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Large-Cap Internet Courtships

Where Does Consolidation Make Sense?

Recently, the *WSJ* and other major publications have reported on potential M&A between various large-cap Internet companies, namely eBay, Google, MSN and Yahoo!. In this report, we explore the reasoning behind and the likelihood of such an event.

- After detailed analysis, we believe a partnership or strategic event among large-cap Internet companies is likely due to 1) increased scale, 2) strengthened global footprint, 3) broadened user insights, and 4) improved operational efficiencies. We also believe recent share gains and product introductions by Google are compelling other large-cap Internet companies to explore strategic alliances.

- In our view, a partnership or merger between eBay and Yahoo! is the most strategically feasible. A combined company would have the leading position in auctions, communications, payments, graphical advertising, audience reach, and geographic breadth. It would also have deeper knowledge of its users and hold a strong position in the SMB market. Using our current company-specific models, we estimate the combined company could generate F'07 revenues and OIBDA of $13.9B and $6.5B.

- Another feasible combination would be a partnership between MSN and Yahoo!, in our view. Based on our analysis, we believe a partnership could create 1) formidable strength in graphical advertising, 2) increased search scale, 3) a substantial access point advantage, and 4) organizational synergies. Using our current company-specific models, we estimate the combined company could generate F'07 revenues and OIBDA of $8.6B and $2.5B.

- We believe a strategic event involving Google is relatively unlikely. Google has momentum in the majority of its businesses and is unlikely to need M&A to boost its competitive standing. While we believe a partnership or strategic event between eBay/Yahoo! or MSN/Yahoo! would create intensified competition, we believe Google has the scale & intellectual capital necessary to continue its recent momentum.

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Introduction

Recently, the *WSJ*, *The Financial Times* and other major publications have reported on potential M&A or strategic events between various large-cap Internet companies. Additionally, the companies discussed in this report have been involved in strategic partnerships and M&A scenarios, which highlight the possibility of additional strategic events in the future. In our view, Google's recent market share gains in search as well as its launch of paid content (Google Video), portal features (IM, VoIP, Google Finance, etc.), classifieds (Google Base) and payments (Google Wallet) are contributing to increased M&A discussions among the other large-cap Internet companies. Additionally, Google's win of the hotly contested AOL search renewal partnership has only strengthened Google's competitive standing in the Internet space. In this report we explore 1) why large-cap Internet consolidation makes sense, 2) the strategic assets, opportunities and threat/vulnerabilities of eBay, Google, MSN and Yahoo!, and 3) several potential consolidation scenarios.

Further, we intend for this report to serve as a guide for large-cap Internet investors as they evaluate potential M&A activity in the space. Though we believe meaningful consolidation activity could occur in many combinations, we limit the scope of this report to eBay, Google, MSN and Yahoo! as we believe these are the companies in our space that (1) are likely to consider a partnership or alliance, (2) are likely to benefit from a partnership or alliance, (3) are likely to be among the most sought after to be part of a partnership or alliance, or (4) have been acquisitive or have made significant strategic alliances over the past 12 months.

Consolidation Makes Sense

In our view, potential consolidation between large-cap Internet companies is strategically feasible. Our thesis is predicated upon the following themes.

User Information & Conversion

Large-cap Internet companies are intently focused on creating deeper customer relationships. We believe consolidation would achieve this goal as it would be possible to own a user during the information gathering as well transactional phase. Accurate and rich user information is among an Internet company's most valuable assets. Additionally, the ability to leverage accurate user information to deliver relevant content to users is the key to increasing conversion rates. There is a large overlap of visitors (and users) among the top large-cap Internet companies, and as such, there would likely be enormous synergies if large-cap Internet companies were to work together to increase their knowledge of their common users.

We think M&A could lead to improved user targeting of both content and advertising. If a company had demographic, search query history and transaction data on a user, we believe the company could provide both content and advertising that is more relevant to the user's interest and needs, thereby increasing user satisfaction and monetization capabilities. A combination between any of the search players and eBay

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would allow the new company to collect information about the user from the beginning to end of the buying process.

Though some user information is protected by user agreements (e.g., credit card numbers, bank account numbers, etc.), there is such a large overlap between user bases of the large-cap Internet companies that we believe user relevance and therefore conversion could be increased dramatically if select user data were shared among these companies. Additionally, the potential cost savings of some types of targeted sales and marketing efforts could be quite significant.

Table 1: User Data Collected During General Signup Process, by Entity

	Google	Yahoo!	MSN	eBay	PayPal
Name		x	x	x	x
Address				x	x
Zip code		x	x	x	x
State			x		
Time Zone			x		
Telephone #				x	x
email address	x			x	x
alternate email address		optional	optional		
Gender		x	optional	optional	
Birthdate		x	x	x	
Credit Card #				x	choice of payment
Bank Account #					choice of payment

Source: Company reports & websites, JPMorgan estimates

Over the last year or so, companies have introduced enhanced functionality to their websites, allowing those who log in to access additional information. The introduction and increased usage of toolbars has also increased companies' knowledge about their users. For example, we believe Google's personalized homepage, which requires a login, allows users to pull content they choose and allows users to leverage tools such as tracking search history, has allowed Google to gain incremental information about specific users' interests while offering new features and functionalities.

International Footprint

All of the companies profiled in this report have an expansive international footprint, and as such, potential partnerships would not be forged with the intention of additivity; rather, there are some international markets where either a partnership to increase share against a common competitor would benefit both players or a partnership where the geographic strengths and weaknesses of both partners compliment the other in a particular region (e.g., eBay and Yahoo! in Asia). The matrix below shows the geographic strength of players based on share of Internet revenues in each geography.

In our view, consolidation will help large-cap Internet companies increase their global footprint without spending large amounts of capital on uncertain results. For example, a strategic event between eBay and Yahoo! would benefit both, allowing eBay to align with the market leader (Alibaba) in China, while Yahoo! could use eBay's significant reach and usage in Europe to increase its search market share.

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Table 2: Geographic Strength by Company

On a scale of 1 to 5, with 5 being the strongest based on share of total Internet revenues

	eBay	Google	MSN	Yahoo!
Australia	4	5	3	3
Brazil	2	5	3	2
Canada	5	5	4	5
China	1	3	1	5
France	5	5	3	2
Germany	5	5	3	2
Italy	5	5	3	2
Japan	1	2	1	5
South Korea	2	2	2	5
Spain	5	5	3	2
United Kingdom	5	5	3	3
United States	5	5	4	5

Source: JPMorgan estimates, www.google.com, www.ebay.com, company reports

Note: Ranking includes geographic reach through joint ventures (Alibaba, Yahoo! Japan, Mercado Libre, etc.)

Communication Interoperability

The most common activity conducted on the Internet each day is email, according to findings from Pew Internet & American Life, with 77% of respondents suggesting that they either receive or send email on an average day. Instant messaging is also a very popular Internet activity, with 18% of respondents using IM on an average day. In addition to having broad reach, IM and email are activities that keep users engaged for a long duration compared to search, news or blog reading. According to comScore Networks, the average email user spends 25 minutes emailing each day while the average IM user spends 31 minutes messaging each day.

Taken together, the attributes of email and IM underscore the importance of being a leader in each market. The leaders in web-based communications have significant advantages over other Internet companies, such as 1) detailed knowledge of their user base from information obtained during the registration process, 2) the ability to market new products and services to their existing email and IM users, 3) the retention inherent in having email and IM users return on a frequent basis, and 4) the ability to integrate email and IM into a portal offering to drive uptake of other services such as search.

Table 3: US Audience Size & Daily Usage of IM

	Total Unique Visitors (000)	Average Minutes per Usage Day
Instant Messengers	78,771	31.4
AIM.COM/AIM App	30,312	31.2
MSN Messenger Service	23,805	19.8
Yahoo! Messenger	23,690	48.5
Yahoo! Insider	22,935	1.0
AOL Instant Message	16,775	38.2

Source: comScore Networks, March 2006

Table 4: US Audience Size & Daily Usage of Email

	Total Unique Visitors (000)	Average Minutes per Usage Day
e-mail	131,344	24.8
Yahoo! Mail	71,308	24.0
AOL Email	47,134	24.5
MSN Hotmail	46,530	23.0
Google Gmail	8,026	12.0
Comcast.net Web Mail	5,842	12.7

Source: comScore Networks, March 2006

One of the reasons the incumbents have maintained their leadership positions in IM and VoIP is due to the closed nature of those communication networks. Until recently, most IM and VoIP platforms have not had interoperability, and as such, users have only been able to communicate with other users on the same network. However, two notable partnerships in recent months may alter the competitive

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landscape in communications. On October 12, 2005, Yahoo! and Microsoft announced an agreement to open their IM platforms so users of MSN Messenger and Yahoo! Messenger will be able to interact with each other. Interoperability is expected to be implemented sometime in 2Q'06. On December 20, 2005, Google and America Online announced a similar interoperability agreement for Google Talk and AIM Instant Messenger. Communications interoperability agreements tend to benefit both companies and the users and open the doors for increased innovation. We believe future interoperability agreements are likely, and we believe communication interoperability is one of the types of agreements that the leading Internet companies are likely to execute in the future.

