majority of Google's revenues in China came from google.com and not from google.cn in 2010.

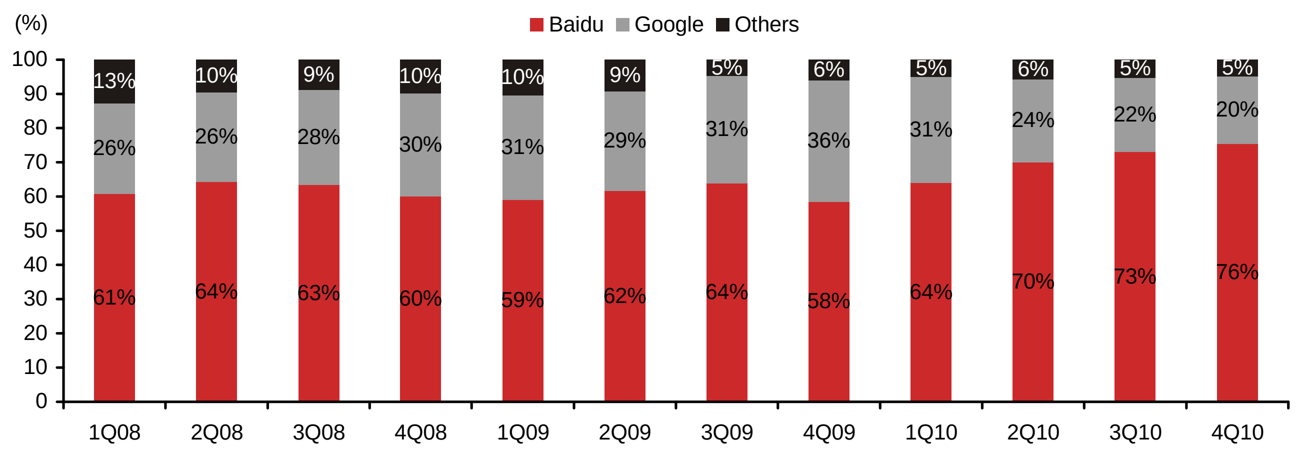
While the weight of search ads is increasing in online advertising spending in China, the percentage is still low compared with more mature markets such as the US. Baidu, with more than 70% revenue market share in China, generates more than 60% of its revenues from B2B-related search queries. Its top 5 advertising categories include medical devices/pharmaceuticals, machinery, construction, education and travel — and many of those are related to B2B. We believe that eventually Baidu will become a B2C search site such as Google. Google generates more around 40% of its revenues from searches related to e-commerce versus Baidu's 5%, on our estimate. When the Chinese e-commerce industry ramps up, all third-party e-commerce sites as well as verticals will be forced to use Baidu to crawl through all the pages. We believe that Baidu is the ultimate e-commerce story in China as the company has the user base, the critical mass and the market share to benefit the most from e-commerce, and we expect to see that happening in the next 12-18 months.

Exhibit 20. Search as % of total online ads



Source: GroupM and Nomura estimates

Exhibit 21. Search market share of major players



Source: Analysys International

Exhibit 22. Valuation table

	Investment Rating	Ticker	Current Price	Mkt. Cap. US$mn	EV/Revenue 2010	EV/Revenue 2011F	EV/EBITDA 2010	EV/EBITDA 2011F	P/E 2010	P/E 2011F	P/E excl. cash 2010	P/E excl. cash 2011F	EPS CAGR 10-12F	PEG 2011F
China														
Internet Portals														
Baidu	BUY	BIDU US	US$143.11	50,005	41.4	24.9	74.9	42.6	92.9	54.0	94.8	54.8	56.8%	0.95
Sina	BUY	SINA US	US$116.56	7,642	17.7	14.3	63.4	51.6	67.4	68.0	64.8	65.6	14.9%	N/A
Sohu	REDUCE	SOHU US	US$97.30	3,802	5.1	3.8	11.1	8.4	23.1	19.8	19.2	16.5	15.0%	1.32
Tencent	BUY	700 HK	HK$196.40	46,859	15.0	10.5	26.2	19.3	37.0	26.5	34.5	24.6	31.6%	0.75
Youku	BUY	YOKU US	US$48.84	5,145	84.8	39.5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Internet Portals Median					**17.7**	**14.3**	**44.8**	**31.0**	**52.2**	**40.2**	**49.6**	**39.7**	**23.3%**	**0.95**
Internet Portals Average					**32.8**	**18.6**	**43.9**	**30.5**	**55.1**	**42.1**	**53.3**	**40.4**	**29.6%**	**1.01**
Online Gaming														
Changyou	BUY	CYOU US	US$33.42	1,785	4.4	2.9	6.7	4.7	9.8	8.1	8.0	6.6	15.8%	0.51
Giant	NEUTRAL	GA US	US$7.38	1,725	7.6	6.1	12.7	10.4	13.7	11.9	8.1	6.9	16.8%	0.71
Kingsoft	REDUCE	3888 HK	HK$4.53	668	2.9	2.7	7.5	6.3	10.3	11.6	8.1	9.6	6.0%	1.94
NetDragon	NEUTRAL	777 HK	HK$3.82	258	1.9	1.7	16.1	10.8	50.1	27.7	76.5	34.8	34.7%	0.80
NetEase	BUY	NTES US	US$51.71	6,739	6.4	4.8	15.2	11.4	19.4	15.9	17.4	14.1	19.5%	0.82
Perfect World	BUY	PWRD US	US$22.36	1,184	2.7	1.8	6.3	4.8	8.7	8.0	7.3	6.8	16.0%	0.50
Shanda Games	BUY	GAME US	US$6.32	1,791	2.3	1.5	6.0	4.2	8.7	7.5	7.4	6.4	18.9%	0.39
Shanda Interactive	NEUTRAL	SNDA US	US$43.83	2,530	2.2	1.4	7.2	5.8	22.1	22.7	10.7	11.6	18.1%	1.26
Online Gaming Median					**2.8**	**2.3**	**7.4**	**6.1**	**12.0**	**11.8**	**8.1**	**8.3**	**17.4%**	**0.75**
Online Gaming Average					**3.8**	**2.9**	**9.7**	**7.3**	**17.8**	**14.2**	**17.9**	**12.1**	**18.2%**	**0.87**
Outdoor Media														
AirMedia	BUY	AMCN US	US$5.34	367	1.1	0.9	13.5	5.3	52.1	10.1	47.9	7.6	156.0%	0.06
Clear Media*	Not Rated	100 HK	HK$4.90	332	1.4	1.2	7.6	6.6	14.4	12.3	N/A	N/A	26.5%	0.46
Focus Media	BUY	FMCN US	US$30.98	4,389	6.5	5.8	15.7	13.4	25.6	21.2	23.1	19.0	22.5%	0.94
VisionChina*	Not Rated	VISN US	US$4.45	455	2.7	2.2	31.8	12.4	68.5	16.0	N/A	N/A	13.9%	1.16
Outdoor Media Median					**2.0**	**1.7**	**14.6**	**9.5**	**38.8**	**14.1**	**35.5**	**13.3**	**24.5%**	**0.70**
Outdoor Media Average					**2.9**	**2.5**	**17.2**	**9.4**	**40.1**	**14.9**	**35.5**	**13.3**	**54.7%**	**0.66**
E-Commerce														
Alibaba	REDUCE	1688 HK	HK$13.58	8,842	9.1	7.1	28.6	18.8	33.2	25.6	30.9	23.7	28.8%	0.89
Ctrip	BUY	CTRP US	US$42.84	5,836	9.6	7.6	23.8	18.4	28.6	23.2	N/A	N/A	26.8%	0.87
Global Sources*	Not Rated	GSOL US	US$12.22	410	1.4	1.3	8.7	7.7	15.7	14.2	N/A	N/A	27.0%	0.53
E-commerce Median					**9.1**	**7.1**	**23.8**	**18.4**	**28.6**	**23.2**	**30.9**	**23.7**	**27.0%**	**0.87**
E-commerce Average					**6.7**	**5.3**	**20.4**	**14.9**	**25.8**	**21.0**	**30.9**	**23.7**	**27.5%**	**0.76**
U.S.														
Amazon.com Inc.*	Not Rated	AMZN US	US$182.94	82,507	1.7	1.3	24.8	19.0	43.8	32.8	N/A	N/A	27.4%	1.20
eBay Inc.*	Not Rated	EBAY US	US$31.39	40,731	3.4	3.0	9.6	8.5	16.2	14.4	N/A	N/A	10.4%	1.39
Expedia Inc.*	Not Rated	EXPE US	US$22.43	6,147	1.8	1.6	6.6	6.0	12.4	10.9	N/A	N/A	13.9%	0.79
Google*	Not Rated	GOOG US	US$587.68	189,372	5.9	5.0	10.2	8.7	16.9	14.7	N/A	N/A	18.9%	0.78
Priceline.com*	Not Rated	PCLN US	US$518.59	25,490	6.1	5.0	19.9	15.7	27.4	21.6	N/A	N/A	21.3%	1.02
Yahoo*	Not Rated	YHOO US	US$16.87	22,090	4.2	4.0	11.6	10.5	21.9	18.7	N/A	N/A	9.6%	1.95
US Internet & Media Median					**3.8**	**3.5**	**10.9**	**9.6**	**19.4**	**16.7**	**N/A**	**N/A**	**16.4%**	**1.11**
US Internet & Media Average					**3.8**	**3.3**	**13.8**	**11.4**	**23.1**	**18.8**	**N/A**	**N/A**	**16.9%**	**1.18**

Note: Pricing as at 4 Apr, 2011, estimates for companies asterisked are from Bloomberg Consensus

Source: Bloomberg, Nomura estimates

Youku.com Inc. YOKU US

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Initiation

BUY

NOMURA
NOMURA INTERNATIONAL (HK) LIMITED

Action

We initiate coverage of Youku.com with a BUY rating and a 12-month price target of US$65. We like Youku's strong potential for revenue growth, virtually unlimited advertising inventory, effective advertising with precisely targeted demographics and high operating leverage.

Catalysts

The transition from traditional TV to online video in China serves as a strong revenue growth catalyst.

Anchor themes

The Internet run in China still has room to move, with growth momentum expected to accelerate on the heels of strong user base expansion and increased utilisation. Among all sub-sectors, we see online gaming as the major beneficiary in the current stage of the industry cycle.

Closing price on 4 Apr	US$48.84
Price target	**US$65.0**
Upside/downside	33.1%
Difference from consensus	73.3%
FY11F net profit (RMBmn)	(258.1)
Difference from consensus	na (loss)

Source: Nomura

Nomura vs consensus

We expect operating leverage to kick in sooner and the transition from traditional TV to online video to happen faster.

A revenue growth story

① Initiating with a BUY and US$65 price target

We initiate coverage of Youku.com with a BUY rating and a 12-month price target of US$65, representing 33.1% potential upside from current levels. Our PT is based on a discounted cashflow (DCF) valuation, which assumes a WACC of 9.4% and terminal growth of 5%. Youku is the largest online video company in China, with most of its revenue coming from advertising on its video platform. We are positive on the company for its scale, high revenue growth potential and high operating leverage.

② High potential for revenue growth

With online video users in China growing at a pace of 17.3% over the next three years, on our estimates, we are optimistic that advertising revenues will follow. We expect the online video industry to grow five-fold (up 400%) over the next three years and Youku's revenue to increase 442% over the same timeline. As a significant part of Youku's cost structure is fixed, we believe its bottom line profit will ramp up rapidly, given its high operating leverage.

③ Valuations

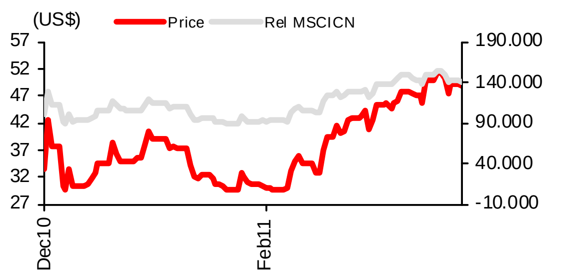
With continued strong user growth and a catch-up in advertising, we estimate Youku will breakeven in 2H12F, when the fill rate reaches 23% and effective CPM reaches RMB31 on our forecasts. On our estimates, Youku is trading at one-year forward price-to-sales of 35.5x and 2011F EV/revenue of 39.5x, a premium to peers (assuming 110.3% y-y net revenue growth in 2011F and 2011-13F net revenue CAGR of 62.4%). Its high operating leverage should also lead to significant EPS growth. As such, not only do we believe Youku's valuation is justified, but we also see further upside on margin expansion; thus supporting our DCF-based price target of US$65.

Key financials & valuations

31 Dec (RMBmn)	FY09	FY10	FY11F	FY12F
Revenue	154	387	814	1,341
Reported net profit	(182.3)	(204.7)	(258.1)	(74.5)
Normalised net profit	(175.4)	(148.4)	(126.7)	65.7
Normalised EPS (RMB)	(1.66)	(1.41)	(1.20)	0.62
Norm. EPS growth (%)	na	na	na	na
Norm. P/E (x)	na	na	na	508.9
EV/EBITDA (x)	na	na	na	215.9
Price/book (x)	119.1	18.2	20.3	20.5
Dividend yield (%)	0.0	0.0	0.0	0.0
ROE (%)	45.9	(29.0)	(14.5)	(4.5)
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		na	na	na
Change from previous (%)		na	na	na
Previous norm. EPS (RMB)		na	na	na

Source: Company, Nomura estimates

Share price relative to MSCICN



	1m	3m	6m
Absolute (US$)	13.8	37.0	na
Absolute (US$)	13.8	37.0	na
Relative to Index	8.9	34.1	na
Market cap (US$mn)			5,145
Estimated free float (%)			100.0
52-week range (US$)			51.3/29.55
3-mth avg daily turnover (US$mn)			96.4
Stock borrowability			
Major shareholders (%)			
Brookside Capital			21.7
TCW Group Inc.			3.1

Source: Company, Nomura estimates

Investment considerations

Executive summary

Initiating with a BUY and price target of US$65

We initiate coverage of Youku (YOKU US) with a BUY rating and a 12-month price target of US$65, representing potential upside of 33.1% from current levels. We believe there are several factors that play into the Youku growth story.

Marketplace potential: According to iResearch, total spending on online video ads in China grew from RMB250mn in 2007 to RMB2,910mn in 2010, taking market share from TV, and we estimate the number can further quintuple by end-2013F from the 2010 level, with a 2010-13 CAGR of 72.7%, much higher than the 2010-13 CAGR of 17.3% for online video users, on our estimates. We estimate that online video advertising, which accounts for only 1.7% of total TV advertising today in China, could exceed 7.5% over the next three years. We estimate TV advertising will record a 5% CAGR over the next three years, which we estimate could top RMB200bn by 2013F. We estimate online video advertising could be RMB15bn by 2013F, driven by continued user transition to online video from TV.

Unlimited advertising inventory: We believe Youku's advertising revenue is primarily determined by demand, given its virtually unlimited content library (and thus potential ads inventory). We believe strong advertising demand will be met by sufficient supply as the components of supply namely the video view (VV) number, the fill rate of ads and the unit price will all increase, on our estimates.

Targeted demographics: Online video sites can place ads according to the advertisers' requirement with precise targeting. The ads could be targeted at specific regions, with specific content to reach a certain demographic group, at specific time slots and with a specific frequency of impression. And in terms of audience demographics, online video audiences are generally younger and better educated than TV audiences, according to CNNIC (China Internet Network Information Center) and CSM Media Research. In terms of cost of advertising, Youku has a reach of over 20mn viewers, make up of 18-40 year olds in 31 capital cities, comparable to major TV channels according to iResearch. Its actual cost per mille (CPM) is only around RMB22, which is at a large discount to that of TV at RMB50-100, as per CTR Market Research.

Scalability. The only variable costs that grow in line with revenue are sales commission and business tax and surcharges. We expect bandwidth cost will increase steadily to meet incremental traffic need, but at a much slower pace than revenue growth. With bandwidth, you are buying capacity, and because much of the capacity was built in the early stages of growth, incremental bandwidth costs will be small as user growth matures. We believe the right way to look at bandwidth costs is not on a y-y percentage growth level, but on a q-q absolute level, as we believe capacity expansion will be minimal on a rolling basis as the business matures. We believe the same will occur with content cost – as the company ramps its content library – but once a portfolio of a run-rate library has been established, incremental content cost should be minimal. Although content cost could grow faster than revenue in the next 2 years, we believe revenue growth will still exceed content cost growth, resulting in decreasing content cost, as a percentage of net revenue, in the longer term.

Valuation. With continued strong user growth and a catch-up in advertising, we estimate Youku will breakeven in 2H12F, when the fill rate is 23% and effective CPM is RMB31, on our forecasts. On our estimates, Youku is trading at one-year forward price-to-sales of 35.5x and 2011F EV/revenue of 39.5x, a premium to peers (assuming 110.3% y-y net revenue growth in 2011F and 2011-13F net revenue CAGR of 62.4%). Its high operating leverage should also lead to significant EPS growth. As such, not only do we believe Youku's valuation is justified, but we also see further upside on margin expansion; thus supporting our DCF-based price target of US$65.

Valuation

BUY, with a price target of US$65

We initiate coverage of Youku with a BUY rating and a price target of US$65, with potential upside of 33.1%. We hold a positive view on Youku for its strong revenue growth potential and high operating leverage. We believe the transition from traditional TV to online video is taking place, with increasingly more TV audience moving online. According to iResearch, Online video users in China grew from 161mn in 2007 to 284mn in 2010, recording a CAGR of 20.8%. We forecast online video users will further increase to 458mn in 2013F, reaching 68% of the online population and 34% of the total population in China by end-2013F. While online video advertising growth hasn't ramped as quickly, we are optimistic that advertising revenue will outpace subscriber growth. We are optimistic on the prospects of online video advertising in China as we witnessed a similar case in the past – Internet user growth was faster than online ad revenue growth back in 2002, but online ad revenue in China soon ramped up and has outgrown the pace of Internet users ever since. We expect to see the same happening to online video ads, as advertisers will follow the audience online. Therefore, we forecast the online video industry to grow five-fold (up 400%) over the next three years and we expect Youku's revenue to rise 442% over the same timeline.

We believe that with critical mass, Youku's business model will be highly scalable and we should see operating margin leverage starting to kick in over the next 18 months. We expect revenues to increase to RMB814mn, 110.3%-plus y-y in 2011F and RMB1,341mn, 64.7%-plus y-y in 2012F. We also expect non-GAAP operating margins to go from -14.4% in 2011F to 2.6% in 2012F. The only variable costs that grow in line with revenue are sales commission and business tax & surcharges. Bandwidth cost will increase steadily to meet the incremental traffic need, but at a much slower pace than revenue growth as user growth will stabilise earlier, in our view. Although content costs could grow faster than revenue over the next 18 months, we believe the growth rate of revenue will again exceed content cost growth, resulting in decreasing content costs as a percentage of net revenue in the longer term. All other costs and expenses including depreciation, sales & marketing expenses, product development expenses and general & administrative expenses will continue to scale down as a percentage of revenue, in our view. Therefore, we believe a significant part of Youku's cost structure is fixed and once Youku breaks even, its bottom line profit will ramp up rapidly due to high operating leverage.

Although Youku is still making a loss now, it achieved a positive EBITDA for the first time in 4Q10 and almost broke even. With continued strong user growth and a catch-up in advertising, we estimate Youku will breakeven in 2H12F, when the fill rate is at 23% and effective CPM is at 31 RMB, on our forecasts. We recommend buying the stock now for top line growth and margin leverage.

Our price target is based on a discounted cashflow (DCF) valuation, assuming a WACC of 9.4% and terminal growth of 5% out 10 years. The cashflows are discounted back to end-2011.

Exhibit 23. DCF assumptions

Risk-free rate	2.5%
Stock beta (equity)	1.25
Equity risk premium	5.5%
Cost of equity	9.4%
Cost of debt	5.0%
Tax rate	18%
Capital structure:	
- Debt	0%
- Equity	100%
WACC	9.4%
Termination growth rate	5.0%

Source: Nomura research estimates

Exhibit 24. FCF calculation

	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2020F
Net revenue (RMBmn)	814	1,341	2,098	3,104	4,221	5,454	6,800	8,224	9,640	11,146
EBIT (RMBmn)	(258)	(91)	111	436	896	1,449	2,097	2,820	3,593	4,435
Operating cashflow (RMBmn)	(109)	55	256	555	984	1,534	2,152	2,849	3,606	4,632
Capex (RMBmn)	130	174	241	341	422	545	680	822	964	1,115
FCF (RMBmn)	(240)	(120)	15	214	562	988	1,472	2,027	2,642	3,517

Source: Nomura estimates

Exhibit 25. Forecast for key metrics

	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2020F
Net revenue (RMBmn)	814	1,341	2,098	3,104	4,221	5,454	6,800	8,224	9,640	11,146
Daily VVs (mn)	213	264	322	387	456	529	604	676	742	802
Fill rate (%)	20.2	23.0	26.0	28.5	30.5	32.0	33.5	34.5	35.1	35.7
Effective CPM (RMB)	27	31	36	40	44	46	49	51	54	56

Note: We assume the 1.8 ads/VV ad load to be fixed.

Source: Nomura estimates

Based on our estimates, Youku is currently trading at one-year forward price-to-sales of 35.5x and 2011F EV/revenue of 39.5x, a premium to its peers. However, we believe Youku deserves a high valuation as it is currently in its high-growth period, on our estimates. If we look at some of Youku's peers' one-year forward price-to-sales ratio in the past, we can find similar valuations during their high growth phase. Baidu, for example, enjoyed a one-year forward prices-to-sales ratio of over 50x in 4Q07, when its revenue y-y growth was around 110%. Likewise, for Google, in 2004 its one-year forward price-to-sales ratio ramped from 5x to over 13x. Tencent and Sina also saw valuation expansions during the high growth phase of their platforms. Tencent's one-year forward price-to-sales ratio expanded from 5x at the beginning of 2009 to over 14x one year after, during which period the PCU (peak concurrent users) on its QQ IM platform re-accelerated. Sina's one-year forward price-to-sales ratio increased from 5x in August 2009, when it started testing its Weibo platform, to close to 15x recently due to the increasing popularity of its Weibo.

Youku's premium is based on 110.3% y-y net revenue growth in 2011F and a net revenue CAGR of 62.4% for 2011-13F on our estimates. Assuming breakeven in 2H12F, we think its high operating leverage could lead to significant EPS growth. In our view, Youku's current high valuation is justified. We see further upside from here based on margin expansion; our DCF-based target price is US$65. If its price were to remain at the current level, Youku's price-to-sales ratio would decrease rapidly over time, as per our estimates.