Table 5: Interoperability Matrix based on all Announced Agreements

	AOL IM	MSN IM	Yahoo! IM	ICQ	Pal Talk	Skype	Google Talk	Lotus/ Sametime
AOL IM	Yes	No	No	Yes	Yes	No	Yes	Yes
MSN IM	No	Yes	Yes	No	Yes	No	No	No
Yahoo! IM	No	Yes	Yes	No	Yes	No	No	Yes
ICQ	Yes	No	No	Yes	Yes	No	Yes	Yes
Pal Talk	Yes	Yes	Yes	Yes	Yes	No	No	No
Skype	No	No	No	No	No	Yes	No	No
Google Talk	Yes	No	No	Yes	No	No	Yes	Yes
Lotus/ Sametime	Yes	No	Yes	Yes	No	No	Yes	Yes

Source: www.ibm.com, www.google.com, www.Yahoo!.com, www.wikipedia.com, JPMorgan estimates

Note: Not all interoperability agreements are live in a production environment

Industry Standards & Protocols

Although it is approaching its 12th year of widespread user adoption, the Internet is still lacking a comprehensive set of standards and best practices. For example, there is no common accepted technical standard for voice and messaging communication, which has led to the proliferation of closed communication networks. Additionally, the Internet industry has not adopted a common method for estimating or attacking click fraud (mal-intentioned clicks meant to either boost ones own revenues or to drive up the sales and marketing expenses of a competitor). But the Internet is not without some standards. The Interactive Advertising Bureau (IAB) has played a central role in establishing many of the established standards and most recently, the IAB has been focused on establishing standards surrounding advertising units (defining a standard set of ad unit sizes & features) to remove friction for publishers and advertisers alike. The IAB has also tackled the creation of guidelines for email marketing, pop-up advertisements, privacy guidelines, etc. We believe it is in the interest of the large-cap Internet companies to adopt best practices. Overall, we believe common standards will eliminate friction in the Internet economy and contribute to faster adoption of the Internet as a marketing and commerce vehicle. As such, we believe the large-cap Internet companies would likely be interested in working together to establish such standards.

Access Points

As the Internet becomes accessible on different devices or platforms such as mobile, IPTV and operating systems, we believe access points will be increasingly important and could be a driving force behind consolidation. Each of the companies we've mentioned has strengths and weaknesses in this area, and in our view, each company will need to be cognizant of how users reach their respective services. Toolbars and

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downloadable applications are currently the most sought after segments of access points, with both Google and Yahoo! signing distribution deals with companies such as Adobe, Dell and Sun, while Microsoft is preparing to embed its search box in the IE browser and potentially MS Office applications.

Table 6: Access Points by Platform

On a scale of 1 to 5, with 5 being the strongest based on ownership or rights to access points

	eBay	Google	MSN	Yahoo!
Browsers - Desktop	1	2	5	1
Browsers - Mobile	1	1	4	1
DSL	1	1	3	5
Game Consoles	1	1	5	1
Home Entertainment	1	1	5	1
Mobile Decks/ Portals	1	4	2	4
O/S - Desktop	1	1	5	1
O/S - Mobile	1	1	4	1
Personal Productivity Software	1	2	5	1
Toolbars	2	5	2	5
Web Distribution	1	5	1	3
Wi-Fi	1	2	1	1

Source: Company reports and JPMorgan estimates

Looking forward, we believe mobile and the convergence of television and the Internet will be the new battlegrounds. Globally, there are almost twice as many mobile subscribers as there are Internet users, and we expect that the number of 3G handsets (high-speed data capabilities) will grow rapidly from the current level of approximately 70M handsets now. We believe there will be fierce competition in the location-based search space, and we are already seeing Google, Yahoo!, MSN and others jockey for positions on wireless decks.

Table 7: Worldwide Wireless Subscriber Forecast

Subscribers in thousands

	2005	2010	CAGR
United States	190,400	231,675	4.0%
Western Europe	285,700	295,607	0.7%
Asia/Pacific (excluding Japan)	663,863	992,757	8.4%
Japan	80,798	85,483	1.1%
ROW	491,730	717,439	7.8%
Worldwide	1,712,491	2,322,962	6.3%

Source: IDC, February 2006

Table 8: Worldwide 3G Subscriber Forecast

Subscribers in millions

	2004	2010
World Wide (millions)	29.1	540

Source: In-Stat

In Europe, IPTV is developing at a rapid pace as carriers are offering triple-play offerings (Internet, television and voice). We believe that it will be important for large-cap Internet companies to strike access deals with the large broadband companies in Europe as well as in the US (similar to the Yahoo!/AT&T relationship). Additionally, we believe it will be important to own/partner with software devices (i.e. MSFT Media Center, TIVO) that transmit IPTV on to traditional television monitors.

Portal & Advertising Relationships

As demonstrated by the recent competition to invest in and partner with AOL (which Google ultimately won), we believe advertising/portal relationships will be an important consideration in evaluating strategic alliances. Similar to the offline advertising world, reach matters and the companies with the largest reach will typically get the most advertisers and the highest advertising spend. We have already seen this trend develop to an extent in the online world, with both Google and Yahoo! getting large shares of online advertising spending due in part to their expansive reach.

Looking forward, we believe large-cap Internet players could benefit from consolidation that will allow them to 1) fill out gaps in global footprint; 2) increase inventory (both MSN and Yahoo! are inventory constrained in key verticals; 3) combine R&D expenditures, which could lead to better ad-targeting; 4) realize cost synergies in the selling organizations; and 5) offer multiple advertising products (search, graphical, cost-per-lead, in-game advertising, etc.) on one platform.

R&D Leverage

Currently, the top large-cap Internet companies are investing in similar products, initiatives, and data serving/storage capabilities, creating significant duplication of efforts. For example, eBay is spending $200M this year to compete with Alibaba (Yahoo!) in China, and Google, MSN and Yahoo! are spending hundreds of millions of dollars on server capacity to achieve similar search objectives. We believe consolidation could potentially allow these companies to reduce duplicative efforts, allowing them to either increase profits or reallocate R&D spend toward future innovations.

Operating Expense Efficiencies

In 1Q'06, aggregate operating expenses (excluding stock-based comp) for eBay, Google, MSN and Yahoo! increased 53% Y/Y, and we expect operating expenses to continue to grow at a significant pace in the near-term. Additionally, slowing revenue growth rates could reduce the businesses leverage. Therefore, we believe consolidation could be a key trend in the sector.

Table 9: Large-Cap Internet Companies Expense Growth

	Y/Y Expense Growth in 1Q
Google	113%
Yahoo!	39%
eBay	38%
MSN	23%

Source: Company reports and JPMorgan estimates.

We think M&A activity could lead to reduced competition and could potentially curb the dramatic increases in R&D and capex that are commonplace today. Each company is cognizant of the rapid pace of innovation and has consequently been aggressive in hiring engineering talent and increasing server capacity. This has led to management teams focusing on products that are not necessarily core in order to compete. Second, we believe there will be a gradually diminishing return with headcount expansion, which could impact margins. In our view, M&A could reduce the need for significant hiring as a combined firm could select the strongest talent, reduce duplicative areas (sales and G&A), and gain leverage in the recruiting & hiring markets.

Table 10: Hiring Trends

Head Count	1Q'04	2Q'04	3Q'04	4Q'04	1Q'05	2Q'05	3Q'05	4Q'05	1Q'06
GOOG		2,292	2,668	3,021	3,482	4,183	4,989	5,680	6,790
YHOO	5,904	6,517	7,022	7,600	7,606	8,309	9,142	9,800	10,098
EBAY	6,300	6,900	7,600	8,100	8,600	8,900	9,300	11,600	12,500
MSFT		57,000				61,000			

Source: Company reports

Note: Microsoft headcount includes employees from all divisions. Within Microsoft, we estimate MSN has ~4,000 employees.

Table 11: Tremendous Overlap between Large-Cap Internet Product Portfolios

Products	GOOG	YHOO	MSN	EBAY
Web Analytics	X	X	X	X
Classified Listings	X	X	X	X
Personalized web	X	X	X	
Book Search	X			
Homepages	X	X	X	
Calendar	X	X	X	
Finance	X	X	X	
Chat	X	X	X	X
RSS	X	X	X	
Alerts	X	X	X	X
Desktop Search	X	X	X	
Local	X	X	X	
Music Downloads		X	X	
Social Search (Q&A)	X	X	X	X
Toolbars	X	X	X	X

Source: Company reports and websites

The following section includes profiles of the current strategic positioning of eBay, Google, Microsoft's MSN division, and Yahoo!. We explore each of these companies in light of today's increasingly competitive search and eCommerce environments. Further, we have chosen to focus on eBay, Google, MSN, &Yahoo! as we believe these are the companies in our space that 1) are likely to consider a partnership or alliance, 2) are likely to benefit from a partnership or alliance, 3) may be most sought after to be part of a partnership or alliance, or (4) have been acquisitive or have made significant strategic alliances over the past 12 months.

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eBay

Strategic Summary: We believe eBay's core assets and strong brand put it in a strong position to capitalize on the various growth opportunities it is cultivating. Like other large-cap Internet players in the space, we believe eBay will continue to benefit from the secular Internet growth story. As we analyze eBay today, we recognize the company faces investment challenges—in the Asian markets, and also with slowing growth rates in its larger markets, but we believe its initiatives surrounding PayPal and Skype have the potential to produce strong ROI and offset some of these challenges. Immediately following our analysis of each company's core assets, growth prospects and opportunities, and vulnerabilities/risks, we assess the strategic benefits of various consolidation configurations.

Core Assets

eBay's core assets include its brand diversity and strength. We believe the following are key components of eBay's strategic positioning in the eCommerce and broader Internet space: 1) global brand and international footprint, 2) solid auction platform, 3) strong and growing payments business, and 4) loyal customer base.

1. **Strong Brand.** eBay currently has 98% aided brand awareness and 14% share of global ecommerce. With a portfolio of brands including eBay, PayPal, and Skype, we believe the company is well positioned to continue to build its brand and gain market share among consumers as a source and enabler of ecommerce.

2. **Large global footprint.** eBay's wide global footprint should continue to extend its leadership position in eCommerce. eBay has core auction platforms in 24 countries (with total presence in 33 including its minority interest in Mercado Libre). Its PayPal service is rolled out on 14 platforms serving 55 countries with payment options in 7 currencies. Over the next 12 months, the company plans to expand its coverage to 105 countries and 17 currencies. Finally, Skype has over 100M users in 200+ countries.

3. **Solid auction platform.** eBay's auction platform continues to expand its international scope, and continues to increase its category relevance for both B2C and B2B transactions. eBay's international GMV currently represents slightly more than half of total GMV. Though growth is slowing on some of the company's more mature platforms, we believe its newer initiatives such as eBay Express will help to re-accelerate growth as eBay captures share of the new/in-season retail market.

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Table 12: eBay Growth Trajectory – GMV, Online Revenue, and Auction Growth

In millions

Millions	Q1-04A	Q2-04A	Q3-04A	Q4-04A	Q1-05	Q2-05	Q3-05	Q4-05	Q1-06	Q2-06E	Q3-06E	Q4-06E
Gross Merchandise Volume Data												
GMV ($M)	$8,039	$8,012	$8,307	$9,810	$10,602	$10,884	$10,800	$12,013	$12,504	$12,587	$12,697	$15,368
% Chg Y-Y	51.2%	42.2%	43.8%	39.1%	31.9%	35.8%	30.0%	22.5%	17.9%	15.6%	17.6%	27.9%
% Chg Q-Q	14.0%	-0.3%	3.7%	18.1%	8.1%	2.7%	-0.8%	11.2%	4.1%	0.7%	0.9%	21.0%
eBay Online Revenue	583	593	613	707	776	820	837	969	991	994	1003	1214
eBay Online Rev as a % of GMS	7.26%	7.40%	7.38%	7.21%	7.32%	7.54%	7.75%	8.07%	7.92%	7.90%	7.90%	7.90%
GMV by Geography												
US	$4,500	$4,400	$4,466	$5,100	$5,302	$5,333	$5,400	5,890	6,230	6,293	6,285	7,530
% Chg Y-Y					18%	21%	21%	15%	18%	18%	16%	28%
% Chg Q-Q		-2%	1%	14%	4%	1%	1%	9%	6%	1%	0%	20%
International	$3,500	$3,600	$3,834	$4,710	$5,300	$5,551	$5,400	$6,123	$6,274	$6,293	$6,412	$7,837
% Chg Y-Y					51%	54%	41%	30%	18%	13%	19%	28%
% Chg Q-Q		3%	6%	23%	13%	5%	-3%	13%	2%	0%	2%	22%
Auction Metrics												
Auctions (M)	328	332	348	405	432	440	459	547	576	572	582	683
% Chg Y-Y	49.2%	47.7%	48.3%	38.7%	31.8%	32.4%	31.8%	35.0%	33.3%	30.0%	27.0%	25.0%
% Chg Q-Q	12.3%	1.4%	4.7%	16.3%	6.7%	1.9%	4.2%	19.1%	5.3%	-0.6%	1.8%	17.3%

Source: eBay company reports and JPMorgan estimates

4. **Loyal customer base.** eBay's core brands comprise an enviable user base especially given its high engagement level. eBay currently has 192.9M total users, of which 39% (or 75.4M) are active users. PayPal currently has 105M total users of which 28% (or 29.4M)are active users. Skype currently has 94.6M total users, with over 500K new downloads per day. With 900K+ Power Sellers and 200K+ eBay Store owners, we believe eBay's users are sticky and loyal. Though eBay sellers are very sensitive to price adjustments, based on total and active user growth, we believe the community base continues to be sticky, and we believe the initiatives eBay is taking to integrate its brands will continue to drive user loyalty.

5. **Community & Feedback.** In 1996, eBay's founder, Pierre Omidyar, introduced the Feedback Forum as a way to increase the transparency of the marketplace by allowing users to know a little more about the person they were transacting with. eBay's community of 193M users have come to rely on each others' feedback to build rapport with buyers and sellers, and with over a decade of feedback, we believe the time barrier to entry makes this asset something that is not easily duplicated by new entrants. At this point, we do not believe other players who have entered the space, either from the auction or the classifieds standpoint (Google Base) will be able to compete with eBay on the Community & Feedback front in the near term.

6. **Trust & Safety.** Promoting trust & safety among its buyers and sellers is a significant initiative at eBay, and to that end, eBay has ~2K employees working on trust & safety initiatives. Additionally, the company has put various programs in place to counteract and/or resolve user issues with fraudulent or potentially fraudulent auctions such as the PayPal Buyer Protection Program, the eBay Standard Purchase Protection Program, and eBay's dispute resolution process.

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7. **Strong search volumes.** According to eBay, consumers conduct approximately 345M searches per day on its auction websites. This metric puts eBay in lock step with the top search players from a volume standpoint.

Table 13: Searches per Month/Quarterly Average

in millions

	January 2006	February 2006	March 2006	1Q'06
Google	8,895	9,582	10,964	9,814
eBay	10,695	9,660	10,695	10,350
Yahoo!	3,078	3,193	3,670	3,314
MSN	1,346	1,437	1,605	1,463
Total Internet	14,835	15,900	18,050	16,262

Source: comScore, eBay, and JPMorgan estimates

8. **PayPal.** Acquired in 2002, PayPal has helped eBay accelerate growth on its auction platform by making transactions close and clear faster. Additionally, PayPal shortens the cash conversion cycle for sellers as they collect funds from buyers faster and are able to use those funds to purchase and repost new items more quickly. As of the end of the first quarter, PayPal had 105M total accounts and 29.2M active accounts, up 47% and 32% Y/Y. Within the last two years, PayPal has begun to pursue opportunities to grow its payments business off the eBay platform.

Growth Prospects and Opportunities

We believe eBay's most immediate growth opportunity lies with PayPal. The company continues to have success rolling the service out on its international platforms, but we believe the PayPal offering will deliver larger incremental returns from further expansion into the off-eBay market. We are also encouraged by the potential for increased conversion rate from the launch of eBay Express in the US and the pending international launch in Germany. We believe eBay's entrance into the in-season retail segment will allow the company to capture additional market share and ecommerce growth. We believe Skype will deliver strong results longer term, though currently the company is still integrating and ramping services.

1. **Continued rollout of PayPal internationally.** From a core eBay perspective, we continue to believe the rollout of PayPal in additional international markets will further accelerate the growth of eBay's auction business. Over the next 12 months, eBay plans to launch PayPal in an additional 50 markets and 10 currencies, expanding its international reach even further.

Table 14: Percent of Listings Offering PayPal by Platform

	mid-1Q'05	end-1Q'05	mid-2Q'05	end-2Q'05	mid-3Q'05	end-3Q'05	mid-4Q'05	end-4Q'05	mid-1Q'06	end-1Q'06
US	94%	91%	96%	91%	96%	97%	94%	97%	91%	96%
Germany	24%	16%	17%	16%	27%	29%	32%	31%	33%	52%
UK	84%	91%	91%	91%	96%	96%	97%	94%	96%	94%
France	35%	32%	50%	45%	58%	59%	60%	71%	74%	69%
Australia	28%	56%	51%	40%	56%	65%	62%	65%	68%	67%
Italy	22%	39%	33%	39%	34%	53%	53%	60%	57%	61%

Source: eBay websites and JPMorgan estimates

2. **Off eBay opportunity/VeriSign payment gateway.** We believe its PayPal's Merchant Services business is poised to scale nicely with the inclusion of VeriSign's payment gateway business as this business is helping eBay penetrate the off-eBay market to serve merchants of all sizes. We estimate that the global ecommerce market is approximately $400B in 2006. As PayPal has approximately 5.5% share of the global ecommerce market, we are encouraged by the Merchant Services opportunity. We estimate that every 1% increase in market share equates to approximately $100M in incremental revenues for PayPal.

3. **Other PayPal opportunities.** We believe the introduction of PayPal Mobile also presents a strong growth opportunity for the company as it reduces friction between buyers and sellers. We believe this opportunity will come from P2P payments, home shopping networks, catalog and outdoor retail advertisements.

4. **eBay Express.** We conducted a sensitivity analysis across the levers we believe eBay Express will positively impact including: Buy It Now listings, Fixed Price listings, Stores listings, and conversion rate. For F'06, we estimate eBay Express could have up to a ~$75M impact on US revenues and a $0.03 on EPS. In F'07, we estimate eBay Express could contribute ~$150M in revenues and $0.06 in EPS. PayPal will process eBay Express payments, allowing consumers to pay for items using PayPal accounts or credit cards and as such, we believe there is opportunity for upside to our current PayPal estimates.