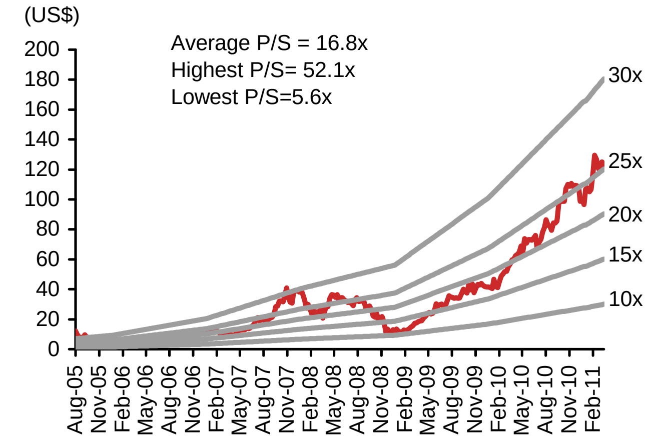
Exhibit 26. Valuation comparison

	Investment rating	Ticker	Current price	Mkt. cap. (US$mn)	EV/revenue (x) 2010	EV/revenue (x) 2011F	EV/EBITDA (x) 2010	EV/EBITDA (x) 2011F	P/E (x) 2010	P/E (x) 2011F	EPS CAGR (%) 10-12F
Sina	BUY	SINA US	US$116.56	7,642	17.7	14.3	63.4	51.6	67.4	68.0	14.9
Baidu	BUY	BIDU US	US$143.11	50,005	41.4	24.9	74.8	43.4	92.9	54.0	56.8
Tencent	BUY	700 HK	HK$196.40	46,859	15.0	10.5	26.2	19.3	37.0	26.5	31.6
Google*	Not Rated	GOOG US	US$587.68	189,372	5.9	5.0	10.2	8.7	16.9	14.7	18.9
Netflix*	Not Rated	NFLX US	US$244.72	12,943	4.1	3.1	25.0	18.1	53.2	38.1	9.6
Youku	**BUY**	**YOKU US**	**US$48.84**	**5,145**	**84.8**	**39.5**	**N/A**	**N/A**	**N/A**	**N/A**	**N/A**
Average					**16.8**	**11.6**	**39.9**	**28.2**	**53.5**	**40.2**	**26.4%**

Note: Pricing as at 4 Apr 2011

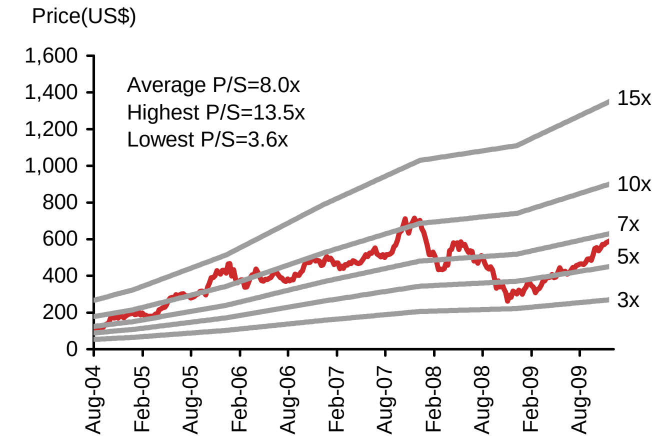
Source: Nomura estimates, *Bloomberg consensus for stocks not rated by Nomura

Exhibit 27. Baidu: One-year forward P/S band



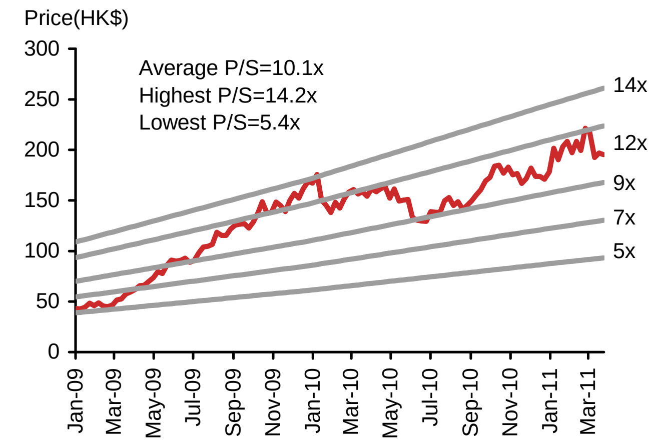
Source: Nomura estimates

Exhibit 28. Google: One-year forward P/S band



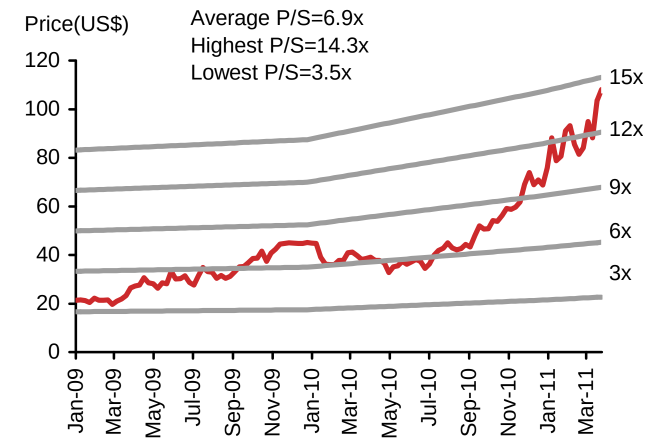
Source: Bloomberg

Exhibit 29. Tencent: One-year forward P/S band



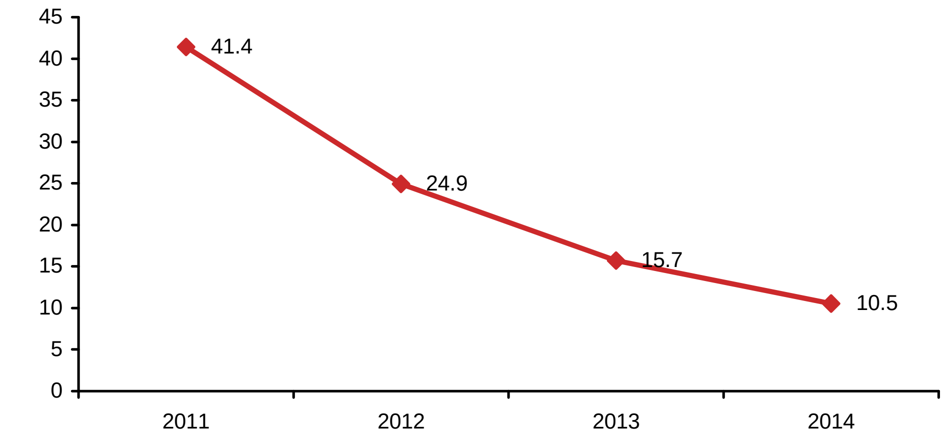
Source: Nomura estimates

Exhibit 30. Sina: One-year forward P/S band



Source: Nomura estimates

Exhibit 31. Youku's price-to-sales ratios at current price



Source: Nomura estimates, pricing as at 4 Apr 2011

Investment risks

Risks to our view

- **Content cost inflation**

  – The unit acquisition cost of professional content, especially key TV drama series and movies, went up dramatically due to intensifying competition among online video companies. According to management, the average unit license fee for TV drama series increased in 2010 by over 100% compared with that in 2009, which in turn increased by 200%-plus from 2008. Unit acquisition cost for movies also went up by 90%-plus in 2010 from 2009, according to Youku. With fierce competition, we think there is still room for a further increase in unit acquisition cost in the short term, especially hot TV drama series and movies. Therefore, we believe, content cost inflation poses a major risk on Youku's path to profitability as content costs could outgrow revenue over a longer term.

- **Slower-than-expected transition from traditional TV to online video**

  – We forecast a revenue CAGR of 62.4% for FY11-13F for Youku based on user uptake of online video and as advertisers follow users to video. Given the high fixed cost base of bandwidth and content, slowing advertiser uptake of online video advertising could delay Youku's profitability, in our view.

- **Government policies and regulations**

  – TV stations in China are all state-owned and heavily regulated. Online video companies in China, including Youku, are also regulated by various authorities including the State Administration of Radio, Film, and Television (SARFT). Therefore, Youku faces regulatory risks as authorities may impose new regulation and restrictions on the industry that could affect Youku's business negatively.

- **Significant competition from larger Internet companies**

  – Although Youku is currently the largest player in the market, it continues to face intense competition from existing online video competitors and new entrants. Some of its competitors are well-financed with unique advantages, such as referral traffic from famous search engines. Therefore, Youku could lose its existing market share to its competitors.

- **Copyright issues**

  – Since Youku started as a user-generated content (UGC)-focused video sharing site in China, it has been involved in hundreds of litigations on infringement of third-party copyright. Youku may continue to face litigation from copyright owners in the future, which could have a potential negative impact on both Youku's financial position and reputation.

Youku

Overview of Youku

Overview

Youku is the largest online video company in China, in terms of user time spent. According to iResearch Consulting Group, or iResearch, Youku had a 40% market share of total user time spent viewing online videos in China in 2Q10, while the second largest player, Tudou had a 23% market share during the same period. From a revenue perspective, Youku recorded net revenue of RMB234.6mn for the first nine months of 2010, which we believe was also the highest among China online video websites, compared with Tudou's RMB224.8mn during the same period.

Youku was founded in 2005 while the Youku.com website was launched in 2006, one year after its major competitor Tudou's launch. The company is based in Beijing and aims to "become the primary source of video content for Chinese Internet users across all Internet-enabled devices".

Business model

Youku aggregates video content on its website and users can view most of the videos for free. While users can watch videos directly on Youku, other functions such as video uploading as well as making comments require user registration, which is also free.

Currently Youku derives most of its revenue from advertisers by placing advertisements in various formats on its website. Brand ads and affiliate advertising programs accounted for 91.6% and 6.3%, respectively, of Youku's net revenue in 2009, and 94.9% and 3.3%, respectively, of its net revenue in the first nine months of 2010. Affiliate advertising programs are basically text-link contextual ads placed by Google and Baidu. The company expects the downward trend in affiliate advertising program revenue to continue over time, compared with brand ads. Brand ads, in turn, take different forms including in-video ads (short advertising video clips of normally 15 seconds that appear at the start or end of the video content), pause ads and banner ads, among many others. In the Exhibits below we show the different types of ads that are placed on Youku.

- Banner ads and text link ads: Similar to traditional portals, most of these ads are charged on a fixed cost per-day basis. A small portion of the banner ads are charged on a CPM basis.
- Focus video ads: The video itself is the ad. It can be played directly on the homepage and is charged on a fixed cost per day.
- Seed video ads: The video itself is the ad. However, they are listed together with normal content and users usually don't know that they are ads. Generally, these video ads are funny and are hence good for viral marketing. The length limit of the video is 10 minutes; however, most of the ads are shorter than three minutes.
- In-video ads: In-video ads on Youku currently include pre-roll ads and post-roll ads. These are a major part of Youku's revenue. Pre-roll and post-roll ads are normally 15 seconds in length with some short pre-roll ads of five seconds. Youku currently puts up to two pre-rolls and one post-roll in each video. In-video ads are charged on a CPM basis.
- Pause-ads: Banner or flash animation ads that show up when a user pauses the video play. They are charged on a CPM basis.
- Affiliate ads programs: Contextual ads provided by Baidu/Google. These ads are not sold to Youku's advertisers and, therefore, are not included in Youku's rate card.

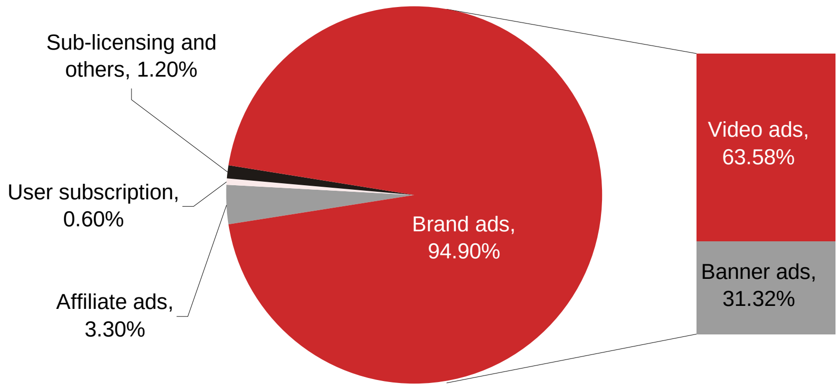
Exhibit 32. Homepage of Youku.com

Source: Company website

Exhibit 33. Video page

Source: Company website

Exhibit 34. Youku's current revenue mix 2010

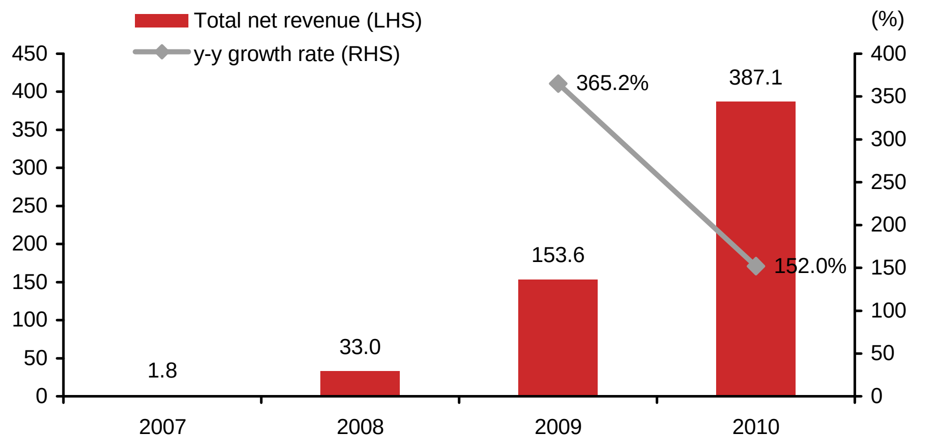


Source: Company data and Nomura estimates

Apart from advertising, Youku also generates other revenue including paid subscription and content sub-licensing. According to management, subscription revenue currently accounts for less than 1% of Youku's total net revenue. Non-advertising revenue, in aggregate, accounted for only 1.8% of the company's total net revenue for the first nine months of 2010.

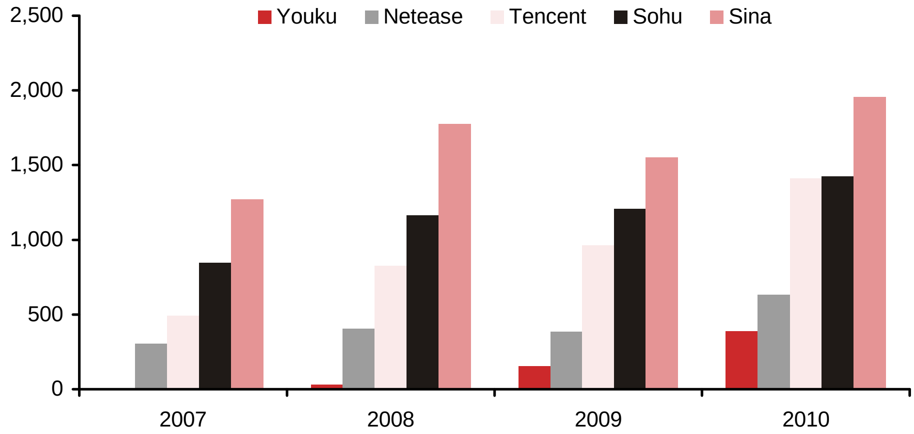
Youku's net revenue grew from RMB1.8mn in 2007 to RMB387.1mn in 2010, recording a CAGR of 502% over the period. However, it is still relatively small compared with the brand advertising revenue of major Internet portals in China.

Exhibit 35. Youku's total net revenue (RMBmn)



Source: Company data

Exhibit 36. Brand advertising revenue (RMB mn) Youku vs. portals



Source: Company data, Nomura estimates

The online TV play

Shift from traditional TV to online TV

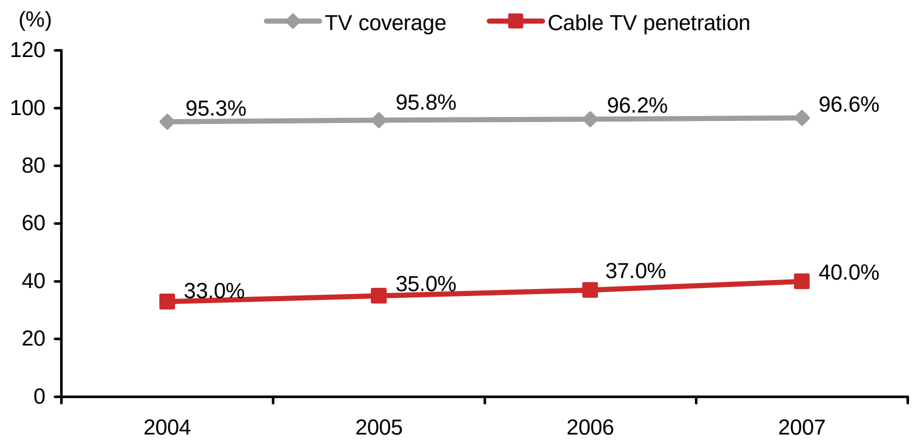
In China, we are seeing a structural shift from traditional TV to online driven by factors such as, Internet penetration and 1) increasing sophistication; 2) on-demand content online, and; 3) less strict regulatory environment compared with TV.

Audience moving online

TV has broad coverage and high popularity among the audience in China. According to SARFT, overall TV coverage and cable TV penetration in China reached 96.6% and 40%, respectively, in 2007. However, China Market Intelligence Center (CMIC) showed that by end-2009, cable TVs were installed in 174mn households in China, representing a penetration ratio of about 45%. We believe TV is the only medium that enjoys a coverage ratio of over 95% in China.

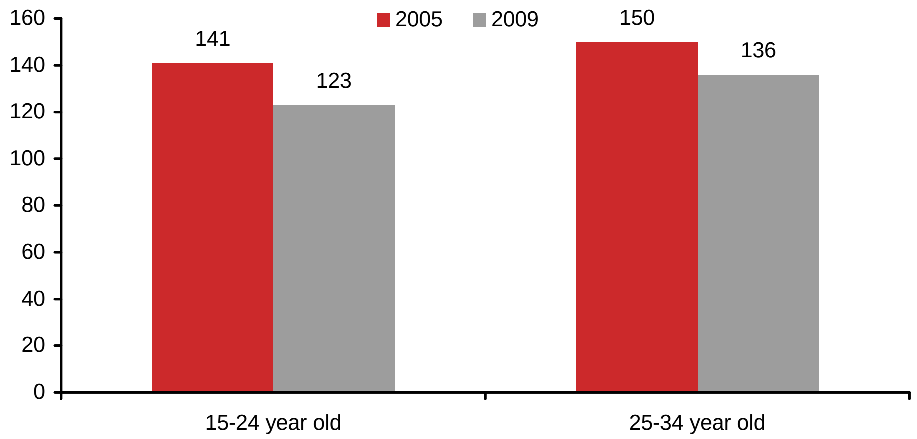
Given the growth of Internet penetration, coupled with on-demand content, we are starting to see greater movement of viewership, with traditional TV audience moving online. According to market research conducted by CSM Media Research, a media audience measurement research firm, the daily time spent watching TV in China for people in the age group of 25 to 34 years has declined from 150 minutes in 2005 to 136 minutes in 2009, or by 9%. The 15 to 24 year old demographic showed a similar trend, with the time spent watching television having declined from 141 minutes in 2005 to 123 minutes in 2009, or by 13%. While we believe this is largely due to the adoption of the Internet, in general, with online video being one of the key drivers. According to CNNIC's online video report 2009, 66.8% of the online video users surveyed indicated that their time spent on TV had decreased. 23.7% of the users even said they almost did not watch TV anymore.

Exhibit 37. TV coverage and Cable TV penetration in China



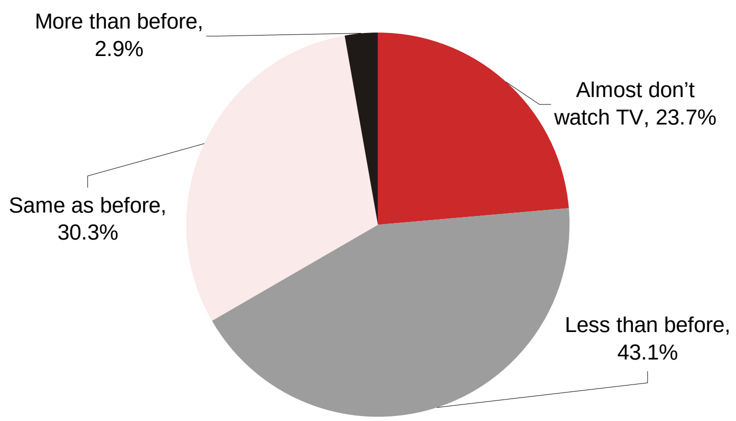
Source: SARFT

Exhibit 38. Change of time (minutes per day) spent on TV for TV audience



Source: CSM Media Research

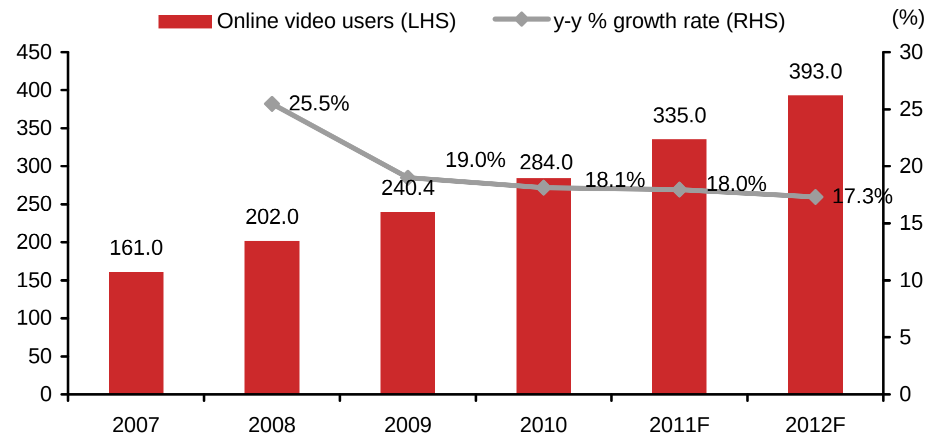
Exhibit 39. Change of time spent on TV for online video users 2010



Source: CNNIC

On the other hand, online video users are growing rapidly in China. According to CNNIC, online video users in China grew from 161mn in 2007 to 284mn in 2010, representing a CAGR of 20.8%. We estimate the number will increase to 393mn in 2012F, with a FY10-12F CAGR of 17.6%. We believe the two key drivers for online video user growth are the availability of Internet and the availability of on-demand content online, compared with traditional TV.