5. **Skype.** Acquired in 2005, Skype is an Internet voice telephony company offering free calls between Internet users and fee-based calls between Internet and land line phones. Additionally, the company charges for enhanced features such as ringtones, ringback tones, etc. Though a current asset, we believe this asset will bring larger returns in the longer term as it is not yet fully integrated. The company has a strong brand internationally and there is a strong network effect among users that we believe will allow the company to scale its user base with minimal marketing for the time being. Skype's software is a peer-to-peer based software and relies on the processing power of each user's PC to build a P2P phone network. Skype has major partnerships with Motorola, Siemens, Logitech, BenQ, Plantronics, HGC, TOM Online, PCHome, Level3, TDC Song and Teleglobe.

   Once Skype is more fully integrated in to eBay's core auction platform, we believe it has the potential to accelerate eBay's listing growth rate and improve listing conversion rates. We think this improved conversion and listing growth rate could lead to $294M of revenue upside in F'06 and consequently $2.8B in incremental market cap value for shareholders.

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Table 15: Skype May Increase the Value of eBay's Core Auction Business by $2.8B

As Indicated

	F'06 Base Case	Listing Improvement 2%	3%	4%	5%	6%
eBay Listing (M)	2,413	2,461	2,485	2,510	2,534	2,558
Conversion Rate (%)	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%
ASP ($'s)	44.06	44.06	44.06	44.06	44.06	44.06
GMV (M)	53,155	54,218	54,750	55,281	55,813	56,344
Take Rate (%)	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%
Online Revenue (M)	4,202	4,286	4,328	4,370	4,412	4,454
Revenue Upside (M)		84.0	126.1	168.1	210.1	252.1
Shareholder Value Creation (10x rev multiple)		0.8B	1.2B	1.6B	2.0B	2.4B
	F'06 Base Case	Conversion Rate Improvement 1%	2%	3%	4%	5%
eBay Listing (M)	2,413	2,413	2,413	2,413	2,413	2,413
Conversion Rate (%)	50.0%	50.5%	51.0%	51.5%	52.0%	52.5%
ASP ($'s)	44.06	44.06	44.06	44.06	44.06	44.06
GMV (M)	53,155	53,687	54,218	54,750	55,281	55,813
Take Rate (%)	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%
Online Revenue (M)	4,202	4,244	4,286	4,328	4,370	4,412
Revenue Upside (M)		42.0	84.0	126.1	168.1	210.1
Shareholder Value Creation (10x rev multiple)		0.4B	0.8B	1.2B	1.6B	2.0B
Total Synergy Value for Shareholders		1.2B	2.0B	2.8B	3.6B	4.4B

Source: Company reports and JPMorgan estimates

Skype currently has ~95M users, most of which are in the international market. Currently, eBay has approximately 75M active users. We believe the addition of Skype could help the company increase eBay's active user count. At this time, the company's presence and brand recognition is primarily international, and we believe its user base in Japan will be particularly helpful to eBay as it has had difficulty penetrating that market in the past. Additionally, we think Skype's geographic presence outside the US could help eBay better penetrate certain underperforming international markets. Skype has users in over 225 countries and generates 87% of its revenue from outside North America.

6. **Growing SMB customer base.** At this time, we estimate there are approximately 900K people (~724K in the US and 170K people internationally) who make their living selling products on eBay. As such, we believe there is strong potential for continued uptake of products such as eBay Stores, eBay Express, and ProStores.

Vulnerabilities/Risks

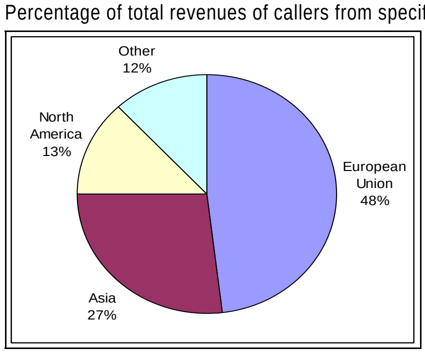
Though eBay has strong brand recognition and the overwhelming majority of its platforms are growing faster then the broader ecommerce rate in their respective markets, the company is facing increased competition from offline retailers who are increasing their online sales channels. As eBay Express grows, this competition will also grow as eBay's exposure to the in-season retail market increases. Additionally, eBay's investments in Asia, particularly in China, have yet to show substantial returns, and we believe competition in these markets will continue to increase. Finally, there are many players introducing VoIP products and Internet based telephony solutions, and in the US, Skype does not yet have strong brand recognition in comparison to some of its competitors.

1. **Asia.** Competition and investments are becoming more intense in this zero-sum game for Asian operations. Last year, eBay earmarked an incremental $100M for investments in China to bolster its website features and functionality. Over the last year, we believe the company has made some progress in making the site more local and relevant to the Chinese market as well as making the payments process faster and safer through the escrow service and PayPal. However, we believe eBay is facing fierce competition in China. A recent survey conducted by the China Internet Network Information Center indicates eBay EachNet’s market share is approximately 29% vs. Taobao at 67%.

2. **Skype’s VoIP brand/presence weaker domestically.** Though we believe eBay’s acquisition of Skype places them in a competitively stronger position than other Internet companies trying to make a play for VoIP market share, we believe Skype's brand recognition in the US is still fairly weak. As such, we believe the US VoIP market is still very much up for grabs. However, the viral nature of Skype’s service will help the company’s brand grow in the US overtime and we believe the company rolling out product enhancements and entering into partnerships with strong US brand recognition that should help improve its recognition. Additionally, Skype’s recent announcement to offer free Skype Out calls in the US and Canada should help increase traction domestically and increase brand recognition for the company.

Figure 1: Geographic Breakdown – Skype’s Revenue Base

Percentage of total revenues of callers from specified geographic area



Source: Skype, Sandvine

Table 16: Feature & User Comparison for Select Soft VoIP Clients (non-telephone replacement)

Launched VoIP	AOL Apr-05	Google Aug-05	MSN Aug-05	Skype Aug-03	Yahoo! May-05
Free PC to PC Calling	Yes	Yes	Yes	Yes	Yes
PC to Phone	Yes	No	No	Yes	Yes
Phone to Phone	Yes	No	No	Yes	Yes
Conference Calling	Yes	No	No	Yes	Yes
Instant Message Conferencing	Yes	No	Yes	Yes	Yes
Call Forwarding	Yes	No	No	Yes	No
File transfer	Yes	No	Yes	Yes	Yes
End-to-End Encryption	No	No	Yes	Yes	No

Source: Company Websites, JPMorgan, comScore Networks

3. **Trust & Safety/Fraud perceptions.** Though the company’s trust and safety initiatives have led to the rollout of programs and services such as the PayPal Buyer Protection Program and eBay’s Standard Purchase Protection Program, there are still incidents of fraud on the site, and we believe these incidents lead to headline risk for the company as eBay does not make it a practice to police its own website. As of 1Q’06, PayPal’s transaction loss rate was 0.29%, down from 0.33% in the fourth quarter and 0.30% in the first quarter of last year. We believe that just as with most other commerce transactions, there will be buyers and sellers who try to game the system, and as such, we believe trust and safety will continue to be a key initiative for eBay for the foreseeable future.

4. **Increasing Competition from Offline Retailers.** As more consumers are looking to the Internet to research and execute retail transactions, many offline retailers are making investments to improve and or establish their online sales channels. Over the last year, web traffic to offline retailers' websites has increased exponentially, following marketing dollars and relaunched websites. We believe eBay (as well as other traditional ecommerce players) will continue to see increased competition from offline players as consumers begin to frequent the websites of their favorite bricks and mortar establishments.

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Table 17: Top 30 Retail Websites - Unique Visitor Trend Y/Y

	Jan-05	Feb-05	Mar-05	Apr-05	Jan-06	Feb-06	Mar-06	Apr-06	4Q Y/Y	1Q QTD	Apr/Apr
Total Internet : Total Audience	162,201	160,287	164,263	164,961	170,797	166,966	171,421	171,690	6.3%	4.6%	4.1%
Retail	130,953	128,171	134,305	129,850	135,874	132,226	136,474	140,323	6.2%	2.8%	8.1%
eBay	62,427	62,021	65,897	63,825	69,765	66,613	70,752	75,952	15.1%	8.8%	19.0%
Amazon Sites	41,557	38,416	40,322	39,066	47,576	42,660	47,105	48,371	18.0%	14.2%	23.8%
Apple Computer, Inc.	18,231	15,281	16,527	15,910	27,137	24,277	26,790	28,826	111.3%	56.3%	81.2%
Wal-Mart	20,915	19,197	19,640	19,736	23,286	20,999	21,719	24,528	22.7%	10.5%	24.3%
Target Corporation	15,689	15,775	17,713	17,193	20,805	19,876	21,372	23,499	51.0%	26.2%	36.7%
Shopzilla.com Sites	15,179	14,471	14,610	13,972	20,552	18,652	19,534	20,130	35.2%	32.7%	44.1%
Yahoo! Shopping	18,696	19,950	19,798	11,547	14,670	15,037	15,226	15,909	-29.5%	-23.1%	37.8%
Yahoo! Stores	N/A	N/A	N/A	N/A	14,969	13,795	14,024	14,009	N/A	N/A	N/A
Ticketmaster	10,494	11,477	12,661	13,832	12,242	12,676	14,621	14,853	38.8%	14.2%	7.4%
Dell	14,437	13,014	12,945	12,913	14,252	12,471	13,890	13,918	7.6%	0.5%	7.8%
OVERSTOCK.COM	14,842	14,647	17,158	14,973	15,997	12,365	12,432	13,610	31.0%	-12.5%	-9.1%
Moviefone	11,020	11,020	12,085	11,799	13,935	11,722	12,712	12,286	22.4%	12.4%	4.1%
AmericanGreetings Property	12,297	16,641	15,982	12,231	8,688	11,587	9,322	10,947	43.3%	-34.1%	-10.5%
Hewlett Packard	10,332	9,541	10,344	9,308	12,513	11,089	11,839	12,685	17.5%	17.3%	36.3%
Best Buy Sites	11,855	10,728	10,457	10,437	13,392	11,069	11,516	10,905	14.5%	8.9%	4.5%
CINGULAR.COM	9,610	11,751	13,569	14,780	11,685	10,545	10,546	11,182	80.1%	-6.2%	-24.3%
NETFLIX.COM	11,074	10,683	12,151	8,382	13,204	9,997	9,609	9,011	19.3%	-3.2%	7.5%
INTUIT.COM	8,523	11,462	9,322	5,742	7,529	9,968	5,981	5,864	-42.7%	-19.9%	2.1%
JCPenney Sites	8,866	9,031	9,465	8,920	10,603	9,837	11,241	10,798	40.0%	15.8%	21.1%
Nextag.com Sites	N/A	N/A	N/A	N/A	10,157	9,577	10,496	9,149	N/A	N/A	N/A
MSN Shopping	7,289	6,226	6,924	6,497	7,825	9,105	10,841	11,283	19.4%	35.9%	73.7%
Hallmark	6,099	6,882	7,658	6,254	6,669	8,912	6,749	9,545	25.7%	8.2%	52.6%
Federated Department Stores	4,008	4,409	5,044	4,389	9,492	8,595	9,177	9,543	114.7%	102.5%	117.4%
Circuit City Stores, Inc.	N/A	6,286	5,776	5,514	9,910	8,184	7,215	7,589	N/A	109.8%	37.6%
The Home Depot, Inc.	8,717	7,723	9,337	10,156	8,867	8,064	9,834	10,818	28.7%	3.8%	6.5%

Source: comScore, April 2006

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Google

Strategic Summary: Google has many assets and opportunities in front of it. The company has an outstanding brand, superior engineering resources, and a significant scale advantage over its search competitors. Additionally, Google is well positioned to benefit from the secular growth of Internet advertising and may also gain traction in other forms of interactive media such as print and radio. But the company is not without challenges. Google must continue to innovate ahead of its challengers in order to maintain its market share advantage. Additionally, it must aggressively defend its position given Microsoft's plans to set MSN search as the default in Internet Explorer 7.0.

Core Assets

Google has a number of core competencies that give it significant advantages over its competition. We believe Google's four most important strategic assets are 1) its global brand, 2) its engineering resources, 3) its scale in search and contextual advertising (network effect reinforces barriers to entry), and 4) its technology and large product lead.

1. **Brand.** Google has one of the most recognizable and admired brands in the world today. According to *Business Week*, Google's brand was worth $8.5B in 2005, its first year on the Top 100 Global Brands scorecard. Additionally, some industry pundits believe that the company's brand has played a large part in Google's recent market share gains. In recent quarters, both Google and Ask Jeeves have gained market share in search, which we believe is due in part to their brands that were initially focused on search.

Table 18: Top Brands According to BrandChannel.com Survey

% of respondents who selected specified brand as most impactful

Brand	% Receiving Votes
Google	39%
Apple	37%
Skype	13%
Starbucks	13%
Ikea	11%
Nokia	8%
Yahoo!	8%
Firefox	7%
eBay	7%
Sony	6%

Source: www.brandchannel.com

2. **Employees.** In addition to having a strong brand, we believe Google has one of the most talented pools of engineers and computer scientists of all technology companies. Over the past couple of years, Google has hired such industry veterans as Vint Cerf (co-designer of TCP/IP), Kai Fu Lee (former head of Microsoft R&D in China), Udi Manber (former CEO of Amazon's A9 division), and Louis Monier (founder of Alta Vista). In addition, Google is known to have one of the most intense screening processes for prospective employees throughout both the junior and senior levels of the organization. Recently, Google was voted the #2 place to work by MBA students, and we believe Google is also a top choice among engineering students.

3. **Scale.** Google also has a huge advantage over its search competitors (Yahoo!, MSN, AOL, and Ask.com) due to its scale in search. Google currently handles approximately 50% of all Internet search requests in the US and even more globally. At the same time, we believe Google has more than 350,000 advertisers managing search campaigns through Google Adwords, giving it the largest reach among all search companies. We believe Google's size is a huge advantage that is often missed by analysts. Google's scale is part of the reason it is able to monetize its searches at a 30-50% advantage over its peers. We believe it also gives Google an advantage in monetizing its AdSense for Content product, an advantage that its competitors (Microsoft, Yahoo!, Amazon, etc.) may have difficulty overcoming.

4. **Technology.** Finally, we believe Google has a leg up on its competition due to its massive technological infrastructure, which includes hundreds of thousands of low-cost Linux based servers. Google's distributed low-cost server network gives it substantial redundancy to prevent outages. Additionally, Google's infrastructure includes numerous data centers, reducing the distance that data must travel between a user and Google's servers. We believe Google's technological advantage provides cost savings and performance advantages that enable web services such as Gmail, Google Maps and Google web search to function with impressive speed.

Growth Prospects and Opportunities

We believe Google's strengths and core competencies afford the company numerous opportunities. First, Google currently generates approximately 99% of its revenue from advertising. And within online advertising, the large majority of Google's revenues are from search-based advertising. Consequently, we believe Google has a large opportunity to leverage its strength in search into other revenue generating segments such as eCommerce, graphical advertising, and classified advertising. Additionally, we believe Google's foray into print and radio advertising (and ultimately television) will help Google garner a larger portion of the global advertising market. Currently, we believe online advertising accounts for only 3-5% of global advertising expenditures. As such, we believe Google should see growth in its existing market (online advertising) and through the expansion of its advertising platform into new media markets.

Vulnerabilities/Risks

While Google is operating from a position of strength, having gained market share across most geographies and demonstrating growth that is substantially greater than its peers, the company is not without threats. The most daunting threat, in our view, is the stiff competition Google faces from Microsoft, Yahoo!, eBay and Amazon. All four competitors have large market capitalizations and access to substantial cash resources. Each of these competitors is investing heavily in R&D and technological infrastructure, and none of them are taking Google lightly. Recently, Microsoft unveiled its F'07 financial guidance which suggests that Microsoft will spend \$3.0B to \$3.2B in operating expenses on MSN, up \$800M to \$1B compared to a year ago, surprising many investors. At the same time, Yahoo! is investing heavily to overhaul its search-based advertising platform while Amazon is busy developing a handful of Web 2.0 offerings. In evaluating Google's weaknesses and threats, we have identified four areas where we believe the company is most vulnerable.

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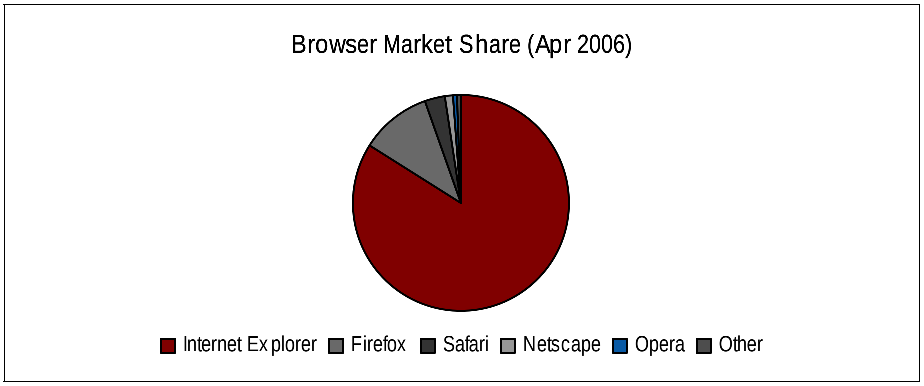
1. **Low Switching Costs.** We believe Google's most significant vulnerability is the fact that its search engine is web-based, requires no login, and therefore has limited lock-in to consumers. Web users can switch between Google, Yahoo!, MSN or Ask.com with minimal effort. As such, the barriers to entry for a competing search engine to gain traction with consumers are somewhat limited. Additionally, smaller competitors may be able to take greater risks in experimenting with new search paradigms. However, we believe Google is taking aggressive measures (Google Accounts, Personalized Search, Search History, etc.) to alter the search dynamic and to gain more insight into the demographics and behavior of its users.