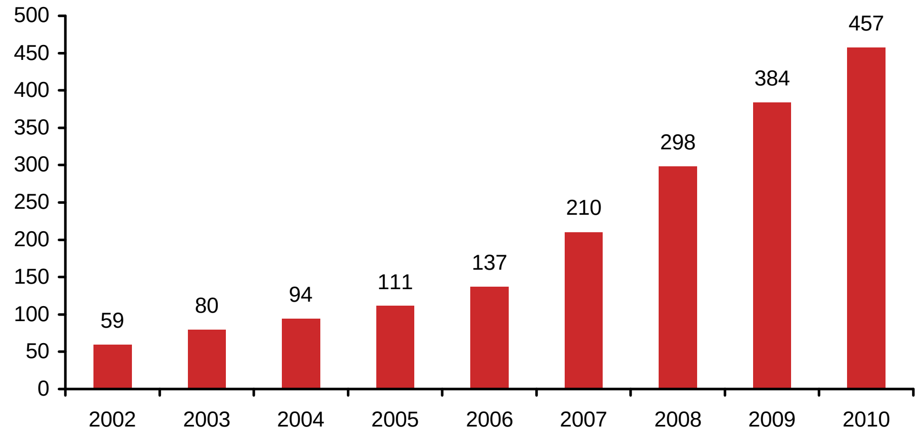
Exhibit 40. Online video users in China mn



Source: CNNIC and Nomura estimates

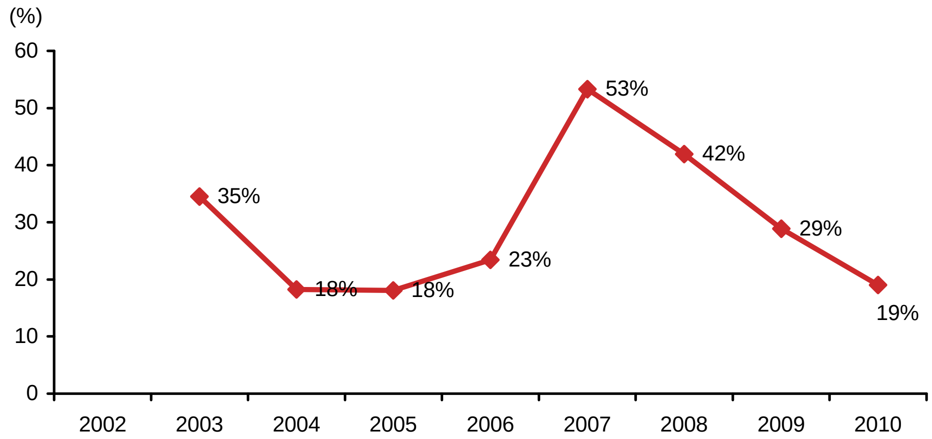
Availability of Internet: According to a recent report by CNNIC, there were 457mn Internet users in China in Dec 2010 – a CAGR of 29% from 2002 to 2010. We believe the Chinese Internet market remains in relative infancy, and we expect steady growth from here, particularly in tier-2 and tier-3 cities where penetration remains quite low at under 40%, compared with tier-1 cities, including Beijing, Shanghai, Guangzhou and Shenzhen all topping 70%. While year-on-year growth may have slowed over the past couple of years due to base impact – to 15-25% annually, from 30%-plus earlier in the first decade of the new millennium – we believe the Internet run has quite a way to go. With China's population exceeding 1.3bn, according to the latest census count, if Internet penetration was at par with its neighbours at 70%, the local user base would gain about 453mn users, a doubling target that we think can be achieved by 2020.

Exhibit 41. China: Internet users (mn)



Source: CNNIC

Exhibit 42. China: Internet users growth rate



Source: CNNIC

Advantages over TV: We believe online video has the following advantages over traditional TV from a user perspective.

- **On-demand and limitless content:** Due to the on-demand nature of online video, users don't need to wait in front of the TV at a specific time. Furthermore, the inventory of content breadth and selection can be essentially limitless. In addition, users have the flexibility to skip certain part of the content, and they can always rewind or fast-forward by dragging the progress bar.
- **Broader distribution:** Along with the advantage of limitless content and scale, online video is not restricted by geography or time. Except for CCTV and some provincial satellite TVs (PSTV), most provincial and local TV channels are only available within a limited geographical region. Most of the audience in Shanghai is not able to watch a local Beijing TV channel. This is not the case for online video as there is only one Internet in the world. As long as a user has Internet access, he/she can watch Youku anywhere in the world (although some of the content may get blocked outside mainland China for copyright reasons).
- **Broader content:** While SARFT does not allow foreign TV dramas to be shown during prime time (from 19:00 to 22:00) on TV, there is no such restriction for online video. On the movie side, SARFT also restricts the number of foreign movies each year in movie theatres to only 20. Once again, there is no such limit for online video. Online video can also host a large number of long-tail content that caters to special consumer needs.

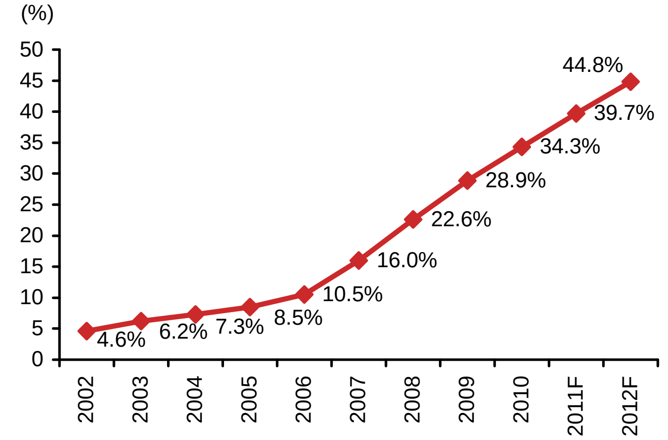
Exhibit 43. Advantages of online video over TV from a user perspective

	Traditional TV	Online video
Flexibility	Can only watch at specific times	24 x 7 on demand
Space	Content can be localised or regionalised	Anywhere with Internet access
Content	Strict controls - No foreign TV dramas during prime time, only 20 foreign movies each year	No such limit, much broader content

Source: Nomura research

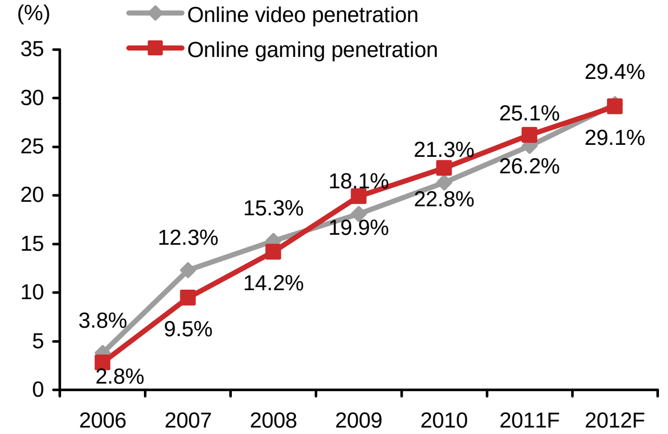
Given the advantages of online video over traditional TV, we believe more users will shift their time spent on TV to online video. In end-2010, there were 284mn online video users in China, representing about 62.1% of the total online population or 21.3% of the total population in China, according to CNNIC. We estimate online video penetration can grow to 29% of the total population over the next two years.

Exhibit 44. Internet penetration in China



Source: CNNIC and Nomura estimates

Exhibit 45. Online video and gaming penetration

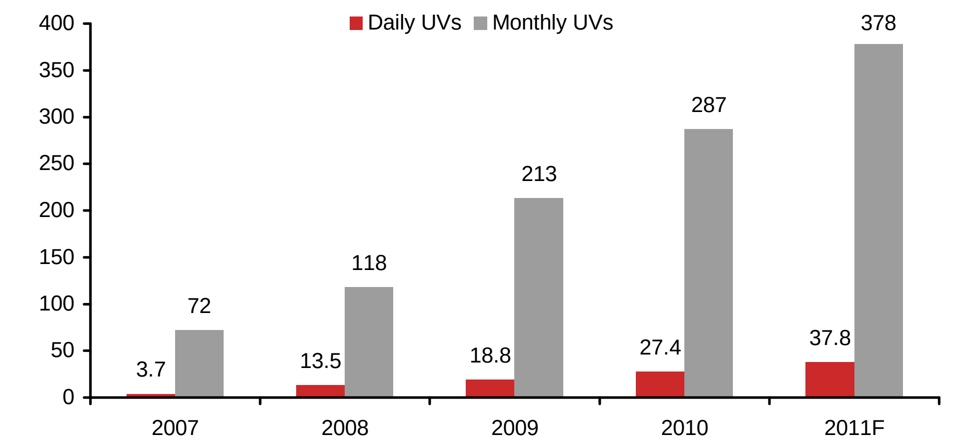


Source: CNNIC and Nomura estimates

Traffic growth on Youku

We expect Youku's traffic base to continue to grow faster than the overall online video user base in China. Based on the company's disclosure and our estimates, Youku's monthly unique visitors (UVs) and daily UVs over the past four years are charted below. Monthly UVs increased from 72mn in 2007 to 287mn in 2010 recording a CAGR of 58.6%, much higher than the 20.8% CAGR of general online video users.

Exhibit 46. Average daily and monthly UVs of Youku (mn)



Source: Company data and Nomura estimates

Youku, as the largest online video player in China, is now able to reach a wider audience, which is comparable with popular TV stations in urban areas. According to a survey by iResearch, in terms of media audience reach for 18 to 40 year olds in tier-1 and tier-2 cities, Youku's reach ranks No. 4, as shown below.

Exhibit 47. Top TV channels by daily audience reach

Rank	Channel	Daily reach (mn)
1	CCTV-6 (Movie Channel)	26.3
2	CCTV-3 (Variety Show and MTV)	24.9
3	Hunan Satellite TV	21.7
4	**Youku**	**20.2**
5	CCTV-5 (Sports)	19.4
6	CCTV-8 (TV Drama)	17.6
7	Zhejiang Satellite TV	17.1
8	Jiangsu Satellite TV	15.8
9	Anhui Satellite TV	15.5
10	Sichuan Satellite TV	15

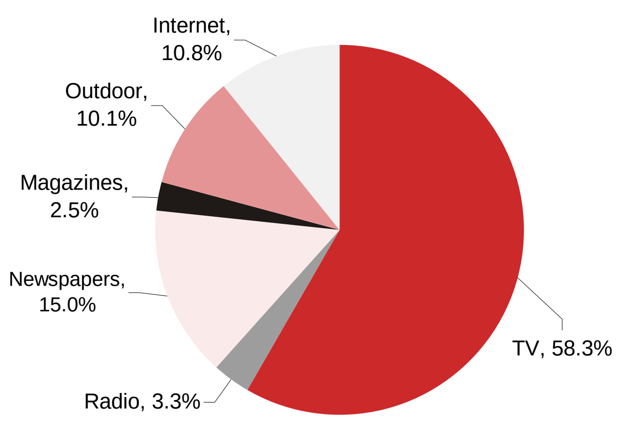
Note: Daily reach in 31 capital cities for 18-40 year olds, excluding CCTV-1.

Source: iResearch

Market size potential

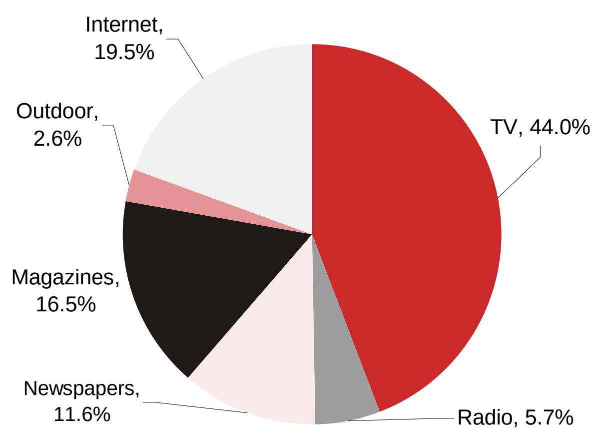
With a strong demand environment for online video content, advertisers have taken notice and advertising spend has increased in triple digits over the past few years, which we expect to remain robust in the near term. TV advertising currently has the lion's share of total ad spending in China. According to GroupM, TV ads accounted for 58.3% of total ad spending in 2010 in China, while in the US, it accounted for only 44.0% during the same year. The share of TV in total ad spending has remained relatively stable over the past six years, while that of the Internet has increased steadily during the same period in China. Although we believe that TV will continue to dominate in the foreseeable future, we do believe that TV share will slowly decline going forward, largely eaten up by strength in online advertisement and online video. We estimate that TV advertising will inch down to 55.6% in 2011F (from 58.3% in 2010) and Internet advertising will reach 13.1% by 2011F (from 10.8% in 2010).

Exhibit 48. Ads spending by media in China (2010)



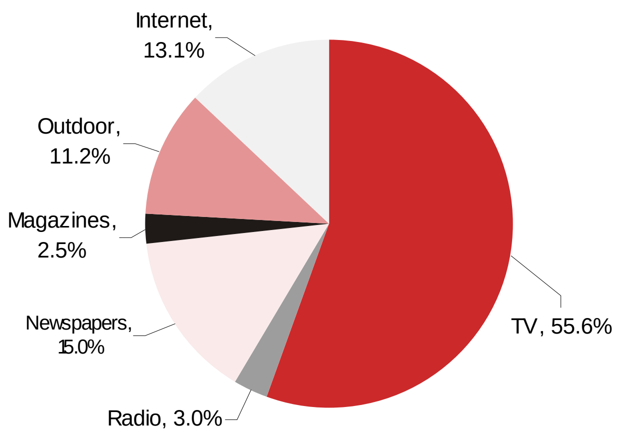
Source: GroupM

Exhibit 49. Ads spending by media in US (2010)



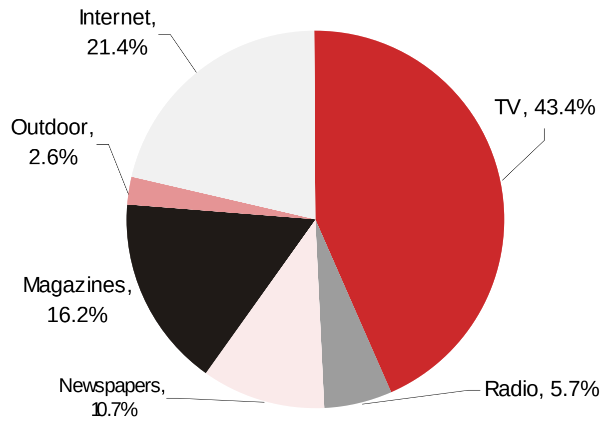
Source: GroupM

Exhibit 50. Ads spending by media in China (2011F)



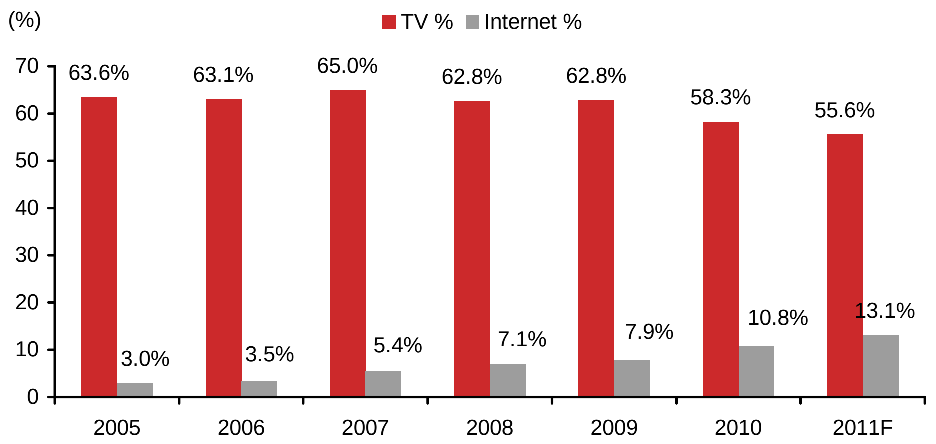
Source: GroupM and Nomura estimates

Exhibit 51. Ads spending by media in US (2011F)



Source: GroupM

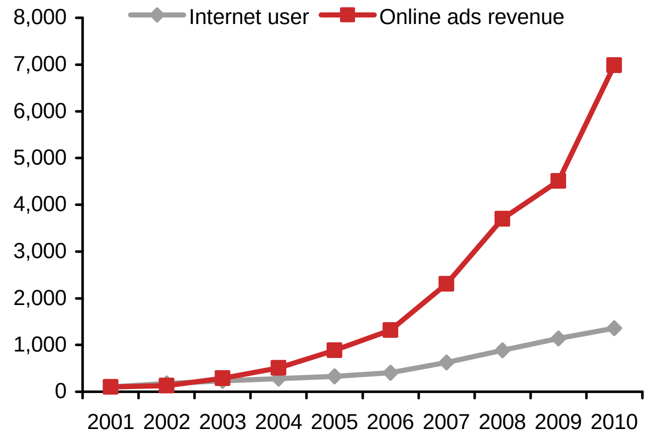
Exhibit 52. TV and Internet share in total ad spending in China



Source: GroupM and Nomura estimates

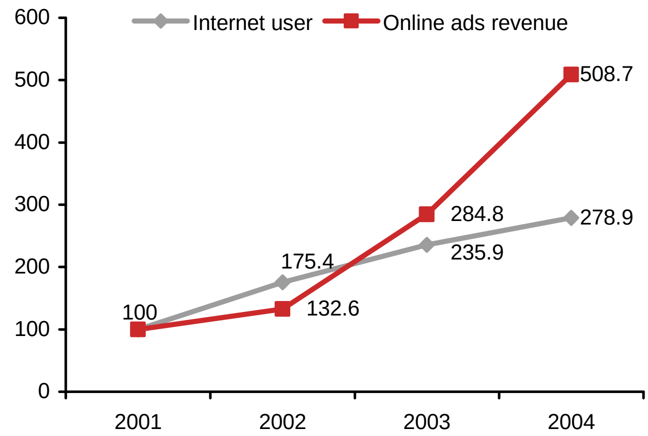
Compared with the shift of users from traditional TV to online video, we believe advertising pick up may take longer despite user growth, as advertisers need convincing evidence that this medium will actually reach its target audience, as verifiable data and key performing metrics for return on advertising investment in China remain inconsistent. Going forward, we believe advertisers will follow the users and spend more on online video advertising. Indeed, we have seen this in the past for Internet users and online advertising. We use 2001 as the base year and analyse how Internet users and online advertising revenue in China grew over the past ten years below. We set both of them to be 100 in the base year and show a close-up of the first four years on the right. We can see clearly that Internet users grew faster initially than online advertising revenue in China. However, after a year and half, growth of online advertising revenue surpassed that of user growth and the gap has kept widening ever since. We believe that we will see the same for online video users and online video advertising revenue in China – user growth is now faster than advertising revenue growth, but we expect an inflection point in the next two years, where advertising revenue should catch up to and surpass user growth.

Exhibit 53. Internet user vs. Online ads revenue (2001-2010)



Source: iResearch and Nomura research

Exhibit 54. Internet user vs. Online ads revenue (2001-2004)



Source: iResearch and Nomura research

Compared with traditional online banner ads, online video ads can enjoy the benefits of multimedia content that allows the advertisement to be more dynamic – whether banner ads, pre-roll, post-roll or mid-roll. Compared with traditional TV ads, online video ads have the following advantages.

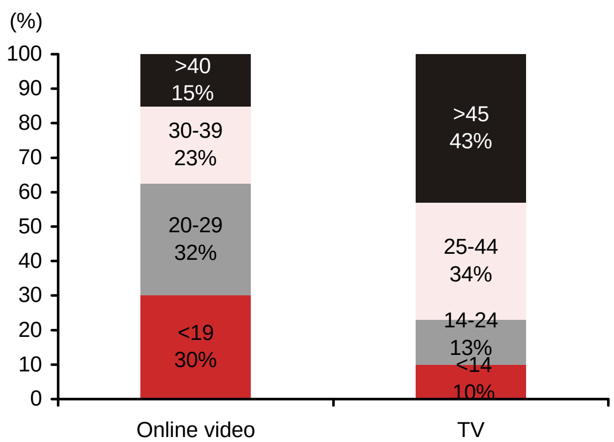
Targeted demographics: Online video sites can place the ads according to the advertisers' requirement, with precise targeting. The ads could be targeted at specific regions, in specific content to reach a certain demographic group, at specific time slots and with a specific frequency of impression. For example, we can see Grey's anatomy with a pre-roll ad featuring medicine in the Exhibit below. And in terms of audience demographics, online video audience is generally younger and better educated than TV audience.

Costs: While Youku has a reach of over 20mn from 18-40 year olds in 31 capital cities, which is comparable to major TV channels according to iResearch, its actual CPM cost is only around RMB22, which is at a large discount to that of TV at RMB50-00 as per CTR Market Research.

Exhibit 55. Grey's anatomy with pre-roll ad featuring medicine

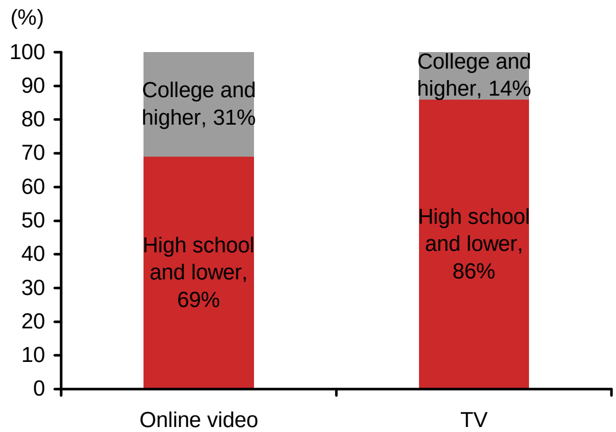
Source: Company website

Exhibit 56. Age structure (Video vs. TV)



Source: CNNIC, CSM Media Research

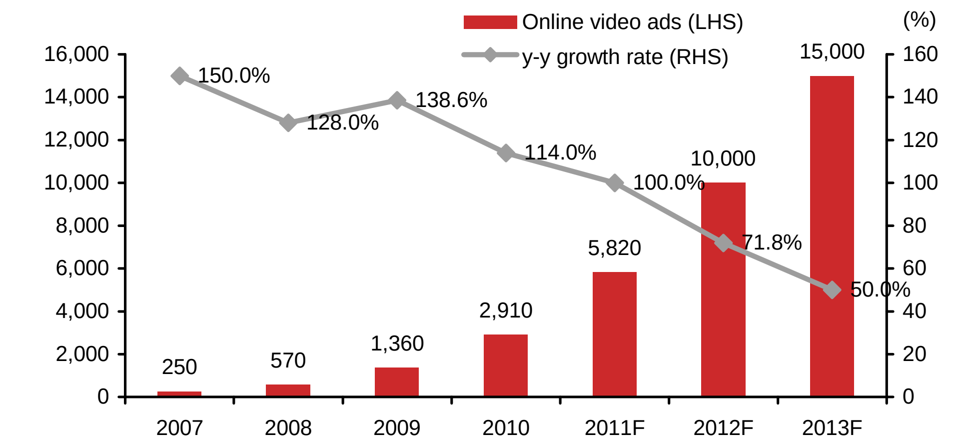
Exhibit 57. Education structure (Video vs. TV)



Source: CNNIC, CSM Media Research

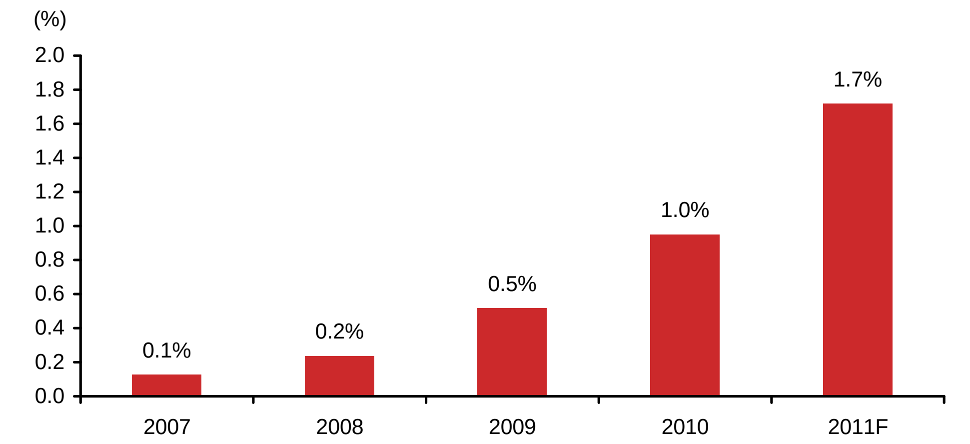
Given the above advantages from the perspective of an advertiser, online video advertising has been gaining popularity over the past few years. According to iResearch, the total spending on online video ads in China grew from RMB250mn in 2007 to RMB2,910mn in 2010, and we estimate the number to further quintuple by end-2013F from the 2010 level, with a 2010-13 CAGR of 72.7%, much higher than the 2010-13 CAGR of 17.3% for online users, on our estimates.