2. **MSFT's Browser Dominance.** Additionally, Google's web-based search engine is accessible through a web browser. Currently Microsoft owns 80-90% of the browser market, while Firefox, Netscape, Opera and Safari own the bulk of the remaining 10-20%. Microsoft's latest update to Internet Explorer includes a built-in search box which Microsoft is planning to default to MSN search. Since Internet users conduct a large number of searches on a monthly basis, they may find it easier to type their search queries rather than by navigating to a website and typing in their query. Although we view this as a material weakness for Google, the company has taken numerous steps to mitigate the risk. First, the company has been aggressive in distributing its search toolbar and desktop search software applications. Second, Google has signed distribution agreements with PC companies such as Dell. Third, Google has been encouraging user loyalty through personalized search results and Google account functionality. And finally, Google has signed partnerships with second tier web browsers to serve as their default search provider.

Figure 2: Microsoft's Dominance of the Web Browser Could Impact Google

% of Internet users accessing Internet through specified web browser



Source: www.netapplications.com April 2006

3. **Weaker Communication Platform:** Another area where we believe Google trails its competitors is in web-based communications. Since 2004, Google has launched an email platform (Gmail), and an IM/VoIP client (Google Talk). And while Gmail gained immense consumer interest due to its offering of 1G of free email storage, neither application has supplanted the leaders in the communication space. In VoIP, Skype is still far and away

the leader with over 200M downloads and approximately 100M active registered users. In email, MSN's Hotmail and Yahoo! Mail have substantially more reach globally than Gmail. And in Instant Messaging, AOL, Yahoo!, MSN and Skype are well ahead of Google Talk. In our view, the company trails the communication leaders due to 1) its relatively late entry into the communications market, 2) the lack of an industry standard for IM and VoIP that has led to the creation of closed communication networks, 3) relatively high switching costs associated with communication platforms (buddy lists, product familiarity, download hurdle, etc.), 4) Google Talk's offering only a basic set of features upon launch, and 5) Google's decision to limit the number of Gmail registrants through its referral sign-up process.

4. **Search-Centric Model could be a Disadvantage:** Finally, we believe Google is disadvantaged because it does not package its variety of services in a cohesive portal model. The portal model has enabled Yahoo! and MSN to sign the bulk of the broadband relationships, including Verizon, SBC, AT&T, British Telecom, Rogers and Bell South. While Google has managed to get its search application onto many platforms (including mobile), we believe the company would be in a more advantageous position if it rolled out a comprehensive portal page to pull all of its applications together.

MSN

Strategic Summary: MSN has several advantages that the other large-cap Internet companies do not, namely, the fact that it is associated with Microsoft. Additionally, the company is a leader in web-based communication, with over 400 million global IM and email user accounts. And MSN has a stronger position in search in Europe than all search companies not named Google. But MSN is operating from a position of relative weakness to other companies in the Internet space that have spent more, been first to market, built brand, and gathered users. The company is losing market share both in terms of revenue and user metrics. Additionally, we believe MSN faces an uphill battle in terms of growing its search share due to the lack of a search brand and the fact that the company has much lower scale than Google or Yahoo!.

Core Assets

MSN has several assets that afford it advantages over its Internet competitors. Below we discuss the five assets that we believe are most valuable and may have the largest impact on MSN's success in the online space, including 1) MSN's ability to leverage Microsoft's dominance of the desktop, 2) MSN's access to Microsoft's financial resources and engineering talent, 3) Microsoft's success in the Mobile, Home Entertainment and Game Console segments, 4) MSN's global leadership in Communications, 5) MSN's relative strength in Europe, 6) breadth of software and technical assets, and 7) the development environment.

1. **Dominance of the Desktop.** In our view, MSN's most important strategic asset is its ability to leverage Microsoft's dominance of the desktop. Microsoft is the global leader in desktop applications, including operating systems, personal productivity software, and Internet browsers. We believe Microsoft owns more than 80% of the global market for all three of these software segments. Further, Microsoft has long standing relationships with the PC manufacturers, providing MSN a potential advantage in distributing future desktop applications.

   We believe Microsoft's dominance in web browsers presents MSN with its most compelling opportunity. Microsoft is set to launch the latest version of IE (version 7.0) with Windows Vista. Version 7.0 will include a built-in search box in the upper right-hand corner of the application. Microsoft has now received DOJ approval to set MSN Search as the default for the IE search box (for users purchasing new PCs or who have not yet selected a default search engine in IE). We believe this will provide MSN with a meaningful advantage that may help the division stabilize its market share losses in search.

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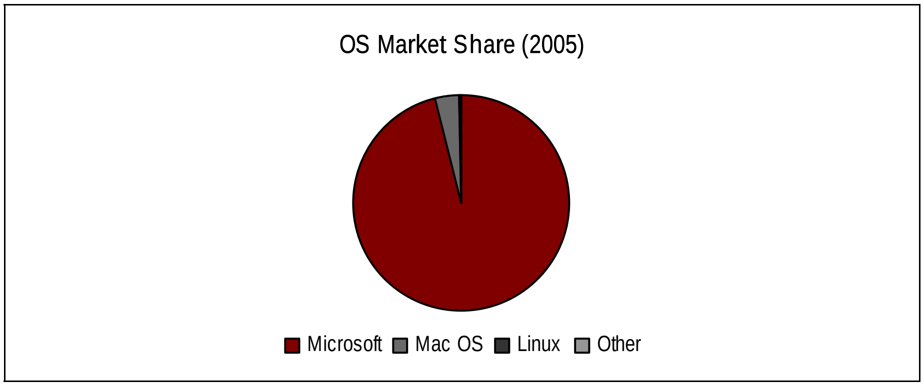
Figure 3: Microsoft owns 96% of the Operating System Market

% of desktop & laptop users operating with specified web browser



Source: www.netapplications.com, 2005

2. **Microsoft's Financial and Human Assets.** MSN's relationship with Microsoft is another advantage that should not be overlooked. Microsoft has a war chest of over $30 billion in cash, generates north of $14B in operating income each year, and has over 60,000 employees throughout 85 different countries. Further, Microsoft has made it clear that it intends to be a major player in the search and online advertising markets. In Microsoft's most recent earnings call, the company introduced F'07 financial guidance that included substantially higher operating expense assumptions than many analysts had been expecting. JPMorgan Software Analyst Adam Holt estimates that Microsoft will invest an incremental $0.8-$1.0B in MSN during F'07, bringing its annual investment in MSN to $3B+.7. In addition to receiving direct financial resources from Microsoft, MSN can leverage some of the research & development efforts of Microsoft Research (MSR), the advanced research division within Microsoft. One of MSR's goals is to support long-term computer science research that is not bound by product cycles, which we believe will help MSN in its effort to keep up with the rapid pace of innovation in the Internet space.

3. **Access Points.** In addition to web browsers, Microsoft has a solid position in other software and hardware segments such as mobile, home multi-media & entertainment, and game consoles. These tech products provide Microsoft with a variety of access points with which MSN may leverage to gain an advantage over its search & advertising counterparts. In particular, Microsoft's broad product portfolio may help MSN & AdCenter gain traction in the global television, radio, print and in-game advertising markets. For example, Microsoft has over 3M online gamers, a captive audience and potentially lucrative advertising base. The global advertising market is estimated to be worth $600-$800B annually, and both Microsoft and Google have voiced their plans to pursue that market opportunity. But Microsoft may have a head start with the success of Windows Mobile, Windows Media Center, and Xbox Live.

4. **Leadership in Communication Platforms.** MSN's global reach in communications applications such as MSN Messenger and Hotmail is another asset that is important to discuss. Earlier this month, MSN reported

241 million global Hotmail accounts and 231 million global Messenger accounts, making MSN one of the leaders in Internet communications. More importantly, MSN is demonstrating excellent growth in user accounts, with Hotmail accounts up 21% Y/Y and Messenger accounts up 39% Y/Y. Additionally, although Microsoft trails Skype in the VoIP market by a large margin, our belief is that MSN Messenger is seeing respectable adoption of its VoIP application, particularly in Europe. We believe MSN's leadership in communications can be attributed to 1) the decision to buy Hotmail at a very early stage (Dec '97), 2) MSN's focus on distributing and marketing its communications products globally, 3) Microsoft's relationships with PC manufacturers (i.e. MSN Messenger short-cuts and application pre-installed on some desktops), and 4) an industry-wide lack of innovation of email and messenger applications, which helped MSN maintain its leadership.

Table 19: Microsoft is a leading web-based communications provider

\# of active accounts in millions

	Sep-04	Dec-04	Mar'05	Sep-05	Dec'05	Mar'06
Active Hotmail Accounts	187	191	200	215	230	241
Active Messenger Accounts	146	156	165	185	205	230
Y/Y Growth – Hotmail				*15%*	*20%*	*21%*
Y/Y Growth – Messenger				*27%*	*31%*	*39%*

Source: Company reports

5. **Strength in Europe.** Finally, we believe MSN's relative strength in Europe is another asset that should help Microsoft in its bid to become a more substantial participant in the online advertising space. Although MSN currently trails both Google & Yahoo! in the global search market, MSN appears to own the second largest share in Europe. Further, MSN's strength in Europe is broad-based and spread across a number of countries. Additionally, we believe MSN's communication products enjoy a strong adoption level in Europe. As MSN continues its bid for a larger share of the online advertising market, it will likely seek to leverage its relative strength in Europe in search and communications to drive adoption of other products & services.