Exhibit 58. Online video ads spending in China (2007-2013F, in RMBmn)



Source: iResearch and Nomura estimates

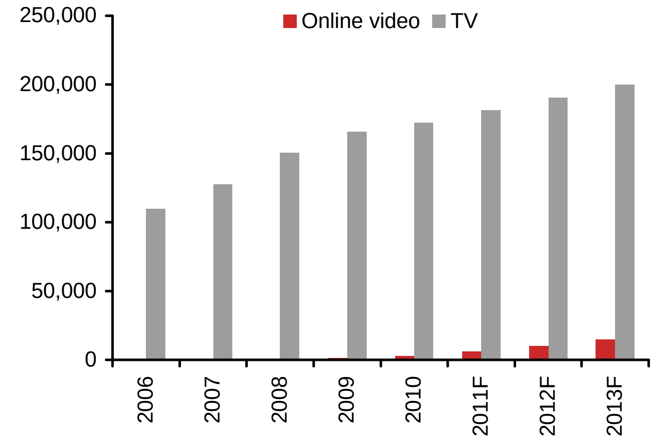
Exhibit 59. Online video's share of total ad spending



Source: iResearch, GroupM and Nomura estimates

Given the market reach of online video, we estimate that online video advertising, while only at 1.7% of total TV advertising today, could rise to 7.5% over the next three years. We estimate that TV advertising will record a 5% CAGR over the next three years and exceed RMB200bn by 2013F. Online video advertising could be RMB15bn by 2013F, driven by continued user transition to online video from TV.

Exhibit 60. Online video vs. TV ads revenue



Note: In RMBmn.

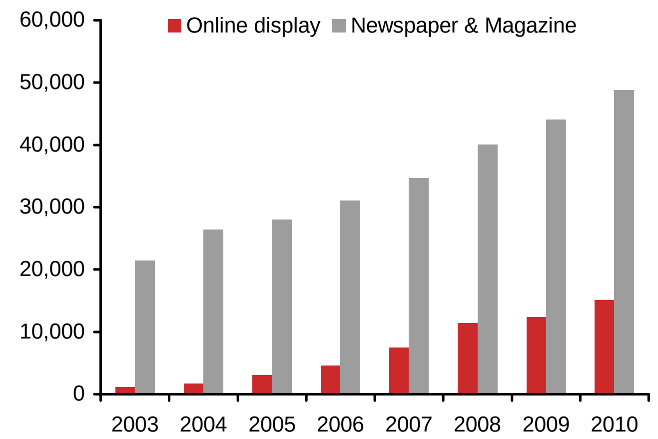
Source: iResearch, GroupM and Nomura estimates

Exhibit 61. Online video as % of TV ads revenue

Source: iResearch, GroupM and Nomura estimates

In the two Exhibits above, we can barely see the bars representing online video ads before 2010, simply because they are too small compared with those representing TV ads. However, this also indicates the potential room that online video ads can grow into. We estimate that online video ads revenue in China will increase to 7.5% of TV ads revenue over the next three years – which is five-times its size in 2010. Indeed, we have seen a similar transition of offline print media ads to online display ads in the past. If we can say that online display ads are the Internet equivalent of print (including newspaper and magazine) ads, it is fair to say that online video ads are the Internet version of TV ads. When we compare the two Exhibits above with the other two Exhibits below, we notice very similar trends. We believe what will happen to online video ads from 2012F will probably mirror what happened to online display ads back in 2003.

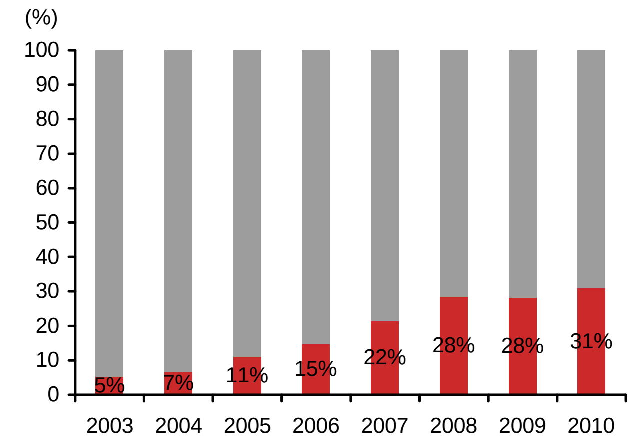
Exhibit 62. Online display vs. Print ads revenue



Note: In RMBmn.

Source: iResearch, GroupM and Nomura estimates

Exhibit 63. Online display as % of print ads revenue



Note: Print ads include newspaper ads and magazine ads.

Source: iResearch, GroupM and Nomura estimates

Youku's advertising growth

Youku's audience reach is already in line with major TV stations in China as we can see in the exhibit titled 'Exhibit 26.Exhibit 25. Top TV channels by daily audience reach'. However, compared to the adspend on the top 10 TV channels as shown in the exhibit below, Youku's advertising revenue is still a fraction of that of major TV stations at RMB387mn in 2010; hence, our optimism that advertising revenues will naturally follow traffic and reach. As per management, although Youku is already doing business with around 60% of the top 50 spending advertisers in China, it only has 0.2-0.3% of the pocket share of the top 50 spenders. We believe Youku has the potential to grow its revenue to the same level achieved by these major TV channels, given its similar audience reach and unique advantages.

Exhibit 64. Top 10 TV channels by adspend in 2010 in China

Rank	Channel	Adspend (RMBmn)
1	CCTV-1	13,432
2	Hunan Satellite TV	9,782
3	Jiangsu Satellite TV	8,228
4	Anhui Satellite TV	7,207
5	Zhejiang Satellite TV	7,104
6	CCTV-8	7,050
7	Shanghai Satellite TV	6,648
8	CCTV-5	6,637
9	CCTV-3	5,941
10	CCTV-News	5,837

Note: Adspend is based on rate card listing prices.

Source: Nielsen AIS database

To analyse Youku's advertising revenue growth in greater detail, we look at several variables that will drive advertising revenues in the near term, from both a demand perspective and a supply perspective. Such variables include number of advertisers and ARPU on the demand side and ad load (the number of ads per video segment), fill rate or utilisation rate of all potential inventory, pricing, and inventory expansion with the addition of new content and new audience, on the supply side.

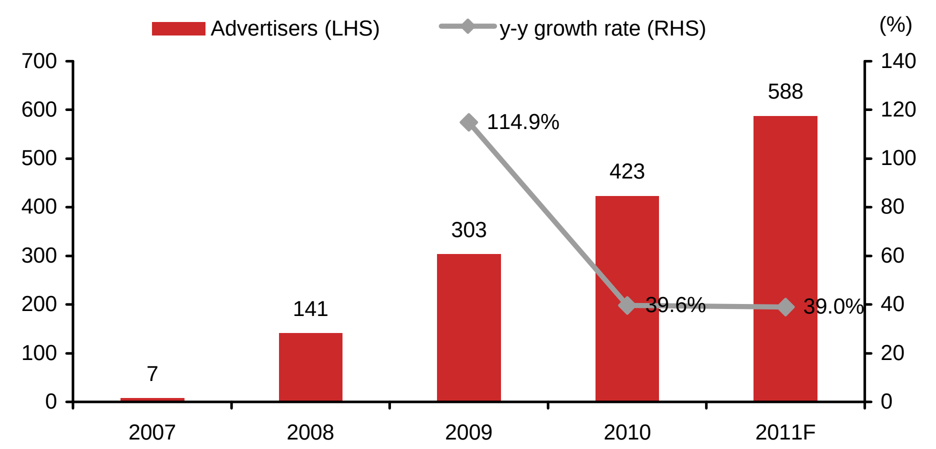
First, from a demand perspective, we formulate Youku's advertising revenue as:

Youku's ads revenue (demand) = # of advertisers x ARPU.

1. Number of advertisers

The number of advertisers on Youku's platform increased from 7 in 2007 to 423 in 2010, representing a CAGR of 292%.

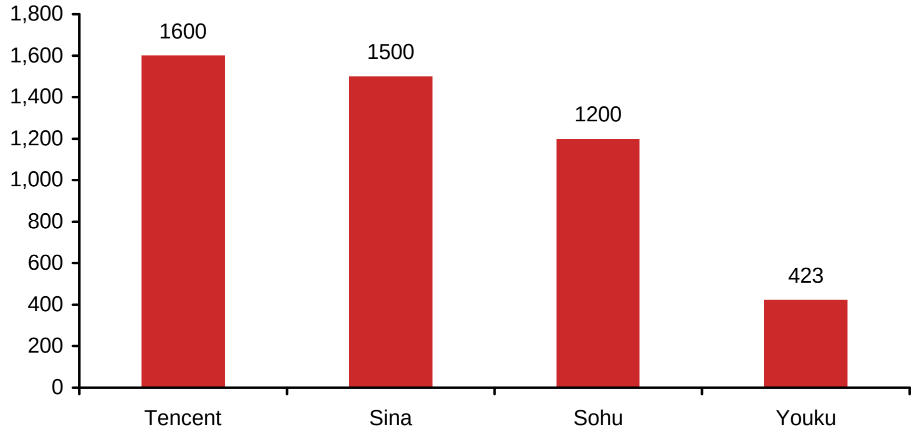
Exhibit 65. Number of advertisers on Youku



Source: Company data and Nomura estimate

Although the y-y growth rate has slowed down due to a larger base (see exhibits 43 and 44), we believe that there is still plenty of untapped client space for Youku to expand into. While Youku currently has less than 500 advertisers, we estimate that the major Internet portals in China including Tencent, Sina and Sohu all have more than 1,000 advertisers. We estimate that the top 5 advertising categories are food & beverages, HBA (health and beauty aids), IT, auto and retail/apparel. However, we believe that there are many segments that have not yet tapped this medium including online gaming, education, e-commerce and travel, which may cater more to the under-30 age group.

Exhibit 66. Number of advertisers comparison (data as of 2010)



Source: Company data, Nomura estimates

Exhibit 67. Top advertising categories of Youku, Sohu, Sina and Tencent

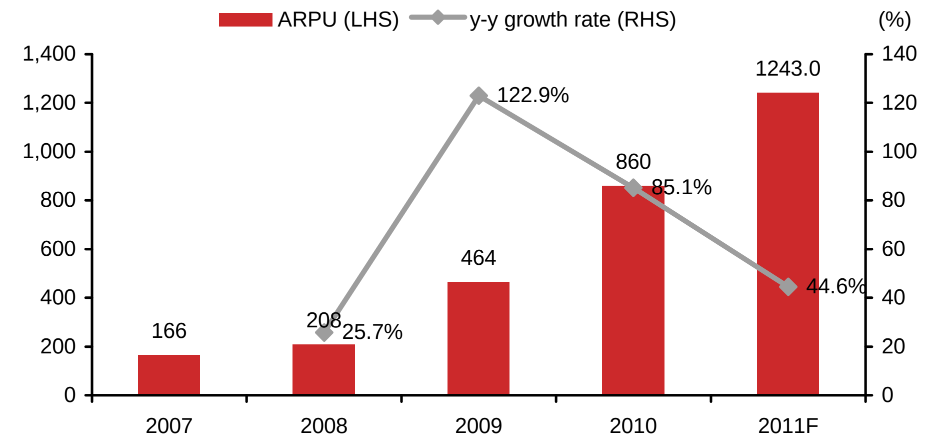
Youku	Sohu	Sina	Tencent
Food and beverages	Automobile	Automobile	Online games
HBA	Real estate	FMCG	Food and beverages
IT industry	FMCG	Financial services	Apparels
Automobile	Online games	IT industry	Automobile
Retail/Apparel	IT industry	Telecom industry	Consumer electronics

Source: Company data and Nomura estimates (data as of 2010)

2. ARPU

Youku's average net revenue generated from each advertiser also grew rapidly from RMB166K in 2007 to RMB860k in 2010, representing a CAGR of 73%. We believe Youku's ARPU will grow further from the current level as online video ads will get more recognition among advertisers over time, in our view. We estimate ARPU to increase 44.6% y-y to RMB1,243k in 2011F.

Exhibit 68. Youku's average net revenue per advertiser (in RMB'000)



Note: We only counted the net revenue from brand ads and excluded other revenues.

Source: Company data and Nomura estimates.

To find the different drivers of Youku's ARPU growth, we further break it down into:

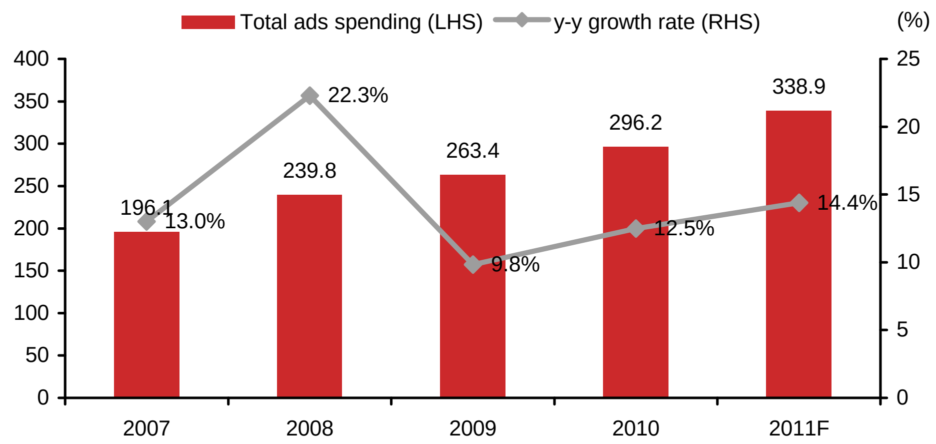
ARPU = Avg. budget per advertiser x online video's share x Youku's mkt share.

And we can look closer at the three factors one by one.

a) Average advertising budget per advertiser

We believe that the overall trend of average advertising budget per advertiser should mimic that of the total advertising spending in China, which is in turn determined by the economic growth in China. For 2011F, GroupM has forecast y-y growth of 14.4% for total advertising spending in China. We believe that should be a good proxy for the average budget growth per advertiser. Indeed, according to Nielsen Global Adview, China's adspend in the first half of 2010 was only 11% shy of that of the US. Although we think Nielsen uses rate card spending, which we believe is inflated as advertisers in China normally enjoy a high discount rate, we do believe that the actual adspend in China has surpassed that of Japan and that China is already the second-largest market in the world in terms of ads spending.

Exhibit 69. Total ads spending in China (2007-2011F, RMB bn)



Source: GroupM

Exhibit 70. Adspend H1, 2010 Global Ranking

Ranking	Market	US$mn
1	USA	53,505
2	China	47,693
3	Japan	21,748
4	Germany	16,151
5	France	15,821

Source: Nielsen Global Adview - Pulse Report

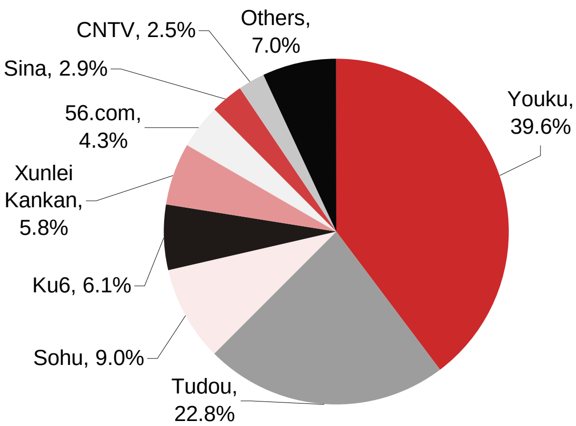
b) Online video's share

As we discussed before, we believe online video's share of total advertising spending in China has significant upside potential. Given the low base impact and the new platform, we estimate that the sector can grow 100% in 2011F, compared with GroupM's forecast for 2011F overall ads spending growth of 14.4%. Accordingly, we estimate online video's share of total advertising spending in China will grow from 1.0% in 2010 to 1.7% in 2011F.

c) Youku's share of the online video market in China

Youku currently has the highest market share among online video websites in China in terms of both time spent and revenue generated, according to iResearch and Analysys International, respectively.

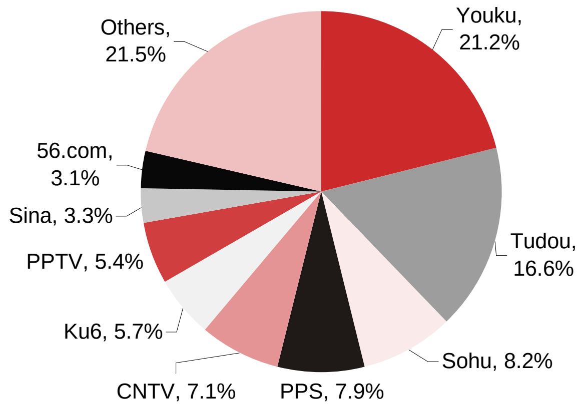
Exhibit 71. Market share by time spent (2Q2010)



Note: Excluding P2P TV streaming sites such as PPS, PPTV

Source: iResearch

Exhibit 72. Market share by revenue (2010)



Note: Including P2P TV streaming sites such as PPS, PPTV

Source: Analysys International

Although there is not necessarily a one-to-one mapping between the user time spent and the revenue generated, we can still find that the rankings of online video websites by the two metrics are largely in line with each other. Indeed, we believe that in the long run, the advertising dollars that advertisers are willing to spend on an online video website will be highly correlated with the number of viewers attracted and the time they spend on the website. In 2Q10, based on iResearch's data, time spent by viewers on Youku was about 1.7 times of that on Tudou, Youku's closest competitor. In 4Q10, according to the management of Youku, this gap had further widened to about 2 times. However, if we use revenue as a metric, Youku's revenue in 2010 was only approximately 28% more than that of Tudou's, based on Analysys International's data. We believe this perceived mismatch between Youku's traffic and revenue indicates the potential room for Youku to further grow its revenue upon greater monetisation. We believe Youku's market share of online video advertising in China will be stable from the current level in 2011F.

To summarize, we reiterate the **advertising demand** on Youku as:

Youku's ads revenue (demand) = # of advertisers x Avg. budget per advertiser x online video's share x Youku's market share of online video

We believe all the above four factors will continue to grow and drive overall advertising demand growth for Youku in the future. For 2011F, we estimate that the number of advertisers on Youku will grow from 423 in 2010 to 588 in 2011F, with each advertiser spending RMB1,234k on average in 2011F, a y-y growth of 44.6% from RMB860k in 2010.

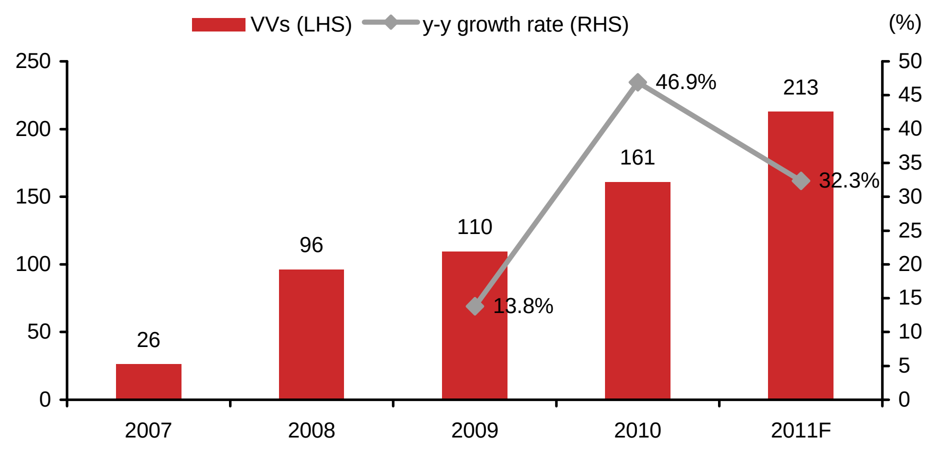
Second, we look at this from a supply perspective. Currently, Youku's advertising revenue growth is primarily driven by the demand since Youku's content library (and thus potential ads inventory) is virtually unlimited. The strong demand from advertisers will be met by sufficient supply from Youku, in our view. The advertising revenue from a supply point of view can be formulated as:

Youku's ads revenue (supply) = Video views (in thousand) x ad load x fill rate x effective CPM

1. Video views

A video view (VV) is defined as a view of a video segment by a single user. The average length of a VV is a function of the length of the videos, the mix of the video inventory (number of long form vs. short form) as well as user habits (a user can watch a video for some time, close it and return next time to resume watching with automatic bookmarks). Currently, the average length of a VV on Youku is about 10 minutes, according to management. Youku's daily VVs grew from 26.4mn in 2007 to 161mn in 2010 with a CAGR of 83%.

Exhibit 73. Daily VVs of Youku (in mn)



Source: Company data and Nomura estimates

We believe the gradual user time shift from TV to online video will continue in the next five years. As a result of expanding user base (increase in daily UVs) and the gradual per user time shift from TV to online video, Youku's daily VVs will increase 32.3% y-y to 213mn in 2011F, on our estimates.

2. Ad load

Ad load is the maximum number of 15 seconds advertisements that can be placed for each VV, at 100% fill rate. However, the ad load is not a hard ceiling but rather an assumption. Currently, Youku assumes the ad load to be 1.8 ads per VV. However we should not look at ad load individually, but rather link it with the fill rate. For example, an ad load of 1.8 coupled with a fill rate of 20% is equivalent to an ad load of 3.6 with a fill rate of 10%, because Youku sells 0.36 ads on average per VV under both situations. Therefore, we assume a fixed ad load of 1.8 and vary the fill rate only. We believe Youku is able to increase its ads inventory at its discretion by placing more ads into the videos. Currently for the in-video ads, Youku has pre-roll (before the content) and post-roll (after the content). Youku is also considering adding a mid-roll to its in-video ads repertoire, according to management.

From a user experience point of view, assuming an ad load of 1.8, even if the fill rate goes to 100%, the ad/content ratio is still just 0.045 (15 sec x 1.8 / 600 sec, where 600 sec is the average content length of a VV), much less than SARFT's limit of 12 minutes per hour imposed on TV ads, in which case the ad/content ratio is 0.25 (12 min / 48 min). In other words, if Youku were to have the same amount of ads as TV has now, it can potentially put up to 10 ads of 15 seconds each in every video clip, to equal TV's ad to content ratio. Although we don't expect that to happen in reality, it does highlight the possibility of Youku's revenue jumping by over 5 times by placing more ads.

3. Fill rate

Fill rate is the ratio of number of actual ads sold over the total number of ads inventory, assuming a fixed ad load. Based on our calculation of fill rate as illustrated below for 4Q10, we estimate that the fill rate increased from 1.1% in 2007 to 15.5% in 2010 and reached 23.5% in 4Q10.

Exhibit 74. Calculation of Youku's fill rate in 4Q10

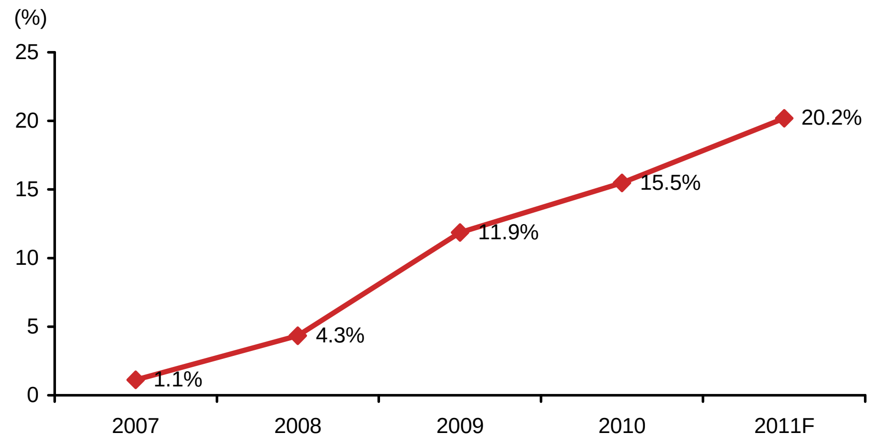
Brand ads net revenue = daily VV x # of days x Effective CPM x Ad load x Fill rate

Daily VVs (mn)	162.3
Days in the quarter	92
Effective CPM (RMB)	22.3
Ad load	1.8
Fill rate	**X = 23.5%**
Brand ads net revenue (RMB K)	141,000

Source: Company data and Nomura estimates

The denominator of the fill rate, namely daily VV, grew from 26.4mn in 2007 to 161mn in 2010, with a CAGR of 83%. As the ad revenue has to grow faster than the denominator to move the fill rate upwards, we can see how strong the growth of online video advertising demand was in the past 4 years. Going forward, we are optimistic that Youku can further increase its fill rate from the current level, as we believe advertisers will buy more of the video ads inventory, which is less attractive to them currently (including the VVs generated by viewers in lower tier cities), as the advertisers expand their businesses into lower tier cities. The long tail effect will show up as the incremental growth will be more from lower tier cities and inland areas rather than from first tier cities, in our opinion. Based on our calculation, we expect to see a profit on the bottom line (non-GAAP) when the fill rate reaches 25%, assuming the effective CPM does not change.

Exhibit 75. Youku's fill rate



Source: Nomura estimates

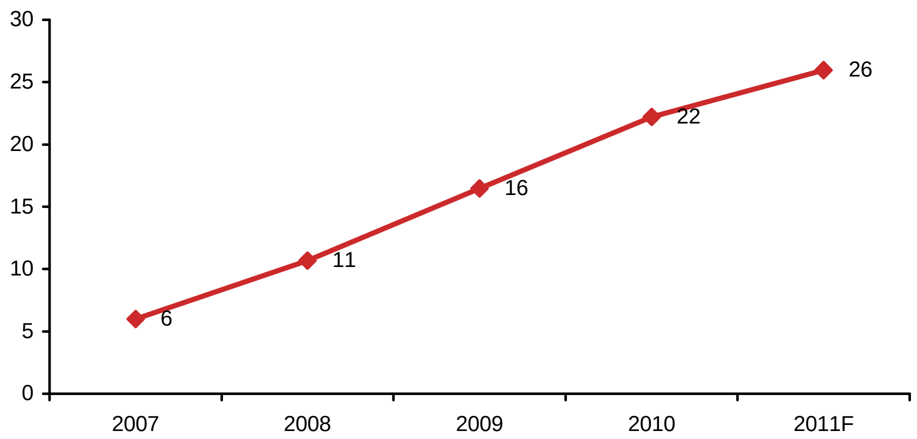
4. Effective CPM

We define effective CPM as the actual CPM from Youku's perspective, after all discounts and all agency commissions.

Effective CPM = CPM on rate card x (1 – discount) x (1 – agency commission)

The first two terms on the right should be considered together as there is no difference between a nominal CPM of RMB25 with 0% discount rate and a nominal CPM of RMB50 with 50% discount rate, as far as the revenue is concerned. For agency commissions, currently about 19% of the price paid by advertisers goes to the agencies, according to management. Youku is targeting a reduced agency commission rate of 15% in 4 years. As the commission rate goes down, the effective CPM will increase accordingly. In 2010, the effective CPM was approximately RMB22, in our estimate, which is much lower than the RMB50-100 levels of TV peers. We believe Youku's effective CPM will approach TV levels over time due to online video ads' advantages over traditional TV ads. Indeed, Youku already announced the increase of its rate card ad prices by 15-20% in 2011. We estimate Youku's effective CPM to grow to RMB26 in 2011F.

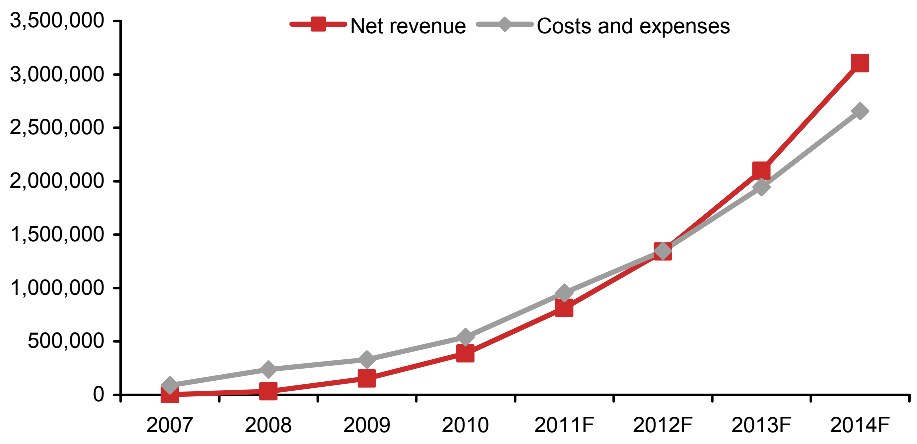
Exhibit 76. Youku's effective CPM in RMB



Source: Nomura estimates

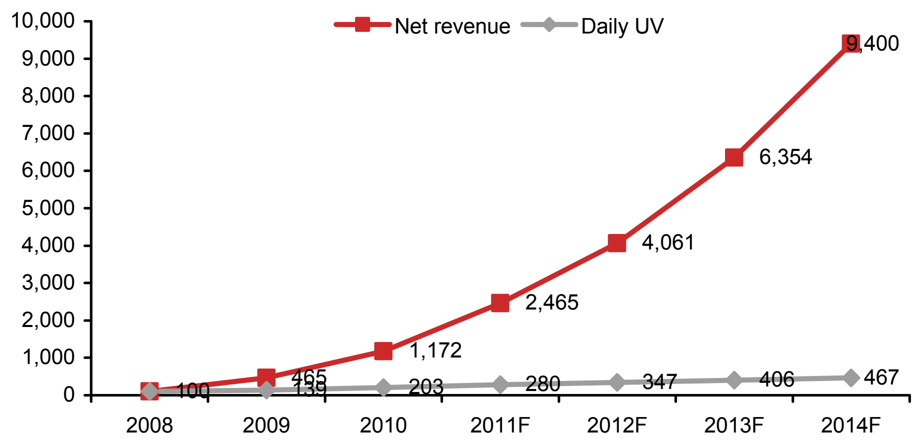
To sum up, our analysis on the growth of key revenue drivers from a supply perspective, including daily VVs, fill rate and CPM, indicates the strong growth potential from the demand side. We estimate Youku will breakeven in 2H12F, when we estimate fill rate should be 23% and effective CPM RMB31.

Exhibit 77. Youku's revenue vs. costs and expenses



Source: Company data and Nomura estimates

Exhibit 78. Youku's revenue vs. daily unique visitors



Note: We use 2008 as the base year by setting both revenue and daily UV to 100 in the base year

Source: Company data and Nomura estimates

More freedom online

Restrictions on TV content and advertising

From an ads budget point of view, Youku competes with all types of traditional media including TV, newspapers, magazines, billboards, radio and other outdoor media. Among all these traditional media, we believe Youku and online video in general will compete more directly with TV as TV commercials can be placed on Youku with very little or no modifications at all.

There are currently a number of restrictions on TV content and advertising imposed by the State Administration of Radio, Film, and Television (SARFT).

Content

Foreign TV drama: To protect domestic TV drama production, SARFT limited the foreign (including Hong Kong) TV drama's share to less than 25% of total TV drama aired on TV channels in 2000. The limit during prime time (from 19:00 to 21:30) was a stricter 15%. In 2002, SARFT banned foreign TV dramas altogether during prime time and also extended the prime time to 22:00. Although this restriction has been relaxed slightly in recent years, most foreign TV dramas still cannot be aired during prime time.

Foreign cartoon: In 2006, SARFT banned foreign cartoon programmes on TV from 17:00 to 20:00.

Inappropriate content: TV dramas and other programmes that SARFT deems inappropriate such as those with violent content are also banned or restricted.

Foreign movies: There is a quota of 20 foreign movies per year that can be shown in theatres in China.

Advertising

SARFT issued "Broadcast on radio and television advertising management approach" (SARFT Decree 61) in 2009 and the decree became effective from 1 Jan 2010. The decree has the following major restrictions:

- Average ad load per hour shall not exceed 12 minutes.
- During prime time (19:00 – 21:00), ad load per hour shall not exceed 18 minutes.
- No overlay ads are allowed with the exception of sponsorships.

Currently, there are no such restrictions for online video. Online video can also host a significant amount of long-tail content that caters to the special needs of consumers. Based on our conversation with some advertisers and agencies, we estimate that the major TV stations raised their prices aggressively by 15-30% y-y in 2011 due to strong advertising demand and limited TV ads inventory as a result of SARFT's decree 61. We believe the increase of TV ad prices will lower the ROI of TV ads and force some advertisers to spend more of their budgets on alternatives. Youku, with similar ad format, national coverage and broad reach, will be a suitable candidate, in our view. Although the TV ad budgets of major advertisers are still growing and we still haven't seen a clear sign that Youku has penetrated these TV ads budgets, we have learned from management that Youku has already tapped into many advertisers' strategic planning budgets. We believe this is a good start and that Youku will gradually earn more of the TV budgets going forward.

Oligopoly in the future

Key competitors

Only the most scalable players will survive, in our view

Youku operates in a highly competitive market with many competitors. We believe Youku strengthening its leadership coupled with the networking impact of online video and the high cost structure of operating this business will eventually wear down many existing players where only the most scalable ones will survive. We do not believe any one company can monopolize the online video segment, as is the case with social networking or search; we believe this is an industry where multiple players will succeed given their respective expertise in niche areas. In the meantime, the market is quite crowded from direct third party online video sites, to verticals like CCTV going on line, to local copycats that offer pirated content to P2P file sharing sites.

Youku faces direct competition from its online video peers, notably Tudou, Qiyi, Sina, Sohu and CNTV, among others.

Tudou

Tudou was launched one year earlier (in 2005) than Youku. The business models are very similar to each other. Similar to Youku, Tudou also started with a Youtube model but is now shifting to the Hulu model. Despite the many things they share in common, Tudou does have some major differences from Youku. Listed below are the two major differences:

Greater monetisation: Tudou reported net revenue of RMB224.8mn in the first 9 months of 2010, only 4% less than Youku's RMB234.6mn during the same period. However, in terms of user time spent on the websites, Tudou's traffic is only slightly more than half of Youku's. We attribute this largely to Tudou's more aggressive monetisation model. By comparing the ads on both Youku and Tudou, we found that Tudou has more ways to show ads. For example, we can see mid-roll video ads on Tudou (when we pause the video, Tudou will play another video which is an ad), whereas Youku only shows a banner when users pause in the middle of a video play. Tudou also has other forms of ads that Youku does not have currently, including but not limited to video player background rich media ads and video player corner overlay ads. However, greater monetisation could result in worse user experience, as the greater the advertising, the greater the clutter.

Exhibit 79. Tudou's video player background rich media ads

Source: Company data

Exhibit 80. Tudou's video player corner overlay ads

Source: Company data

Less spending on bandwidth: Tudou has invested substantially less than Youku on bandwidth in recent years. In the first 9 months of 2010, Tudou's reported bandwidth cost was only RMB76.3mn, compared to Youku's RMB140.0mn. Although Tudou achieved a positive operating margin in 3Q10 due to cost control, we believe the lack of bandwidth spending will result in generally slower speed, which is detrimental to user experience.

Qiyi

Qiyi was founded by Baidu and also had investment from Providence Equity Partners. The website of Qiyi was launched in April 2010. Unlike many other online video websites in China such as Youku and Tudou, Qiyi's content was 100% long-form professional ones. There is no UGC on Qiyi's platform. Qiyi's monthly UV exceeded 100mn by Dec 2010, only eight months after its launch. In contrast, we believe both Youku and Tudou took more than two years to pass that milestone. Qiyi's monthly UV further increased to 148mn in Feb 2011, covering more than 50% of the online video users in China. We expect Qiyi's monthly UV number could double by the end of this year. We believe Qiyi's growth momentum is driven by traffic feed from Baidu, as the company generates about 50% of its traffic from Baidu search and a Hulu-like business model, specializing in long-form high definition video. In addition, as Baidu is a good distribution channel and marketing platform for the content suppliers, Qiyi, who has a strong tie with Baidu, will be more likely to get favorable terms when licensing content from the suppliers.

Exhibit 81. Youku vs. Tudou vs. Qiyi

	Youku	Tudou	Qiyi
Ads format	In-video ads, banner ads	In-video ads, banner ads, overlay ads, background ads	In-video ads, banner ads
# of Advertisers (9M10)	343	420	N/A
Net revenue (9M10, RMB mn)	235	225	About 10
Content library	(3Q10)	(3Q10)	(Feb 11)
	Movies: 2,200 TV drama: 1,250 titles, 36,000+ episodes Variety shows: 194 Video clips: 45.1mn	Movies: 640 TV drama: 1,530 episodes Variety shows: 150 Video clips: 36.3mn	Movies: 2,000 TV drama: 40,000+ episodes Variety shows: 15,000+ episodes Documentaries: 10,000+ hours
Monthly UV (mn)	287 (4Q10)	N/A	148 (Feb 11)
Registered users (9M10, mn)	77	72	No registered users on Qiyi
Average daily VV (mn)	161 (2010)	N/A	47 (Feb 11)
Daily video file uploads (K)	60	42	N/A
Share of user time spent (2Q10)	40%	23%	N/A
Traffic from Baidu	~25%	N/A	~50%

Source: Company data and Nomura estimates

Sohu and Sina

Traditional Internet portals in China, especially Sohu and Sina, are also spending heavily on online video. According to Sohu's management, Sohu's video-related ads revenue was US$28mn in 2010, almost half of Youku's 2010 revenue. Sohu's video market share in terms of user time spent grew from 3.4% in 2009 to 13.4% in 2010. Online video is also one of the priorities in 2011 for Sina. Its strong portal background, partnership with NBA and its popular Weibo platform are all comparative advantages over other players in China.

CNTV

China Network Television, or CNTV, is the state-owned online TV broadcaster. It features contents from CCTV and other sources. As a state-owned website, CNTV has some unique advantages, especially on the content front. For example, CNTV had the exclusive right to broadcast the 2010 FIFA Football World Cup in China. CNTV retained the exclusive live broadcast right and sub-licensed the delayed broadcast right to other online video companies in China, including Youku and Tudou.

We list the key comparative advantages of the online video websites discussed above in the table below:

Exhibit 82. Key comparative advantages of other major online video websites in China

Name	Key comparative advantages
Tudou	Second largest player with comprehensive content library. More monetisation methods.
Qiyi	Strong financial support and traffic support from Baidu. Benefits from Baidu's database and distribution channel.
Sohu	Strong financial support from the listed company.
Sina	Strong financial support. NBA co-operation. Weibo platform. Strong portal as a distribution channel.
CNTV	Government-backed. Strong tie with CCTV.

Source: Nomura research

Youku also faces competition from another form of online video – video streaming software. PPTV (PPLive), PPS and Xunlei Kankan all fall into this category. In general these software all started by providing online streaming of traditional TV channels. They gained popularity over time by meeting the needs of online users who have no/limited access to traditional TV channels. However, we believe these softwares have several major disadvantages compared to online video websites like Youku:

Client software: The client software installation is a must for these players. In contrast, users can simply go to Youku's website in their browsers without the need to install anything. On some computers, the installation of software is not permitted. Therefore, this could negatively affect the penetration of video streaming software.

Content: Most of the video streaming software relies heavily on peer-to-peer (P2P) technology for content distribution. As a result, video play tends to be smooth and fast when there are many people watching the same content at the same time. While this is good for watching live content or hot content, it is bad for other contents. As a result, it is almost impossible to watch many of the older contents and the long-tail ones on these platforms. Therefore, their breadth of content is narrower than Youku's.

Community: These platforms are software rather than online video communities. User participation is generally less active than Youku. User participation is not only uploading UGC, but also commenting on the professionally produced contents such as movies and TV dramas. Without such user interaction, we believe their user stickiness is much lower than Youku's. Indeed, we saw some of these players such as PPTV also established an online video website similar to Youku and Tudou that requires no software installation.

We summarise the key differences between Youku and video streaming software:

Exhibit 83. Youku vs. video streaming software

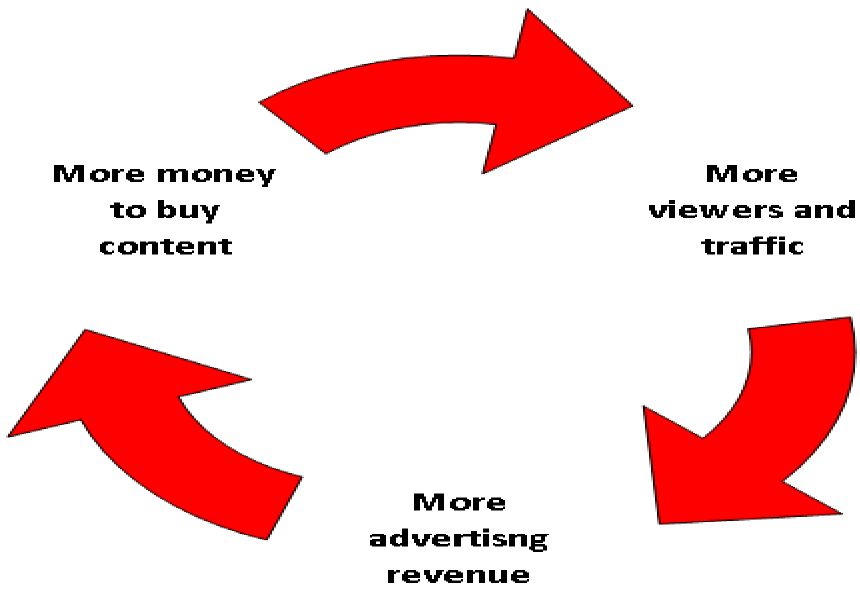
	Youku	Video streaming software
Client software	Ancillary software available, but not required.	Installation is a must.
P2P	Supplementary method of content distribution	Primary method of content distribution
UGC	Yes	No
Content library	Comprehensive	Limited
User interaction	Active	No/ Low
Bandwidth cost	High	Low

Source: Nomura research

Long-term winners

We believe that despite the competitive landscape where all major internet sites are involved in video — from Baidu to Tencent to Sina and Sohu — the industry will naturally weed out the losers. We do believe there is a networking impact and online video cycle — when a site has a large content library > it will attract users > the more users it attracts > eventually the advertisers will catch on > and when advertisers come on board > the company will have revenues to generate and buy more content and the cycle continues.

Exhibit 84. The self-enhancing cycle



Source: Nomura research

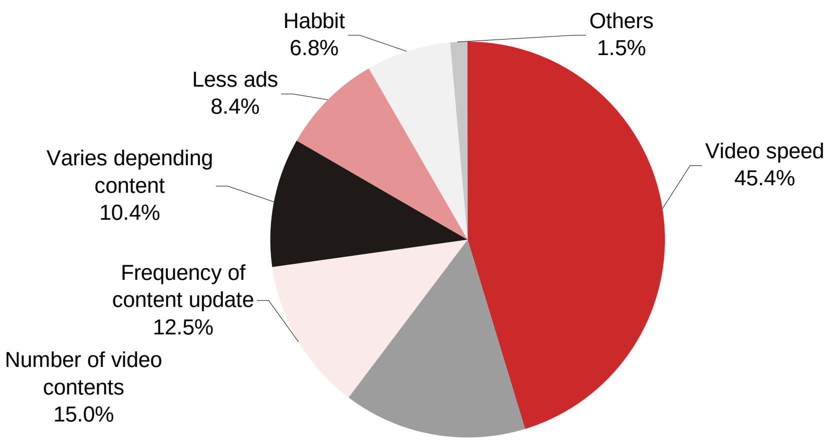
Unlike social networking or search we do not believe that online video is a monopoly, but rather an oligopoly where there are several dominating players all providing a differentiated product. We believe that in the long run there will be three players that will dominate the space.

1. Youku — We believe Youku has the following advantages as the largest player in the market:

Scale: Size does matter. There are more than 2,500 TV Channels in China. The fragmentation of TV channels is reasonable as even the most popular TV channel can only have up to 24 hours of content each day. Due to the diversity of the audience's needs, it is necessary for people to switch channels frequently to watch what they want. However, online video is different. Theoretically the breadth of content library is almost unlimited. Therefore users can probably watch what they want on a single site. Thus, we believe the online video market will consolidate over time. Being the largest player in the market, Youku can enjoy the economies of scale because most content is licensed at a fixed charge. Moreover, although most of the content suppliers can't share the revenue from online video sites, they still want their content to be viewed by as many people as possible – the more people watch their content, the more valuable their product placement ads are. For some content such as cartoons, the content suppliers make most of the money out of peripheral products sales. As a result, they are willing to charge a lower license fee or even provide the content for free, as long as the content can reach more people.

Speed: Speed is the essence of the game. Although we believe that content is king and users normally go to places where the content is, the reality is most hot contents like TV dramas can be found on almost every online video website. Even though some sites purchase exclusive rights from content suppliers, they normally swap or sub-license these contents. As a result, real exclusive content is very rare in China. When everyone has more or less the same content, speed becomes the key. In a survey done by CNNIC regarding "the most important factor in choosing online video site", more than 45% of the respondents chose "video speed". Through heavy investments in bandwidth over the recent years, we believe Youku is a leader in terms of video speed in China. For example, Youku's bandwidth cost in the first 9 months of 2010 was RMB140.0mn or 59.7% of its net revenue, while Tudou only spent RMB76.3mn or 33.9% of its net revenue on bandwidth during the same period.

Exhibit 85. Most important factor in choosing online video site



Source: CNNIC survey

Brand: Although the brand name is still less important than content and speed, we believe Youku is benefiting from post-IPO publicity. According to the management, 58% of the traffic entries are now coming from directly typing youku.com in the browser, compared to 50% before the IPO in December 2010. Moreover, community features such as user interaction through uploading UGC and commenting also increased the stickiness of Youku's platform over time.

2. Qiyi — Having the backend support from Baidu, which drives 50% of its total traffic, offers the company sufficient leverage. For example if we search a popular TV drama in Baidu, we will find Qiyi on the top with detailed display of a number of episodes. After that we will then see other online video sites like Youku. Unlike Youku, which offers both long and short form as well as user generated content, Qiyi replicates the Hulu model in China that emphasizes long from, including movies from domestic and overseas producers. Given the company's strategic positioning in long from and in high definition, we believe that Qiyi can have an opportunity to venture into a viable subscription model - where people pay for content - the likes of Netflix.

Exhibit 86. Search result page of Baidu

Source: Baidu website

3. Sina — We believe Sina is different from Youku and Qiyi and also very different from Sohu. While many of its competitors are bidding for content, including foreign drama series and movies, Sina we estimate will be more of a social media and interactive video site. We believe that Sina will continue to leverage its portal and Weibo platforms to include video in key interactive entertainment contents, including NBA, concerts and shows, reality TV. And we expect much of its video content to be self produced, including interviews and talk shows.