6. **Breadth of Software and Technical Assets.** Microsoft's key differentiator is the breadth of its software and technical assets. In addition to its ubiquitous desktop applications, MSFT has a portfolio of applications including firewall/security applications, hosted applications and systems management/storage applications among others, that the company could leverage to strengthen its online presence in a way that no pure play Internet company can offer.

   Microsoft's OneCare, which combines anti-spyware, antivirus and firewall and is expected to be launched in July on a subscription basis, will be relevant to SMBs and consumers in our view. In addition to OneCare, MSFT is likely to include Windows Defender, an anti-spyware program, within Vista which is slated to be released to consumers in January 2007. Microsoft is also working on Microsoft Client Protection, a security application targeted to business laptops, desktops and file servers and has a broad range of security initiatives underway.

Through Office Live, Microsoft offers hosted applications to small and medium businesses. Office Live includes a number of services for SMBs including web-page hosting, collaborative email and CRM and ERP solutions that will allow SMBs to manage their employees, serve customers, and benefit from best in class applications in a hosted environment—with synergies across desktop productivity. Office Live is presently in the beta stage and the company expects to have two versions available—a free version supported by advertising and a subscription-based paid version.

Microsoft also plans to offer a hosted storage solution and is presently developing a product code named "Live Drive." Live Drive will allow users to store and access digital data irrespective of user's location. While the company has not commented on availability or target audience for Live Drive, we believe it will be targeted mainly to consumers and SMBs. We expect the pricing for Live Drive to be similar to Office Live with the company providing a free service supported by advertisement and a paid-subscriber service.

7. **Development Environment.** Microsoft has built a development framework and community through .Net and Visual Studio that serves as the bull pen for new applications and a significant pool of technical talent. This community, and the underlying development infrastructure will aid MSFT in the build out of web based applications and services, as well as the adoption of partners. The adoption of .Net platform has been aided Windows Server 2003 and Visual Studio 2005 release and we believe there are over 6M professional developers on Microsoft's .Net and Visual Studio platform.

   We expect the huge developer community to play a key role in building applications downstream on the "Live" platform. By opening up the Windows Live platform, MSFT hopes to build an ecosystem with the expectation that the third-party developers will build applications for its web services similar to Live Mail, MSN Spaces, and Live Marketplaces.

Growth Prospects and Opportunities

Microsoft's assets present MSN with enormous opportunities, in our view. As discussed above, the company will launch Internet Explorer 7.0 with Windows Vista later in early 2007, which may help the company stabilize its market share losses in search. Secondly, Microsoft launched AdCenter in the US this month, and we believe the initial results have been positive. As the company continues to sign-up additional advertisers and fine-tunes its paid search algorithm, we believe the company stands to gain better monetization per search. Additionally, Microsoft has launched a host of new products through its Windows Live initiative and may see better uptake of those services in the future. Finally, MSN currently owns less than 10% of the US online advertising market, suggesting that there may be upside from here. The company has stated its intentions to pursue opportunities in other forms of interactive media (validated by the acquisition of in-game advertising pioneer Massive, Inc.), and we believe the company is in a position to participate in several offline advertising markets.

Vulnerabilities/Risks

Although MSN has the benefit of leveraging Microsoft's financial resources and engineers, the company is arriving to the search game late, and the results thus far have been largely mixed. Since launching algorithmic search in Jan 2005, the company has seen disappointing share gains. In addition, MSN's launch of AdCenter has led to declining search monetization vs. Yahoo!. The company also faces a challenge as its brand portfolio (MSN, Windows Live, Windows, Office, etc.) does not have a strong association with search. Consequently, while the company may invest millions of dollars in advertising, we believe it may have difficulty changing consumer behavior over the long-term.

1. **Share Losses.** Microsoft's online division has been losing market share for several years. In the most recent quarter, MSN grew its net advertising revenues by 7% Y/Y compared to Google and Yahoo!, which grew their net advertising revenues by 93% and 33%, respectively. In search, we have seen MSN's share of US search queries decline from 16.3% in 1Q'05 to 13.5% in 1Q'06, according to comScore Networks. MSN's market share losses have coincided with the company's introduction of its own algorithmic search engine in January 2005. While Microsoft has closed the gap with Google technically, it is still viewed as an inferior search engine and Microsoft counts less than 8B page views indexed, vs. more than 50B at Google. In addition to losing query share in search, MSN has also been losing revenue share due in part to the rollout of its recently developed AdCenter platform. Since MSN has a smaller number of advertisers participating in AdCenter, the average bid price trails that of Google's Adwords and Yahoo!'s Search Marketing platform. Microsoft believes it can geometrically drive users by increasing advertising, but we believe it does not make sense for the company to focus on re-branding and repositioning itself vs. leveraging its existing technology assets.

2. **Timely Internet Innovation.** Another area where we believe MSN may be vulnerable is its below-average track record for innovation in the Internet space—possibly due to under-investment historically. For example, although Microsoft acquired Hotmail in Dec 1997, the product remained largely the same for the following eight years. Additionally, MSN didn't develop its own search engine until 2005, several years after Google and Yahoo! proved the economics of such an engine. In fact, we can only identify a few products where MSN led the market in innovating, but we can identify several where they played catch-up. Microsoft has a history as a packaged-software provider with a focus of large-scale upgrades that take several years to complete is different than many Internet companies and MSFT has spent far less than pure plays historically. Although we view this as a weakness relative to Google and other Internet leaders, we believe the company has taken aggressive steps to speed up the pace of innovation. The appointment of Ray Ozzie to CTO of Microsoft, the hiring of Steve Berkowitz as SVP of the Online Business Group, and the creation of "Windows Live" initiatives should help the company in its efforts to innovate at the pace of the leaders in the space without a more aggressive strategic partnership approach.

3. **Lower Search Monetization Due to Scale Disadvantage.** With the launch of AdCenter in the US earlier this month, MSN now serves all of its search sponsored listings in-house, with no assistance from Yahoo!. Initially, we believe MSN will realize lower revenue-per-search from AdCenter than it did from Yahoo! as AdCenter has fewer advertisers, which should lead to lower coverage and lower CPCs. Further, we believe MSN's search monetization trails Google's by an even larger margin due to MSN having only limited knowledge of historical clickthrough rates. In 2005, it was widely reported that Microsoft was aggressively seeking to secure a deal to provide sponsored search results on AOL's search property, but the deal was ultimately won by Google. We believe Google's monetization advantage enabled the company to guarantee a larger absolute revenue share, which contributed to Google winning the deal with AOL. Given MSN's lower search monetization, we believe the company may have difficulty signing up search distribution partners in the future.

   MSN is currently #3 in the paid search market in terms of query volumes; however, it trails the leaders in the space by a substantial margin. In 1Q, MSN received 13.5% of all search requests in the US and 6.4% of requests outside the US, compared to Google which had market share of search requests of 42.2% in the US and 70.7% internationally, according to comScore Networks. We believe MSN's lack of scale in search may limit the company's ability to sign up a broad advertiser base. According to our estimates, Google currently has more than 350,000 advertisers who leverage Adwords for search marketing. But we believe MSN has far fewer and likely has less than 100,000 advertisers at this point. As discussed above, if MSN is unable to attract a broad following among advertisers, the division of Microsoft could have difficulty reaching the search monetization levels of Google or Yahoo!.

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Yahoo!

Strategic Summary: We believe Yahoo! has several key advantages versus its large-cap Internet competitors, including significant global reach (almost 500M users including joint ventures in China and Japan), market leading position in graphical advertising, strong knowledge of the media industry/distribution and strong DSL access relationships with AT&T and Verizon. However, we believe Yahoo! faces challenges in search from continued competition from Google and MSN as well as from its efforts to improve search monetization. Additionally, we believe the traditional media companies pose a threat to Yahoo!'s dominance in content and branded advertising as they could potentially steal some market share from Yahoo! as they launch new online initiatives. We think it is imperative that Yahoo! stabilize its search market share, improve search monetization, and continue to create/license compelling content over the next 12 to 18 months.

Core Assets

Yahoo! has a number of core assets that differentiate it from the competition and that we believe will enable Yahoo! to succeed in a highly competitive market. We believe Yahoo!'s four most strategic assets are 1) its global reach and registered users, 2) its market leading position in graphical advertising, 3) its strong media relationships and ability to aggregate the best content, and 4) its access relationships with DSL companies such as AT&T and Verizon.

1. **Global Reach.** Yahoo! is one of the most recognizable brands on the Internet, with significant user penetration in virtually every global market. At the end of 1Q, the company had 402M unique users, (ex China), up 27% Y/Y. Additionally, the company reported 208M active registered unique users, up 23% Y/Y as well as a market leading 13.3M fee paying customers. In terms of global reach, Yahoo! trails only MSN, which had 241M active Hotmail users as of 1Q. Including traffic metrics from Yahoo!'s joint ventures in China and Japan, it is likely that Yahoo! has a greater global reach than MSN.