Exhibit 87. Video embedded in Sina Weibo

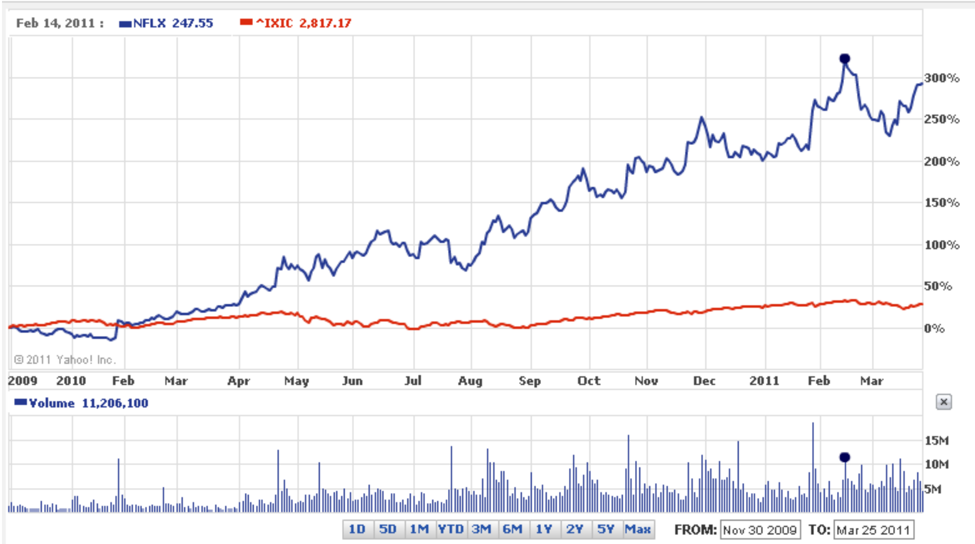
Source: Sina Weibo website

A potential catalyst in the next five years

Subscription model: A free option

The business model of paid user subscription is already quite mature in the US. Netflix is the clear market leader in this field with over 20mn subscribers at the end of 2010, as per Netflix annual report. 91.3% of these 20mn subscribers were paid subscribers, while the rest 8.7% were in their one-month free trial period. Monthly ARPU for Netflix in 2010 was US$12.19. With Netflix shifting its model from offline DVD rental to online streaming, we saw the stock re-rate rapidly. Although its 2010 revenue and EPS only grew 29.5% and 49.5% y-y respectively from 2009, its share price almost quadrupled during the same period.

Exhibit 88. Netflix's share price almost quadrupled from 2009 to 2010



Source: Yahoo finance

Some people may argue that the subscription model is not viable in China due to the lack of copyright awareness. We believe the situation is improving in China as the government continues to push for copyright awareness and fight against copyright infringement. Many free downloading sites of copyrighted contents were shut down during the process. As it is increasingly harder for users to find "free lunches" in China, we believe more people will be willing to pay for copyrighted contents going forward. If the users can get copyrighted contents at reasonable prices, we believe they will naturally accept the subscription model as even pirated DVDs cost several RMB per movie. If Youku can offer premium contents that users can't get for free from elsewhere, users' willingness to pay for these contents will not be low, in our view.

In fact, there is already an online video company in China which achieved profit through the subscription model. Leshi Internet Information (300104.CH) reached monthly APA of 400k at the end of 2010. Paid users can watch high-definition video contents without ads on the company's video website www.letv.com at a cost of RMB30 per month.

Youku has also started to explore its options in this field. It offers a cheaper monthly charge of RMB20. In addition, it also offers an item-based scheme under which users can pay RMB2-5 for a premium movie/TV drama/online education and watch them as many times as they want within a fixed time period, normally 48 hours.

Youku's subscription revenue can be formulated as:

Video consumer demand = APAs x ARPU

Here we borrow the concept of APAs (active paying accounts) from online gaming as we believe the user subscription model of online video watching resembles that of online game playing. Under the subscription model, to enjoy premium video content without ads, video consumers can choose to either pay a fixed monthly subscription fee (similar to the time-based model of online games) or pay on per item basis (similar to the item-based model of online games).

If Youku can convert 1% of its current 287mn monthly unique visitors to APA and assume a monthly ARPU of RMB20, the annual revenue from subscription alone will be RMB689mn, 78% more than Youku's 2010 revenue of RMB387mn. We believe Youku's subscription business is growing steadily and could be the next catalyst in the longer term.

High operating leverage

Scalability of cost

Online video is a capital-intensive business, with heavy investment required in bandwidth and content

In general, online video is a capital-intensive business as an online video company has to invest heavily in bandwidth and content before even making a penny of revenue. The fear of lack of scalability and visible profitability had prevented the larger Internet players in China entering the online video market about five years ago, in our view.

We believe Youku's business is scalable with high operating leverage. Instead of looking at Youku's cost structure directly, we take an alternative approach by going through the revenue drivers we discussed before one by one to see if there are direct costs associated with them. After that, we discuss the remaining cost items that don't have direct correlations with the revenue drivers.

Cost analysis of the revenue drivers

1. Daily VVs (video views)

We believe the daily VV number is correlated with Youku's bandwidth cost. As more users come to watch videos on Youku every day, the company has to increase its bandwidth to cater to the needs and prevent service outage as well as frequent buffering that is detrimental to user experience. Our study of the correlations between bandwidth cost and the daily VV numbers in the past four years also confirmed our assumption as the bandwidth cost per daily VV remained stable at around RMB1.3 per daily VV in the past four years. Therefore, we estimate that the growth rate of bandwidth cost going forward will be inline with that of daily VV.

Exhibit 89. Bandwidth cost and daily VV

	2007	2008	2009	2010
Bandwidth cost (RMBmn)	35.7	131.9	149.5	191.7
Daily VV (mn)	26.4	96.3	109.6	161
BW. Cost per Daily VV (RMB)	1.35	1.37	1.36	1.19

Source: Company data and Nomura estimates

2. Ad load and fill rate

We believe that there is no cost directly associated with the ad load and fill rate. There is a hidden cost, in our opinion, of worse user experience when the fill rate goes up, as viewers will have to watch more ads. However, we don't think this hidden cost is material as our analysis in the revenue section before suggests that Youku's ad/content ratio will only increase to 0.045 even if the fill rate increases to 100%, in contrast with SARFT's limit of 12 minutes per hour imposed on TV ads, in which case the ad/content ratio is 0.25 (12 min / 48 min).

3. Effective CPM

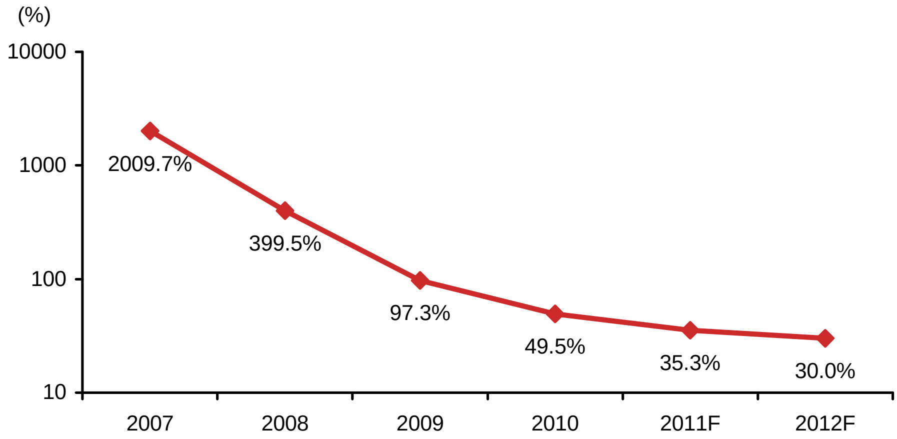
The costs associated with effective CPM are the business tax and sales people's commissions, in our opinion. In other words:

Net effective CPM = effective CPM x (1 – business tax rate) x (1 – sales commission)

Since the business tax rate is fixed and we believe Youku's sales commission rate will remain stable or possibly scale down slightly as Youku's revenue further increases in the future, these two cost items as a percentage of revenue will not increase going forward, in our view.

In summary, we believe that the cost items that have high correlations with the revenue drivers include bandwidth cost, business tax and sales commissions. For the bandwidth cost, there is an additional dimension of video quality growth that will also increase the bandwidth requirement. As more videos become high definition ones, the bandwidth required to transmit the video stream will certainly increase accordingly. However, with time the unit cost of bandwidth will decrease and offset the upward bandwidth cost pressure brought by the shift from standard videos to high definition ones, in our opinion. Indeed, the bandwidth cost as a percentage of net revenue decreased from 2,009.7% in 2007 to 49.5% in 2010 and reached a new low of 33.9% in 4Q10. We believe this downward trend will continue in the future as a result of top-line leverage and we forecast the bandwidth cost will be 30% of revenue at the end of 2012F. While the bandwidth cost as a percentage of net revenue will decrease year over year, this percentage may fluctuate slightly between quarters as the revenue can vary within a year due to seasonality, in our opinion. We believe the better way to look at this is that the dollar amount of bandwidth cost should grow steadily quarter over quarter to meet the incremental traffic demand

Exhibit 90. Youku's bandwidth cost as a percentage of net revenue

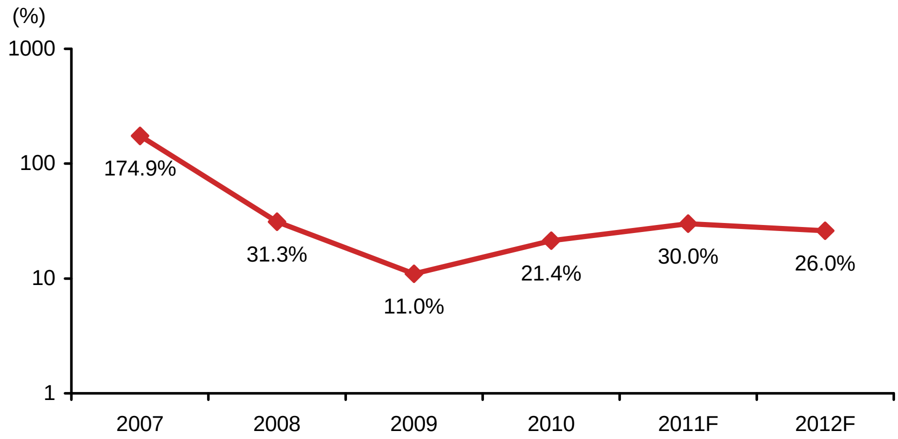


Source: Company data and Nomura estimates

Content cost

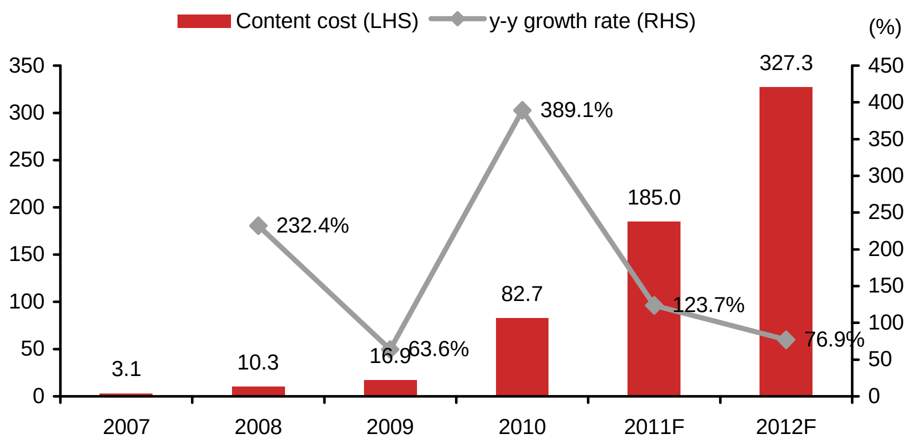
We discuss the content cost separately as we believe it is the only major cost item that has the potential risk of outgrowing Youku's revenue going forward. Similar to bandwidth cost, the content cost as a percentage of net revenue decreased from 174.9% in 2007 to 11.0% in 2009 as a result of top-line leverage. Unlike bandwidth cost however, the downward trend of content cost as a percentage of net revenue reversed starting from 2009, with the percentage number almost doubling from 11.0% in 2009 to 21.4% in 2010. This means that the content cost grew much faster than revenue from 2009 to 2010. In absolute terms, Youku's content cost increased 389.1% y-y from RMB 16.9mn in 2009 to RMB 82.7mn in 2010.

Exhibit 91. Youku's content cost as a percentage of net revenue



Source: Company data and Nomura estimates

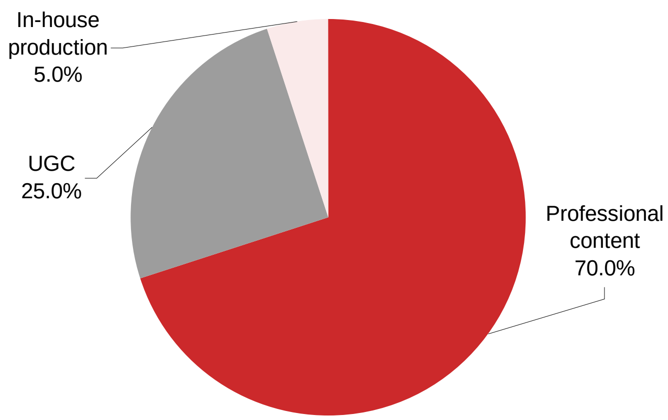
Exhibit 92. Youku's content cost (RMB mn)



Source: Company data and Nomura estimates

The hike of content cost was from two sources: expansion of the online video content library and increase in unit acquisition cost of professional content. On the one hand, Youku, like most other online video websites in China, started with a Youtube-like video sharing model. Thus a few years ago, majority of the contents on Youku were UGC (user generated content) and therefore free of charge. As Youku shifted from the Youtube-like video sharing model to a Hulu-like online TV model with approximately 70% of its contents now professionally produced over the past three years, the volume of paid content naturally went up.

Exhibit 93. Youku's content breakdown



Source: Company data and Nomura estimates

On the other hand, the unit acquisition cost of professional content, especially key TV drama series and movies, went up dramatically due to intensifying competition among online video companies. According to management, average unit license fee for TV drama series increased in 2010 by over 100% compared with that in 2009, which in turn increased by 200%+ from 2008. Unit acquisition cost for movies also went up by 90%+ in 2010 from 2009, according to Youku. But due to the fierce competition, we think there is still room for further increase of unit acquisition cost in the short term, especially hot TV drama series and movies. And with a comprehensive video content library strategy, Youku will also need to enrich its current library with more new contents. We expect content costs to grow inline with revenues in the near term.

However, we believe that content cost inflation at Youku can be alleviated by the following factors:

Fragmentation of content suppliers: Unlike in the US, content suppliers in China are highly fragmented and less vertically integrated with TV stations. Even Youku's largest content supplier accounted for less than 5% of Youku's content cost, according to the management. Therefore in the longer run, we believe the content unit acquisition cost for online video companies should not exceed that of the TV stations and the addition of new content each year will also become stable.

Fixed license fee structure: Except for a very limited number of movies licensed from the US, for which Youku has to share 50% of the revenue generated, most contents are licensed with a fixed fee. The fixed license fee is the prevalent option for content suppliers in China as there is not a reliable way to monitor the revenue brought by certain content. We believe this fixed fee structure is an advantage for Youku as it has higher viewership than its competitors on the same content.

In-house production: Currently about 5% of Youku's content is self-produced. These contents are quite popular among online video viewers. For example, Old Boys, a web-based movie Youku co-produced with China Film Group was viewed over 30 million times since its premier in Nov 2010, and was searched more than twice that of Harry Potter 7, as per the management. The cost of self-produced content tends to be lower than licensed content as income from product placement ads can partially offset the production cost.

Swap and sub-licensing: Although some online video websites in China purchase exclusive rights from content suppliers, they normally swap or sub-license these content. As a result, real exclusive content is rare in China. Therefore, Youku is able to get 80%-90% of the total TV dramas in China without paying high exclusive license fees.

Taking all the above factors into consideration, we forecast that Youku's content cost will increase to 30% of revenue in FY11F and decrease gradually in the longer term.

Other costs and expenses

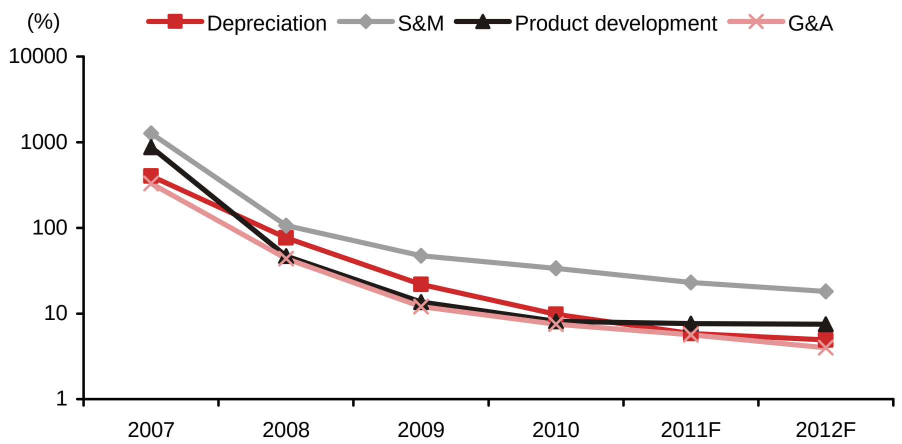
Other costs and expenses include depreciation of hardware, sales & marketing expenses, product development expenses and general & administrative expenses. Although these costs and expenses will all grow as Youku's business expand, we believe their growth rate will be much lower than that of the revenue. We can see that the items as percentages of revenue all decreased sharply in the past four years as a result of operating leverage. Depreciation of hardware, sales & marketing expenses, product development expenses and general & administrative expenses decreased from 402.4%, 1,263.7%, 873.5% and 328.6% respectively in 2007 to 9.8%, 33.6%, 8.1% and 7.5% respectively in 2010. These percentages further decreased to 5.9%, 25.4%, 6.6% and 6.7% respectively in 4Q10.

Exhibit 94. Youku's other costs and expenses as percentages of revenue

(%)	2007	2008	2009	2010	2011F	2012F
Depreciation	402.4	76.8	21.9	9.8	5.8	4.9
S&M	1,263.7	106.3	47.4	33.6	23.0	18.0
Product development	873.5	46.6	13.6	8.1	7.6	7.5
G&A	328.6	43.5	12.1	7.5	5.6	4.0

Source: Company data, Nomura estimates

Exhibit 95. Youku's other costs and expenses as percentages of revenue



Source: Company data and Nomura estimates

We believe Youku's business model to be highly scalable. The only variable costs that grow inline with revenue are sales commission and business tax & surcharges. Bandwidth cost will increase steadily to meet the incremental traffic need, but at a much slower pace than the revenue growth, in our view. With bandwidth you are buying capacity, and because much of the capacity was built in the early stages of growth, incremental bandwidth costs will be small as user growth will eventually mature. We believe the right way to look at bandwidth costs is not on a y-y percentage growth level but rather q-q absolute level as we believe capacity expansion will be minimal on a rolling basis as the business matures. We believe the same will occur with content costs as the company ramps up its content library, but once a portfolio of a run-rate library has been established, incremental content costs will be minimal. Although content cost could grow faster than revenue in the next two years, we believe the growth rate of revenue will again exceed the content cost growth, resulting in a decreasing content cost as a percentage of net revenue in the longer term. All other costs and expenses including depreciation, sales & marketing expenses, product development expenses and general & administrative expenses will continue to scale down as a percentage of revenue, in our view. Therefore, we believe once Youku breaks even in 2H12F, its bottom line profit will ramp up rapidly due to high operating leverage.

Management profile

Senior management and ownership

Exhibit 96. Management profiles

Name	Position	Profile
Victor Wing Cheung Koo	Chairman of Board of Directors, CEO and Founder	Founded Youku in 2005 President, CEO,CFO of Sohu (1999-2005) VP, Director of Richina Capital Partners (1994-1999) P&G Hong Kong (1993) Bain & Co. (1989-1992) Bachelor's degree from UC Berkeley, MBA at Stanford
Dele Liu	Director, CFO, Senior VP	CFO since 2006 VP of Power Pacific Corporation Limited (1996-2005) Investment manager of Richina Capital Partners (1995-1996) Bachelor's degree in economics from Shanghai Maritime University
Leo Jian Yao	CTO	CTO since 2007, Chief architect from 2006 to 2007 CTO of Sino Credit Technologies (China) Inc. (2005-2006) Head of network operations at Sohu (2000-2002, 2003-2004) Bachelor's degree in engineering from Southwest Jiaotong University
Frank Ming Wei	Senior VP of operations	With Youku since 2007 Sales director of focus.cn (real estate website of Sohu) (2005-2007) Sales manager and assistant to president of Sohu (2000-2005) Bachelor's degree in computer science from Southwest University
Sunny Xiangyang Zhu	Chief Editor	Chief editor since 2006 Content director of Beijing Flying Network Music Software (2004-2005) Content director of China Guangya Radio Information (2004-2005) Building up music and movie channels at Sohu (1999-2001) Undergraduate program in Nanjing Political Institute

Source: Company data

Exhibit 97. Major shareholders immediately after the IPO

Holder	%	% of voting power
Victor Koo	34.80	60.98
Brookside Capital Partners Fund	14.26	8.33
Sutter Hill Funds	10.37	6.06
Maverick Funds	9.62	5.62
Farallon Funds	9.28	5.42

Note: Mr. Victor Koo holds 1% directly and 33.8% through 1Verge Holdings, a company own by him and the Chengwei Funds.

Source: Company report

Shares owned by the above shareholders have a lock-up period of 180 days after the IPO done on December 8th, 2010.

Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
Revenue	33	154	387	814	1,341
Cost of goods sold	(171)	(217)	(351)	(660)	(951)
Gross profit	**(138)**	**(63)**	**36**	**154**	**390**
SG&A	(61)	(108)	(178)	(271)	(355)
Employee share expense					
Operating profit	**(199)**	**(171)**	**(142)**	**(117)**	**35**
EBITDA	**(171)**	**(130)**	**(105)**	**(31)**	**148**
Depreciation	(27)	(36)	(33)	(39)	(59)
Amortisation	(1)	(5)	(5)	(47)	(54)
EBIT	**(199)**	**(171)**	**(142)**	**(117)**	**35**
Net interest expense	1	(5)	(6)	(10)	14
Associates & JCEs					
Other income	(2)	0	0	0	0
Earnings before tax	**(201)**	**(175)**	**(148)**	**(127)**	**49**
Income tax	-	-	-	-	16
Net profit after tax	**(201)**	**(175)**	**(148)**	**(127)**	**66**
Minority interests					
Other items	-	-	-	-	-
Preferred dividends					
Normalised NPAT	**(201)**	**(175)**	**(148)**	**(127)**	**66**
Extraordinary items	(4)	(7)	(56)	(131)	(140)
Reported NPAT	**(204)**	**(182)**	**(205)**	**(258)**	**(75)**
Dividends	-	-	-	-	-
Transfer to reserves	**(204)**	**(182)**	**(205)**	**(258)**	**(75)**
Valuation and ratio analysis					
FD normalised P/E (x)	na	na	na	na	508.9
FD normalised P/E at price target (x)	na	na	na	na	677.3
Reported P/E (x)	na	na	na	na	na
Dividend yield (%)	-	-	-	-	-
Price/cashflow (x)	450.3	na	na	na	613.2
Price/book (x)	178.4	119.1	18.2	20.3	20.5
EV/EBITDA (x)	na	na	na	na	215.9
EV/EBIT (x)	na	na	na	na	918.7
Gross margin (%)	(418.2)	(41.1)	9.4	18.9	29.1
EBITDA margin (%)	(517.6)	(84.6)	(27.1)	(3.8)	11.1
EBIT margin (%)	(603.5)	(111.1)	(36.7)	(14.4)	2.6
Net margin (%)	(619.2)	(118.7)	(52.9)	(31.7)	(5.6)
Effective tax rate (%)	na	na	na	na	(33.1)
Dividend payout (%)	na	na	na	na	na
Capex to sales (%)	160.1	26.4	27.9	16.0	13.0
Capex to depreciation (x)	2.0	1.1	3.3	3.4	2.9
ROE (%)	na	45.9	(29.0)	(14.5)	(4.5)
ROA (pretax %)	na	(99.5)	(56.5)	(25.0)	4.7
Growth (%)					
Revenue		365.2	152.0	110.3	64.7
EBITDA		na	na	na	na
EBIT		na	na	na	na
Normalised EPS		na	na	na	na
Normalised FDEPS		na	na	na	na
Per share					
Reported EPS (RMB)	(1.94)	(1.73)	(1.94)	(2.45)	(0.71)
Norm EPS (RMB)	(1.90)	(1.66)	(1.41)	(1.20)	0.62
Fully diluted norm EPS (RMB)	(1.90)	(1.66)	(1.41)	(1.20)	0.62
Book value per share (RMB)	1.89	2.80	18.00	15.78	15.46
DPS (RMB)	-	-	-	-	-

Source: Nomura estimates

Revenue ramping up

Cashflow (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
EBITDA	(171)	(130)	(105)	(31)	148
Change in working capital	250	124	(24)	44	(23)
Other operating cashflow		(130)	2	(122)	(71)
Cashflow from operations	**79**	**(136)**	**(127)**	**(109)**	**55**
Capital expenditure	(53)	(41)	(108)	(130)	(174)
Free cashflow	**26**	**(176)**	**(235)**	**(240)**	**(120)**
Reduction in investments		-	-	-	-
Net acquisitions					
Reduction in other LT assets		0	(4)	(7)	(8)
Addition in other LT liabilities		-	-	-	-
Adjustments		128	4	7	8
Cashflow after investing acts	**26**	**(47)**	**(235)**	**(240)**	**(120)**
Cash dividends		-	-	-	-
Equity issue		0	1,742	-	-
Debt issue					
Convertible debt issue					
Others	(95)	260	2	2	2
Cashflow from financial acts	**(95)**	**260**	**1,745**	**2**	**2**
Net cashflow	**(69)**	**213**	**1,510**	**(238)**	**(118)**
Beginning cash	158	89	302	1,811	1,574
Ending cash	89	302	1,811	1,574	1,456
Ending net debt	-	(263)	(1,771)	(1,531)	(1,411)

Source: Nomura estimates

Balance sheet (RMBmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
Cash & equivalents	89	302	1,811	1,574	1,456
Marketable securities					
Accounts receivable	21	75	216	366	603
Inventories					
Other current assets	119	8	20	32	51
Total current assets	**229**	**384**	**2,048**	**1,972**	**2,111**
LT investments					
Fixed assets	61	55	64	99	120
Goodwill					
Other intangible assets	-	1	58	66	99
Other LT assets	2	1	5	12	20
Total assets	**292**	**442**	**2,175**	**2,149**	**2,350**
Short-term debt	19	24	22	23	24
Accounts payable	3	6	36	57	80
Other current liabilities	39	102	202	387	597
Total current liabilities	**60**	**132**	**260**	**467**	**702**
Long-term debt	32	14	18	19	20
Convertible debt					
Other LT liabilities	-	-	-	-	-
Total liabilities	**92**	**147**	**279**	**486**	**722**
Minority interest					
Preferred stock	508	781	-	-	-
Common stock					
Retained earnings	(308)	(486)	1,896	1,663	1,628
Proposed dividends					
Other equity and reserves	-	-	-	-	-
Total shareholders' equity	**200**	**295**	**1,896**	**1,663**	**1,628**
Total equity & liabilities	**292**	**442**	**2,175**	**2,149**	**2,350**
Liquidity (x)					
Current ratio	3.80	2.90	7.87	4.22	3.01
Interest cover	na	(35.7)	(22.7)	(12.3)	na
Leverage					
Net debt/EBITDA (x)	na	na	na	na	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable		113.9	137.3	130.6	132.3
Days inventory		-	-	-	-
Days payable		7.5	21.8	25.6	26.5
Cash cycle	-	106.4	115.5	105.0	105.9

Source: Nomura estimates

Net cash, no debt

Focus Media FMCN US

MEDIA & INTERNET/INTERNET & NEW MEDIA | CHINA

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From Neutral

BUY

Action

Our recent conversations with global media agencies along with media buyers all suggest that the demand environment for digital and outdoor media for scaled players remains sound, with inventory in key markets still scarce and pricing still strong. We upgrade Focus Media to BUY and lift our DCF-based PT to US$36, assuming a WACC of 9.4% and terminal growth of 2%.

Catalysts

We believe strong demand for outdoor digital advertising will benefit Focus Media as it will have greater pricing leverage.

Anchor themes

The Internet/media run in China still has room to advance further, in our view, with growth momentum expected to accelerate on a strong rise in user base expansion and increased utilisation. Among the sub-sectors, we see digital advertising, at this stage of the industry lifecycle, as the major potential beneficiary.

Closing price on 4 Apr	US$30.98
Price target	**US$36.00**
	(from US$27.00)
Upside/downside	16.2%
Difference from consensus	11.0%
FY11F net profit (US$mn)	156.5
Difference from consensus	14.0%

Source: Nomura

Nomura vs consensus

Our non-GAAP net profit estimate is higher than consensus as we see strong advertising demand for digital and outdoor media for scaled players.

Demand remains strong

Upgrade to BUY; price target to US$36

We have increased our FY11F top- and bottom-line estimates on continued advertising strength in China. We upgrade Focus Media to BUY and increase our PT to US$36, based on our discounted cashflow (DCF) valuation. Our DCF calculation assumes a WACC of 9.4% and terminal growth of 2% (methodology unchanged). Reflecting our revised estimates, our new price target implies a 24.6x FY11F P/E. Our recent conversations with global media agencies such as WPP and Publicis Group, as well as media buyers suggest that the demand environment for digital and outdoor media for scaled players remains very sound as inventory levels in key markets remain scarce and pricing remains strong. Furthermore, we believe strong demand has allowed for easier transition of the original “A” and “B” networks into “A1” and “A2” networks. While the traditional “A” network has more office buildings and higher quality than the “B” network, the two new networks after the remix, namely “A1” and “A2”, are similar in terms of both building quantity and quality. In our view, many advertisers are increasing their utilization of the platform.

Our non-GAAP 1Q11F EPS estimate remains at US$0.27, while our top-line estimate increases by 2.4% to US$143.7mn, representing a 13.9% q-q decline. We expect the company to beat its guided range of a 15.5-17.3% q-q decline on the top line, as we believe that given strong demand and an earlier CNY, business continued to ramp nicely, particularly in the second half of 1Q11F. Our new FY11F non-GAAP EPS estimate goes to US$1.46 (+21% y-y) on sales of US$654.5mn (13% y-y) from US$1.42 (+17% y-y) on sales of US$642.8mn (+11% y-y).

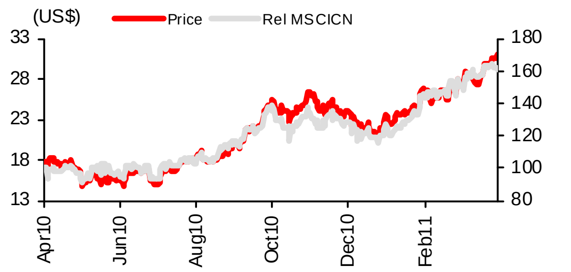
On the valuation front, Focus Media shares are trading at 21.2x our FY11F non-GAAP EPS estimate, below the peer Internet group average of 25.2x. However, the stock looks more attractive, in our view, given its direct exposure to advertising and Chinese consumer growth. For FY11-13F, we pencil in a non-GAAP (ie, excluding share-

Key financials & valuations

31 Dec (US$mn)	FY09	FY10	FY11F	FY12F
Revenue	613	580	654	767
Reported net profit	(175.3)	104.9	156.5	208.8
Normalised net profit	89.3	177.4	207.1	257.4
Normalised EPS (US$)	0.68	1.21	1.46	1.82
Norm. EPS growth (%)	(56.6)	77.1	20.7	24.3
Norm. P/E (x)	45.3	25.6	21.2	17.1
EV/EBITDA (x)	22.4	15.7	13.4	10.6
Price/book (x)	3.4	3.7	3.0	2.5
Dividend yield (%)	0.0	0.0	0.0	0.0
ROE (%)	(14.7)	8.8	11.9	13.5
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		177.4	200.8	242.2
Change from previous (%)		-	3.1	6.3
Previous norm. EPS (US$)		1.21	1.42	1.71

Source: Company, Nomura estimates

Share price relative to MSCICN



	1m	3m	6m
Absolute (US$)	12.7	30.7	25.4
Absolute (US$)	12.7	30.7	25.4
Relative to Index	7.8	27.7	20.4
Market cap (US$mn)			4,389
Estimated free float (%)			55.0
52-week range (US$)			30.98/14.80
3-mth avg daily turnover (US$mn)			42.45
Stock borrowability			Easy
Major shareholders (%)			
Fosun International			25.6
Nanchun Jiang			19.5

Source: Company, Nomura estimates

based compensation) EPS CAGR of 17.8% for Focus Media, compared with 39.9% for Baidu and 16.6% for AirMedia, two other direct advertising plays.

② Strong demand environment

Our conversations with media agencies and key customers including leading auto and handset manufacturers suggest that demand for outdoor digital media for scaled networks is at a premium. We believe that the outdoor digital space in China will grow in the low-20% range in 2011F. However, we also believe that Focus Media will top that as we estimate 29% growth for the company's traditional business — namely, advertising on LCD display networks, in-store networks and poster frame networks. Given the lack of inventory for key media, we believe Focus Media will have greater pricing leverage than in the recent past, and we estimate that pricing (after discounts) could increase by 12%, compared to management's expectations of approximately 10%. This also compares favourably with that of competitors such as AirMedia and Vision China, which we expect will see relatively low pricing increases in the low- to mid-single digits given their relative smaller scale.

As mentioned previously, with new sectors such as e-commerce, education and even travel starting to advertise on outdoor digital media, inventory continues to be at a premium and pricing remains strong. As many of these "new" sectors are very fragmented and all are trying to grab brand share, companies like Focus Media are benefiting as traditional media such as TV continues to be less affordable; digital outdoor can be 60-80% cheaper on a CPM basis compared that to traditional TV, based on our estimates.

We also believe that given the strong demand environment, the company's transition of the original "A" and "B" networks into "A1" and "A2" networks in Tier-1 cities has gone smoother than anticipated. In speaking with key customers such as some leading auto and handset manufacturers, the combined network in effect has increased prices to traditional "A" network levels; however, the discount has not been as significant, with pricing up 10-15% on a like-for-like basis. Furthermore, clients are buying more inventory with the combined network — as much as 10% more according to our channel checks and estimates. We think the combined utilization rate of the "A1" and "A2" networks is approximately 60% and believe that this can move to 70-75% by the end of this year as the combined network is up-selling inventory otherwise not utilized. Moreover, given the lack of advertising inventory and higher media inflation in other media, advertisers do not have as much pricing leverage as in the past, hence the discounting has been less than in the past according to our checks.

③ Pure advertising play

In our opinion, Focus Media and even Baidu may be the best ways to play the advertising growth and consumer consumption story in China. We believe that while the company's advertising scale and ROI are less attractive compared to its Internet portal peers, companies like Sina and Sohu are no longer pure advertising plays as their advertising business is overshadowed by other businesses such as social media and online video.

We believe the growth engine of Focus Media remains the Chinese consumer as consumer-related advertising represents approximately 70% of the company's revenue contributions. In 4Q10, according to management, the company had 31% revenue from FMCG, 30% from transportation and 7-8% each from telecom and financial services. It has minimal exposure to cyclical industries such as real estate (3% of revenues). Although there is concern over demand from the auto industry following the restrictive policy on car purchases adopted by the Beijing government at the end of December 2010, the overall impact on the company should be minimal, in our opinion. In fact, auto only accounted for about 15% of the 30% from transportation, according to management.

Risks: Downside risks to our price target include: 1) demand may be weaker than expected; and 2) new entrants, if any, could constitute competition.

Exhibit 98. Valuation comparison

	Investment rating	Ticker	Current price	Mkt. Cap. US$mn	EV/Revenue		EV/EBITDA		P/E		P/E excl. cash		EPS CAGR 10-12F (%)
					2010	2011F	2010	2011F	2010	2011F	2010	2011F	
AirMedia	BUY	AMCN US	US$5.34	367	1.1	0.9	13.5	5.3	52.1	10.1	47.9	7.6	156.0
Clear Media*	Not rated	100 HK	HK$4.90	332	1.6	1.4	8.4	7.3	14.4	12.3	N/A	N/A	26.5
VisionChina*	Not rated	VISN US	HK$3.94	403	2.4	1.9	28.5	11.2	57.1	14.1	N/A	N/A	13.9
Sina	BUY	SINA US	US$116.56	7642	17.7	14.3	63.4	51.6	67.4	68.0	64.8	65.6	14.9
Sohu	REDUCE	SOHU US	US$97.30	3802	5.1	3.8	11.1	8.4	23.1	19.8	19.2	16.5	15.0
Focus Media	**BUY**	**FMCN US**	**US$30.98**	**4,389**	**6.5**	**5.8**	**15.7**	**13.4**	**25.6**	**21.2**	**23.1**	**19.0**	**22.5**
Advertising Average					**5.6**	**4.5**	**25.5**	**16.9**	**45.1**	**25.2**	**44.0**	**29.9**	**45.3**

* Bloomberg consensus estimates. Pricing as of 4 April 2011.

Source: Company data, Bloomberg, Nomura estimates

Financial statements

Income statement (US$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
Revenue	790	613	580	654	767
Cost of goods sold	(444)	(431)	(270)	(280)	(325)
Gross profit	**346**	**182**	**310**	**375**	**442**
SG&A	(595)	(240)	(195)	(202)	(220)
Employee share expense	489	166	81	51	49
Operating profit	**240**	**108**	**196**	**223**	**271**
EBITDA	**312**	**170**	**242**	**264**	**307**
Depreciation	(48)	(35)	(28)	(25)	(25)
Amortisation	(24)	(27)	(18)	(15)	(11)
EBIT	**240**	**108**	**196**	**223**	**271**
Net interest expense	5	4	7	7	29
Associates & JCEs					
Other income	(0)	23	-	-	-
Earnings before tax	**245**	**134**	**203**	**231**	**300**
Income tax	(40)	(8)	(24)	(23)	(42)
Net profit after tax	**205**	**126**	**179**	**207**	**258**
Minority interests	(2)	(37)	(2)	(0)	(0)
Other items					
Preferred dividends					
Normalised NPAT	**203**	**89**	**177**	**207**	**257**
Extraordinary items	(971)	(265)	(72)	(51)	(49)
Reported NPAT	**(768)**	**(175)**	**105**	**156**	**209**
Dividends					
Transfer to reserves	**(768)**	**(175)**	**105**	**156**	**209**
Valuation and ratio analysis					
FD normalised P/E (x)	19.7	45.3	25.6	21.2	17.1
FD normalised P/E at price target (x)	22.8	52.6	29.7	24.6	19.8
Reported P/E (x)	na	na	43.2	28.1	21.0
Dividend yield (%)	-	-	-	-	-
Price/cashflow (x)	23.7	25.2	24.5	14.7	15.0
Price/book (x)	3.3	3.4	3.7	3.0	2.5
EV/EBITDA (x)	13.6	22.4	15.7	13.4	10.6
EV/EBIT (x)	17.7	35.5	19.4	15.8	12.0
Gross margin (%)	43.8	29.6	53.4	57.3	57.6
EBITDA margin (%)	39.5	27.8	41.6	40.3	40.0
EBIT margin (%)	30.4	17.5	33.7	34.1	35.3
Net margin (%)	(97.3)	(28.6)	18.1	23.9	27.2
Effective tax rate (%)	16.4	5.6	11.6	10.1	14.0
Dividend payout (%)	na	na	-	-	-
Capex to sales (%)	9.2	1.7	3.1	3.8	3.4
Capex to depreciation (x)	1.5	0.3	0.6	1.0	1.0
ROE (%)	(50.3)	(14.7)	8.8	11.9	13.5
ROA (pretax %)	15.6	9.7	24.2	28.1	33.3
Growth (%)					
Revenue	56.0	(22.4)	(5.4)	12.8	17.2
EBITDA	33.2	(45.4)	41.9	9.2	16.5
EBIT	26.4	(55.2)	82.0	14.2	21.2
Normalised EPS	0.6	(56.6)	77.1	20.7	24.3
Normalised FDEPS	0.6	(56.6)	77.1	20.7	24.3
Per share					
Reported EPS (US$)	(5.96)	(1.34)	0.72	1.10	1.47
Norm EPS (US$)	1.58	0.68	1.21	1.46	1.82
Fully diluted norm EPS (US$)	1.58	0.68	1.21	1.46	1.82
Book value per share (US$)	9.29	9.11	8.48	10.47	12.38
DPS (US$)	-	-	-	-	-

Source: Nomura estimates

Revenues driven by traditional business

Cashflow (US$mn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
EBITDA	312	170	242	264	307
Change in working capital	(282)	277	(19)	52	(2)
Other operating cashflow	138	(287)	(38)	(17)	(12)
Cashflow from operations	**168**	**161**	**185**	**299**	**293**
Capital expenditure	(73)	(10)	(18)	(25)	(26)
Free cashflow	**96**	**150**	**167**	**274**	**268**
Reduction in investments	90	-	-	-	-
Net acquisitions					
Reduction in other LT assets	(469)	616	34	5	11
Addition in other LT liabilities	7	(8)	5	-	-
Adjustments	18	(475)	27	(5)	(11)
Cashflow after investing acts	**(258)**	**283**	**232**	**274**	**268**
Cash dividends					
Equity issue					
Debt issue					
Convertible debt issue					
Others	(50)	143	(208)	(0)	0
Cashflow from financial acts	**(50)**	**143**	**(208)**	**(0)**	**0**
Net cashflow	**(308)**	**426**	**24**	**274**	**268**
Beginning cash	450	142	568	592	867
Ending cash	142	568	592	867	1,134
Ending net debt	(142)	(568)	(592)	(867)	(1,134)

Source: Nomura estimates

Balance sheet (US$mn)					
As at 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
Cash & equivalents	142	568	592	867	1,134
Marketable securities	-	-	-	-	-
Accounts receivable	135	173	157	157	192
Inventories					
Other current assets	530	93	103	110	120
Total current assets	**808**	**834**	**852**	**1,133**	**1,446**
LT investments					
Fixed assets	6	78	69	71	72
Goodwill	31	410	425	425	425
Other intangible assets					
Other LT assets	688	72	38	33	22
Total assets	**1,532**	**1,393**	**1,384**	**1,663**	**1,965**
Short-term debt					
Accounts payable	68	53	17	59	77
Other current liabilities	251	143	156	173	198
Total current liabilities	**319**	**197**	**173**	**232**	**275**
Long-term debt					
Convertible debt					
Other LT liabilities	14	5	10	10	10
Total liabilities	**332**	**202**	**183**	**242**	**285**
Minority interest	2	2	1	1	0
Preferred stock					
Common stock					
Retained earnings					
Proposed dividends					
Other equity and reserves	1,198	1,190	1,200	1,420	1,680
Total shareholders' equity	**1,198**	**1,190**	**1,200**	**1,420**	**1,680**
Total equity & liabilities	**1,532**	**1,393**	**1,384**	**1,663**	**1,965**
Liquidity (x)					
Current ratio	2.53	4.24	4.94	4.89	5.26
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	79.1	91.7	103.8	87.7	83.2
Days inventory	-	-	-	-	-
Days payable	48.8	51.3	47.2	49.3	76.3
Cash cycle	30.3	40.4	56.6	38.4	6.9

Net cash; no debt

Source: Nomura estimates

Baidu BIDU US

MEDIA & INTERNET/INTERNET & NEW MEDIA | CHINA

Maintained

BUY

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NOMURA
NOMURA INTERNATIONAL (HK) LIMITED

Action

We continue to believe that Baidu's revenue growth momentum remains very strong. We reaffirm our BUY call and lift our price target to US$165 on the heels on strength in the advertising market and the company's exposure to online video. Our DCF calculation assumes a WACC of 8.6% and terminal growth of 2% (methodology unchanged).

Catalysts

Increased investment in search advertising from new segments such as e-commerce, travel and education will drive the incremental growth.

Anchor themes

The Internet/media run in China still has room to advance further, in our view, with growth momentum expected to accelerate on a strong rise in user base expansion and increased utilisation. Among the sub-sectors, we see digital advertising, at this stage of the industry lifecycle, as the major potential beneficiary.

Closing price on 4 Apr	US$143.1
Price target	**US$165.0**
	(from US$140.0)
Upside/downside	15.3%
Difference from consensus	19.9%
FY11F net profit (RMBmn)	5,986
Difference from consensus	9.5%

Source: Nomura

Nomura vs consensus

Advertising demand for digital media in China is stronger than previously expected and Baidu is a direct beneficiary as a pure advertising play.

E-commerce and video driving incremental growth

Maintain BUY; price target to US$165

We maintain a BUY on Baidu and increase our 12-month price target to US$165 on the heels of strength in the advertising market and the company's exposure to online video. Our DCF calculation assumes a WACC of 8.6% and terminal growth of 2% (methodology unchanged). Reflecting our revised estimates, our new price target implies 62.2x FY11F P/E. We continue to believe that the company's revenue momentum remains very strong in the near term as we believe new segments such as e-commerce, travel and education will continue to invest more in search advertising. We estimate that e-commerce-related advertising accounts for approximately 5% of revenues and believe this figure can double over the next 12-18 months.

Our non-GAAP 1Q11F EPS estimate is up 2.4% to RMB3.36 from RMB3.28, while our top-line estimate remains at RMB2,474mn, representing 0.9% q-q growth. We expect the company to beat its guided range of 0-2.9% q-q decline on the top line. Our FY11F non-GAAP diluted EPS estimate goes to RMB17.50 (+69% y-y) on sales of RMB12,915mn (+63% y-y) from RMB16.84 (+63% y-y) on sales of RMB12,635mn (+60% y-y).

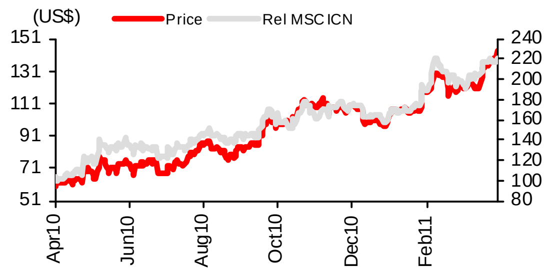
On the valuation front, Baidu shares are trading at 54x our FY11F non-GAAP diluted EPS estimate. On a PEG basis, the stock is trading at 0.95x FY11F PEG. The stock looks attractive in our view, given its direct exposure to advertising and Chinese consumer growth, as well as its fast-growing online video subsidiary, Qiyi. For FY11-13F, we pencil in a non-GAAP (ie, excluding share-based compensation) diluted EPS CAGR of 39.9% for Baidu, compared with our estimates of 17.8% for Focus Media and 16.6% for AirMedia, two other direct advertising plays.

Key financials & valuations

31 Dec (RMBmn)	FY09	FY10	FY11F	FY12F
Revenue	4,448	7,915	12,915	19,078
Reported net profit	1,485	3,528	5,986	8,709
Normalised net profit	1,571	3,619	6,115	8,899
Normalised EPS (RMB)	4.54	10.40	17.55	25.54
Norm. EPS growth (%)	37.2	129.0	68.8	45.5
Norm. P/E (x)	216.5	92.9	54.0	36.5
EV/EBITDA (x)	173.6	74.9	42.6	27.7
Price/book (x)	71.2	39.8	22.6	13.8
Dividend yield (%)	0.0	0.0	0.0	0.0
ROE (%)	37.9	53.6	52.1	45.8
Net debt/equity (%)	net cash	net cash	net cash	net cash
Earnings revisions				
Previous norm. net profit		3,619	5,885	8,277
Change from previous (%)		-	3.9	7.5
Previous norm. EPS (RMB)		10.40	16.89	23.75

Source: Company, Nomura estimates

Share price relative to MSCICN



	1m	3m	6m
Absolute (US$)	17.0	41.7	48.7
Absolute (US$)	17.0	41.7	48.7
Relative to Index	12.1	38.8	43.8
Market cap (US$mn)			50,005
Estimated free float (%)			99.2
52-week range (US$)			143.1/60.1
3-mth avg daily turnover (US$mn)			826
Stock borrowability			Easy
Major shareholders (%)			
Baillie Gifford			9.4
T Rowe			6.7

Source: Company, Nomura estimates

② B2C and e-commerce

We estimate that more than 60% of all search revenues for Baidu come from B2B-related search queries. In fact, sectors such as medical devices/pharmaceuticals, machinery and construction are among the top 5 advertising verticals, while we believe that e-commerce-related searches represent approximately 5% of total search revenues. This is quite the stark contrast from Google, which generates approximately 40% of its revenues from e-commerce-related fields.

Once China's e-commerce becomes more mature and active, we believe that search will become more important as a means to "crawl" these sites and B2C will become an increasingly more important component of revenues. Hence, we expect that Baidu will not only be a China search play, but more important, an e-commerce play.

We are seeing increasing activity on Baidu's website for e-commerce-related listings. For example, while Taobao does not allow Baidu to crawl its website, we are seeing increasingly more Taobao merchants buying paid links from Baidu in various categories including apparel, personal electronics, health/beauty, and sporting equipment, among others. Using like-for-like key words, we estimate that we have seen 20% more Taobao mall-related links as well as e-commerce links over the past six months. For example, when we search "Dell Taobao" (in Chinese) on Baidu, we can find the paid link of Dell's Taobao mall shop now. In some other cases, we just search the brand name and the Taobao mall shop of that brand shows up as a paid link on the result page. The children's wear brand M.Knit House is an example of that. We believe that although Taobao still does not allow Baidu to "crawl" its site or show the pages of Taobao shops as organic search results, the above example illustrates that more Taobao merchants are buying keywords on Baidu by themselves to attract potential customers to their online shops on Taobao.

Exhibit 99. Search result of "Dell Taobao"

Source: Baidu website

Exhibit 100. Search result page of "M.Knit House"

Source: Baidu website

③ Qiyi.com

Unlike social networking or search, we do not believe that online video is a monopoly, but rather an oligopoly where there are several dominating players all providing a differentiated product. We believe that in the long run, there will be three players that will dominate the space — namely, Youku, Qiyi and Sina.

Qiyi.com's greatest competitive advantage, as we see it, is that it generates more than half its traffic through Baidu queries. Unlike many other online video websites in China such as Youku and Tudou, Qiyi's content was 100% long-form professional. There is no UGC on Qiyi's platform. Its monthly UV exceeded 100mn by December 2010, only eight months after its launch. In contrast, we believe both Youku and Tudou required more than two years to pass that milestone. Qiyi's monthly UV further increased to 148mn in Feb 2011, covering more than 50% of the online video users in China. We expect Qiyi's monthly UV number could double by the end of this year. We believe Qiyi's growth momentum is driven by traffic feed from Baidu and a Hulu-like business model, specializing in long-form high-definition video. In addition, as Baidu is a good distribution channel and marketing platform for the content suppliers, Qiyi, with its strong tie with Baidu, should be more likely to get favorable terms when licensing content from the suppliers, in our view.

Exhibit 101. Youku vs. Tudou vs. Qiyi

	Youku	Tudou	Qiyi
Ads format	In-video ads, banner ads	In-video ads, banner ads, overlay ads, background ads	In-video ads, banner ads
# of Advertisers (9M10)	343	420	NA
Net revenue (9M10, RMBmn)	235	225	About 10
Content library	(3Q10) Movies: 2,200 TV drama: 1,250 titles, 36,000+ episodes Variety shows: 194 Video clips: 45.1mn	(3Q10) Movies: 640 TV drama: 1,530 episodes Variety shows: 150 Video clips: 36.3mn	(Feb 11) Movies: 2,000 TV drama: 40,000+ episodes Variety shows: 15,000+ episodes Documentaries: 10,000+ hours
Monthly UV (mn)	287 (4Q10)	NA	148 (Feb 11)
Registered users (9M10, mn)	77	72	No registered users on Qiyi
Average daily VV (mn)	161 (2010)	NA	47 (Feb 11)
Daily video file uploads (K)	60	42	NA
Share of user time spent (2Q10)	40%	23%	NA
Traffic from Baidu	~25%	NA	~50%

Source: Company data and Nomura estimates

Having the backend support from Baidu, which drives 50%+ of its total traffic, is very sufficient leverage. For example, if we search a popular TV drama on Baidu, we would find Qiyi on the top with detailed display of several episodes. After that, we would then see other online video sites like Youku. Unlike Youku, which offers both long and short form as well as user-generated content, Qiyi replicates the Hulu model in China that emphasizes long-form contents, including movies from domestic and overseas producers. Given Baidu's strategic positioning in long form and in high definition, we believe that Qiyi can have an opportunity to venture into a viable subscription model, where people will pay for content — the likes of Netflix.

Exhibit 102. Search result page of Baidu

Source: Baidu website

Valuation methodology

Our price target is based on DCF, which assumes a WACC of 8.6% and terminal growth of 2% (methodology unchanged). Our price target implies 62.2x FY11F P/E.

Key risks

Downside risks to our price target include: 1) slower-than-expected economic growth that would slow search market growth; 2) weaker-than-expected operational leverage could lead to lower margins; and 3) new entrants or smaller players in the search market that attract customers and constitute competition to the company.

Financial statements

Income statement (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
Revenue	3,198	4,448	7,915	12,915	19,078
Cost of goods sold	(1,151)	(1,610)	(2,143)	(3,280)	(4,903)
Gross profit	**2,047**	**2,838**	**5,772**	**9,635**	**14,175**
SG&A	(867)	(1,147)	(1,720)	(2,730)	(4,044)
Employee share expense					
Operating profit	**1,181**	**1,691**	**4,053**	**6,905**	**10,130**
EBITDA	**1,407**	**1,942**	**4,384**	**7,422**	**10,893**
Depreciation	(226)	(251)	(332)	(517)	(763)
Amortisation	-	-	-	-	-
EBIT	**1,181**	**1,691**	**4,053**	**6,905**	**10,130**
Net interest expense	48	33	67	93	95
Associates & JCEs					
Other income	20	46	35	89	89
Earnings before tax	**1,248**	**1,769**	**4,155**	**7,087**	**10,314**
Income tax	(116)	(198)	(536)	(972)	(1,414)
Net profit after tax	**1,132**	**1,571**	**3,619**	**6,115**	**8,899**
Minority interests					
Other items	-	-	-	-	-
Preferred dividends					
Normalised NPAT	**1,132**	**1,571**	**3,619**	**6,115**	**8,899**
Extraordinary items	(84)	(86)	(91)	(129)	(191)
Reported NPAT	**1,048**	**1,485**	**3,528**	**5,986**	**8,709**
Dividends	-	-	-	-	-
Transfer to reserves	**1,048**	**1,485**	**3,528**	**5,986**	**8,709**
Valuation and ratio analysis					
FD normalised P/E (x)	299.8	216.5	92.9	54.0	36.5
FD normalised P/E at price target (x)	345.6	249.6	107.1	62.2	42.1
Reported P/E (x)	319.1	227.7	94.9	55.0	37.2
Dividend yield (%)	-	-	-	-	-
Price/cashflow (x)	191.5	148.4	68.4	41.0	29.3
Price/book (x)	108.3	71.2	39.8	22.6	13.8
EV/EBITDA (x)	241.1	173.6	74.9	42.6	27.7
EV/EBIT (x)	287.3	199.4	81.0	45.8	29.8
Gross margin (%)	64.0	63.8	72.9	74.6	74.3
EBITDA margin (%)	44.0	43.7	55.4	57.5	57.1
EBIT margin (%)	36.9	38.0	51.2	53.5	53.1
Net margin (%)	32.8	33.4	44.6	46.4	45.6
Effective tax rate (%)	9.3	11.2	12.9	13.7	13.7
Dividend payout (%)	-	-	-	-	-
Capex to sales (%)	13.1	9.0	10.6	9.6	8.6
Capex to depreciation (x)	1.9	1.6	2.5	2.4	2.1
ROE (%)	41.0	37.9	53.6	52.1	45.8
ROA (pretax %)	82.0	95.7	156.3	175.4	180.5
Growth (%)					
Revenue	83.3	39.1	78.0	63.2	47.7
EBITDA	91.6	38.1	125.7	69.3	46.8
EBIT	101.1	43.2	139.6	70.4	46.7
Normalised EPS	67.6	37.2	129.0	68.8	45.5
Normalised FDEPS	69.3	38.4	129.6	68.9	45.5
Per share					
Reported EPS (RMB)	3.1	4.3	10.1	17.2	25.0
Norm EPS (RMB)	3.3	4.5	10.4	17.6	25.5
Fully diluted norm EPS (RMB)	3.3	4.5	10.4	17.5	25.5
Book value per share (RMB)	9.0	13.7	24.2	41.8	67.4
DPS (RMB)	-	-	-	-	-

Source: Nomura estimates

Strong organic growth in revenue

Cashflow (RMBmn)					
Year-end 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
EBITDA	1,407	1,942	4,384	7,422	10,893
Change in working capital	162	478	828	1,328	1,575
Other operating cashflow	178	(140)	(317)	(717)	(1,402)
Cashflow from operations	**1,746**	**2,279**	**4,895**	**8,033**	**11,066**
Capital expenditure	(418)	(399)	(836)	(1,235)	(1,633)
Free cashflow	**1,328**	**1,880**	**4,059**	**6,798**	**9,433**
Reduction in investments	(56)	(82)	(269)	(879)	(528)
Net acquisitions	-	(12)	274	149	-
Reduction in other LT assets	(59)	(9)	(60)	0	-
Addition in other LT liabilities	(3)	4	87	-	-
Adjustments	(125)	(38)	(513)	132	(24)
Cashflow after investing acts	**1,085**	**1,743**	**3,578**	**6,200**	**8,881**
Cash dividends	-	-	-	-	-
Equity issue	(36)	95	42	44	46
Debt issue	-	-	-	-	-
Convertible debt issue					
Others	(38)	(1)	-	-	-
Cashflow from financial acts	**(74)**	**94**	**42**	**44**	**46**
Net cashflow	**1,012**	**1,838**	**3,620**	**6,244**	**8,927**
Beginning cash	1,351	2,362	4,200	7,820	14,065
Ending cash	2,362	4,200	7,820	14,065	22,992
Ending net debt	(2,362)	(4,200)	(7,820)	(14,065)	(22,992)

Source: Nomura estimates

Balance sheet (RMBmn)					
As at 31 Dec	**FY08**	**FY09**	**FY10**	**FY11F**	**FY12F**
Cash & equivalents	2,362	4,200	7,820	14,065	22,992
Marketable securities	301	381	376	1,107	1,635
Accounts receivable	93	162	297	469	693
Inventories					
Other current assets	96	100	289	301	442
Total current assets	**2,852**	**4,843**	**8,782**	**15,942**	**25,762**
LT investments	12	14	288	436	436
Fixed assets	884	1,092	1,622	2,058	3,089
Goodwill	51	64	64	64	64
Other intangible assets	31	28	116	33	47
Other LT assets	107	116	176	176	176
Total assets	**3,938**	**6,157**	**11,048**	**18,709**	**29,574**
Short-term debt					
Accounts payable	423	750	1,318	2,177	3,216
Other current liabilities	426	650	1,234	1,887	2,787
Total current liabilities	**849**	**1,400**	**2,552**	**4,064**	**6,004**
Long-term debt					
Convertible debt					
Other LT liabilities	-	4	91	91	91
Total liabilities	**849**	**1,404**	**2,643**	**4,155**	**6,095**
Minority interest					
Preferred stock					
Common stock	14	14	14	14	14
Retained earnings	1,980	1,980	1,980	1,980	1,980
Proposed dividends					
Other equity and reserves	1,095	2,759	6,411	12,560	21,485
Total shareholders' equity	**3,089**	**4,753**	**8,406**	**14,554**	**23,479**
Total equity & liabilities	**3,938**	**6,157**	**11,048**	**18,709**	**29,574**
Liquidity (x)					
Current ratio	3.36	3.46	3.44	3.92	4.29
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	9.0	10.4	10.6	10.8	11.2
Days inventory	-	-	-	-	-
Days payable	124.4	133.0	176.1	194.5	201.3
Cash cycle	(115.4)	(122.5)	(165.5)	(183.7)	(190.2)

Source: Nomura estimates

Net cash, no debt

Any Authors named on this report are Research Analysts unless otherwise indicated

Analyst Certification

We, Jinkyu Yoon and George Meng, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures

Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Baidu	BIDU US	143.11 USD	04-Apr-2011	Buy	Not Rated	123
Focus Media	FMCN US	30.98 USD	04-Apr-2011	Neutral	Not Rated	123
Youku.com Inc.	YOKU US	48.84 USD	04-Apr-2011	Not Rated	Not Rated	123

Disclosures required in the U.S.

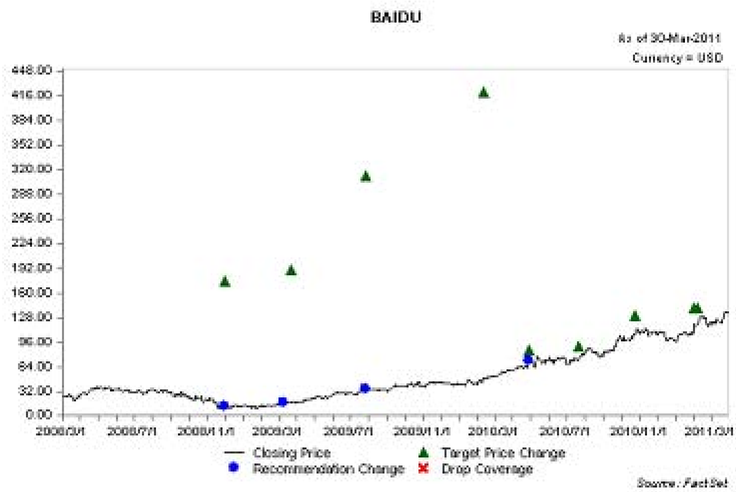
123 **Market Maker - NSI**
Nomura Securities International Inc. makes a market in securities of the company.

Previous Rating

Issuer name	Previous Rating	Date of change
Baidu	Reduce	29-Apr-2010
Focus Media	Buy	05-Oct-2010
Youku.com Inc.	Not Rated	

Baidu (BIDU US) **143.11 USD (04-Apr-2011)** Buy (Sector rating: Not Rated)

Rating and target price chart (three year history)

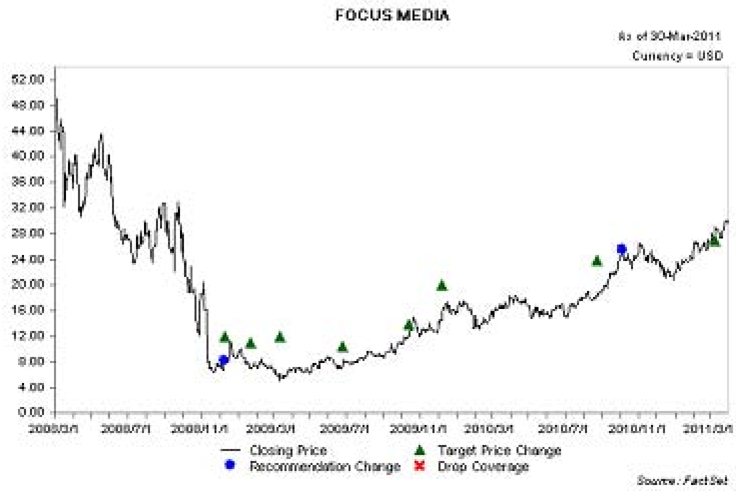


Date	Rating	Target price	Closing price
08-Feb-2011		140.00	119.84
01-Feb-2011		140.00	118.73
25-Oct-2010		130.00	109.75
22-Jul-2010		90.00	74.45
29-Apr-2010		85.00	70.99
29-Apr-2010	Buy		70.99
11-Feb-2010		420.00	48.75
28-Jul-2009		311.30	35.11
28-Jul-2009	Reduce		35.11
23-Mar-2009		190.00	18.26
11-Mar-2009	Neutral		16.82
01-Dec-2008		175.00	11.63
01-Dec-2008	Buy		11.63

For explanation of ratings refer to the stock rating keys located after chart(s)

Focus Media (FMCN US) **30.98 USD (04-Apr-2011)** Neutral (Sector rating: Not Rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
09-Mar-2011		27.00	29.03
05-Oct-2010	Neutral		25.47
24-Aug-2010		24.00	18.94
09-Dec-2009		20.00	15.49
13-Oct-2009		13.98	11.96
24-Jun-2009		10.54	7.50
12-Mar-2009		12.00	6.19
22-Jan-2009		11.00	6.99
11-Dec-2008		12.00	8.13
11-Dec-2008	Buy		8.13

For explanation of ratings refer to the stock rating keys located after chart(s)

Youku.com Inc. (YOKU US) **48.84 USD (04-Apr-2011)** Not Rated (Sector rating: Not Rated)

Chart Not Available

Important Disclosures

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49% have been assigned a Buy rating which, for purposes of mandatory disclosures, are classified as a Buy rating; 37% of companies with this rating are investment banking clients of the Nomura Group*.

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11% have been assigned a Reduce rating which, for purposes of mandatory disclosures, are classified as a Sell rating; 16% of companies with this rating are investment banking clients of the Nomura Group*.

As at 31 March 2011.

**The Nomura Group as defined in the Disclaimer section at the end of this report.*

Explanation of Nomura's equity research rating system in Europe, Middle East and Africa, US and Latin America for ratings published from 27 October 2008

The rating system is a relative system indicating expected performance against a specific benchmark identified for each individual stock. Analysts may also indicate absolute upside to target price defined as (fair value - current price)/current price, subject to limited management discretion. In most cases, the fair value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as discounted cash flow or multiple analysis, etc.

STOCKS

A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months.

A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months.

A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.

A rating of '**Suspended**', indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.

Benchmarks are as follows: **United States/Europe**: Please see valuation methodologies for explanations of relevant benchmarks for stocks (accessible through the left hand side of the Nomura Disclosure web page: http://www.nomura.com/research);**Global Emerging Markets (ex-Asia):** MSCI Emerging Markets ex-Asia, unless otherwise stated in the valuation methodology.

SECTORS

A '**Bullish'** stance, indicates that the analyst expects the sector to outperform the Benchmark during the next 12 months.
A '**Neutral'** stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next 12 months.
A '**Bearish'** stance, indicates that the analyst expects the sector to underperform the Benchmark during the next 12 months.
Benchmarks are as follows: **United States**: S&P 500; **Europe**: Dow Jones STOXX 600; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Target Price - Current Price) / Current Price, subject to limited management discretion. In most cases, the Target Price will equal the analyst's 12-month intrinsic valuation of the stock, based on an appropriate valuation methodology such as discounted cash flow, multiple analysis, etc.
A '**Buy'** recommendation indicates that potential upside is 15% or more.
A '**Neutral'** recommendation indicates that potential upside is less than 15% or downside is less than 5%.
A '**Reduce'** recommendation indicates that potential downside is 5% or more.
A rating of '**Suspended'** indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company.
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SECTORS

A '**Bullish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.
A '**Neutral'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.
A '**Bearish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009 (and ratings in Europe, Middle East and Africa, US and Latin America published prior to 27 October 2008)

STOCKS

A rating of '1' or '**Strong buy'**, indicates that the analyst expects the stock to outperform the Benchmark by 15% or more over the next six months.
A rating of '2' or '**Buy'**, indicates that the analyst expects the stock to outperform the Benchmark by 5% or more but less than 15% over the next six months.
A rating of '3' or '**Neutral'**, indicates that the analyst expects the stock to either outperform or underperform the Benchmark by less than 5% over the next six months.
A rating of '4' or '**Reduce'**, indicates that the analyst expects the stock to underperform the Benchmark by 5% or more but less than 15% over the next six months.
A rating of '5' or '**Sell'**, indicates that the analyst expects the stock to underperform the Benchmark by 15% or more over the next six months.
Stocks labeled '**Not rated'** or shown as '**No rating'** are not in Nomura's regular research coverage. Nomura might not publish additional research reports concerning this company, and it undertakes no obligation to update the analysis, estimates, projections, conclusions or other information contained herein.

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A '**Bullish'** stance, indicates that the analyst expects the sector to outperform the Benchmark during the next six months.
A '**Neutral'** stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next six months.
A '**Bearish'** stance, indicates that the analyst expects the sector to underperform the Benchmark during the next six months.
Benchmarks are as follows: **Japan**: TOPIX; **United States**: S&P 500, MSCI World Technology Hardware & Equipment; **Europe**, by sector - *Hardware/Semiconductors*: FTSE W Europe IT Hardware; *Telecoms*: FTSE W Europe Business Services; *Business Services*: FTSE W Europe; *Auto & Components*: FTSE W Europe Auto & Parts; *Communications equipment*: FTSE W Europe IT Hardware; **Ecology Focus**: Bloomberg World Energy Alternate Sources; **Global Emerging Markets**: MSCI Emerging Markets ex-Asia.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Fair Value - Current Price)/Current Price, subject to limited management discretion. In most cases, the Fair Value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as Discounted Cash Flow or Multiple analysis etc. However, if the analyst doesn't think the market will revalue the stock over the specified time horizon due to a lack of events or catalysts, then the fair value may differ from the intrinsic fair value. In most cases, therefore, our recommendation is an assessment of the difference between current market price and our estimate of current intrinsic fair value. Recommendations are set with a 6-12 month horizon unless specified otherwise. Accordingly, within this horizon, price volatility may cause the actual upside or downside based on the prevailing market price to differ from the upside or downside implied by the recommendation.
A '**Strong buy'** recommendation indicates that upside is more than 20%.
A '**Buy'** recommendation indicates that upside is between 10% and 20%.
A '**Neutral'** recommendation indicates that upside or downside is less than 10%.
A '**Reduce'** recommendation indicates that downside is between 10% and 20%.
A '**Sell'** recommendation indicates that downside is more than 20%.

SECTORS

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A '**Bearish**' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

Target Price

A Target Price, if discussed, reflect in part the analyst's estimates for the company's earnings. The achievement of any target price may be impeded by general market and macroeconomic trends, and by other risks related to the company or the market, and may not occur if the company's earnings differ from estimates.

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Additional information available upon request

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