Table 20: Yahoo!'s Global Reach

In millions, except percentages

Traffic Metric	1Q'05	1Q'06	Y/Y Growth
Unique Users	317	402	27%
Active Registered Users	169	208	23%
Fee Paying Customers	8.9	13.3	49%
Ending Daily Average Page Views	3,070	3,799	24%

Source: Company reports (1Q 2006); Excludes Yahoo! China and Japan

2. **Market leading Position in Graphical Advertising.** We estimate that graphical advertising in the US will grow at a 20% CAGR through 2009 and at a faster rate in international markets. In our view, Yahoo! is well positioned to take advantage of this growth as it has the strongest graphical advertising and targeting platform of any large-cap Internet company. We expect Yahoo!'s inventory to become more valuable as traditional branding media becomes less effective for advertisers. Further, we expect Yahoo! to benefit from its large video inventory as more advertising campaigns are run on the Internet versus television, and as Yahoo! deepens its relationships with Ad Age 200 companies.

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Table 21: Yahoo! Graphical Advertising vs. Global Graphical Advertising

$ in millions

	2004	2005	2006E	2007E
Global Graphical Advertising	10,645	13,200	16,157	19,469
Yahoo! Graphical Advertising	779	1,052	1,412	1,800
Y/Y Growth				
Global Graphical Advertising	25.5%	24.0%	22.4%	20.5%
Yahoo! Graphical	45.9%	35.0%	34.2%	27.5%

Source: Company reports and JPMorgan estimates.

3. **Strong Media Relationships.** Yahoo! has an advantage over its competitors due to its strong relationships in the media world and its experience aggregating content over the past ten years. Several of its executives, including Terry Semel, came from media backgrounds and understand the dynamics of the media industry, which are different from the technology industry. As traditional media companies such as Disney and Viacom move content online, we believe Yahoo! will be well positioned to aggregate this content due its reach, extensive media relationships and experience aggregating content.

4. **Access Relationships.** Traditional telecom companies are expanding their product offerings to offset revenue losses from their voice businesses. AT&T and Verizon, two of Yahoo!'s partners are beginning to offer IPTV (Internet Protocol Television) services and both have wireless offerings. We believe that Yahoo! will continue to benefit from its existing DSL relationships with AT&T and Verizon (as both lower prices to gain additional subscribers), and could be the chief beneficiary as IPTV gains traction and the Internet becomes more viable on mobile devices. In addition to relationships with AT&T and Verizon, Yahoo! also has partnerships with Rogers Communications in Canada and British Telecom (BT) in the UK.

Table 22: Yahoo! DSL Partners

in thousands

	Subscribers	1Q Net Adds
AT&T	7,432	511
Verizon	5,700	541
Bell South	3,145	263
British Telecom (UK)*	1,801	176
Rogers Communications (Canada)	1,177	40

Source: Company reports. *Note that British Telecom subscribers and net adds are from 4Q'05

Growth Prospects and Opportunities

We believe the largest near-term opportunity for Yahoo! is to improve its search monetization, closing the gap with Google .We estimate that Yahoo!'s search monetization or revenue per search trails Google's by 30% to 40% (assuming a similar page layout). Though we do not expect this task to be easy or quick, we believe Yahoo! will see its efforts pay off in F'07. Additionally, we believe search monetization increases could potentially make Yahoo! Search Marketing a viable alternative to Google, allowing Yahoo! to rebuild its network business and ultimately replace inventory lost from MSN. Secondly, we believe increased search monetization will allow Yahoo! to invest more in its search products and brand, without degrading profits margins.

Vulnerabilities/Risks

Though Yahoo! has solid assets and a large opportunity to improve its search monetization, we believe the company faces several challenges going forward, which include 1) market share losses in search, 2) increased competition for users from traditional media companies (Viacom, News Corp) and the traditional portals (AOL, MSN), 3) more intense competition in communications products (email, IM and VOIP) from Google, Skype and potentially MySpace, 4) lack of mass market technology innovation, and 5) its search monetization efforts continue to trail competitors.

1. **Market Share Losses in Search.** Over the past several years, Yahoo! has been losing market share in search to Google despite creating its own search technology, placing search boxes across its verticals and aggressively marketing its search product. Though we believe market share losses have slowed for Yahoo!, we believe maintaining market share may be difficult in light of increased competition from other search players. Both Google and MSN continue to spend more on search research & development, while Ask.com and AOL (which uses Google technology) have embarked on large marketing campaigns. In order for Yahoo! to gain or maintain share, it will be critical for the company to keep pace with Google and MSN in terms of technology innovation and to shift user perceptions about the quality of Yahoo! search relative to Google.

Table 23: US Search Query Share

Percent of search query share

	1Q05	2Q05	3Q05	4Q05	1Q06
Google Sites	36.0%	37.0%	37.1%	39.6%	42.2%
Yahoo! Sites	31.2%	30.4%	30.0%	29.4%	28.1%
MSN-Microsoft Sites	16.3%	15.6%	15.6%	14.3%	13.5%
Other	16.5%	17.0%	17.3%	16.6%	16.3%

Source: comScore Networks

2. **Potential Competition from Traditional Media.** In our view, Yahoo! may face increased competition from traditional media companies (News Corp, Viacom) and established portals such as AOL and MSN. Over the past year, News Corp and Viacom have increased their focus on the online space, with News Corp acquiring MySpace and IGN, and Viacom launching broadband channels for MTV and Comedy Central. We believe these efforts could impact Yahoo!'s usage (similar to how cable impacted the television networks) as well as shift advertising spend away from Yahoo!. Additionally, both AOL and MSN are in the process of offering more compelling offerings, with AOL opening its portal to non-access subscribers and Microsoft's hiring former Ask.com CEO Steve Berkowitz to run MSN. Though it would be highly unlikely for either to unseat Yahoo! as the portal of choice for most consumers, increased competition from either one could potentially impact Yahoo!'s growth rates.

3. **Increased Online Communications Competition.** Yahoo!, MSN, and AOL are leaders in the online communications segment, with the vast majority of Internet users connecting through these companies' email and IM platforms. Email and instant messaging applications often drive page views and searches for portal companies. We believe that increased competition in the communications space

from Google (email, VOIP), Skype, MySpace (IM) and others could lead to a lower share of online communications for Yahoo!. Additionally, we think it is important that Yahoo! continue to focus its efforts on improving its email (Yahoo! Mail Beta has received good reviews) and IM products as well as continuing its progress with VOIP. If Yahoo! is unable to maintain its market share in online communications, we would expect that the company's market share in search and graphical advertising would also be impacted.

4. **Lagging Product Innovation.** Google and Skype have benefited from creating or improving mass market technologies, with Google making search relevant and Skype bringing VOIP to the masses. We believe that Yahoo! may fall further behind its competitors if it is unable to innovate and create new products that are differentiated. Currently, the company is working on "social search," though we are not yet convinced it will be a game-changing innovation.

5. **Search Monetization Risk.** Yahoo! is in the process of improving its search monetization, an effort which we believe is imperative to the company's future outlook. If Yahoo!'s efforts fail, we believe that Yahoo!'s network search revenues could be at risk, given Google's monetization lead and MSN's progress with AdCenter. Additionally, we believe that without improved monetization, it will be more difficult for Yahoo! to make the necessary investments in its business for future growth without impacting its margin structure.

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Synergy Landscape

eBay/Search Partnerships

In the following section, we explore potential areas where eBay and a leading search player could benefit from expanding their relationship. We have identified the following areas where working more closely could benefit both players 1) increased monetization of listings through inclusion in search listings, 2) increased monetization of eBay search results pages through inclusion of sponsored listings for those pages with limited results, 3) Skype interoperability with search player's VoIP offering, 4) expanded PayPal distribution, and 5) user base analytics.

Monetization opportunities via distribution and sponsored search on eBay
Currently, eBay lacks strong distribution beyond its own branded websites. Though eBay generates strong traffic, we believe eBay's growth in some of its more mature markets could benefit from wider distribution. As such, we believe a partnership to incorporate current eBay listings in relevant search results pages has the potential to drive additional qualified traffic to the site.

Currently, eBay does not provide sponsored listings on its search results pages (likely due to potential seller backlash), and therefore, we believe it may be losing out on some incremental revenue it could garner for those searches that do not produce satisfactory auction results. According to comScore Networks, eBay generates over 40 billion page views on a monthly basis, with over 10 billion coming from the US (see Table 24 below). Additionally, eBay has stated that it receives more than 345 million search requests on its site each day. Given the large number of page views and searches on eBay's website, we believe eBay may have an opportunity to increase its overall website monetization through search advertising.

Table 24: eBay Generates Over 44 Billion Global Monthly Page Views

Monthly page views, in millions

	Total Pages Viewed (MM)
eBay	44,618
eBay U.S.	13,433
eBay.com*	11,840
eBay Motors	702
eBay Stores	263
eBay Clothing, Shoes & Accessories	190
eBay Collectibles	88
eBay Sports	71
eBay Electronics	68
eBay Home	60
eBay Entertainment	43
eBay Jewelry and Watches	42
eBay Toys	26
eBay Business & Industrial	25

Source: comScore Networks, March 2006

Expanding Communications Platforms
Currently, eBay owns the number one VoIP franchise in Skype, with approximately 100M active registered users globally. eBay is also a leading provider of IM interactions through the Skype platform. Additionally, over the past several months, there have been some ground breaking interoperability agreements. AOL and Google

have agreed to make their IM platforms interoperable, as have Yahoo! and Microsoft. Finally, we believe there may be an opportunity for cross promotion between Skype and a search partner's VoIP/IM offering.

Increased PayPal distribution and payment processing opportunities
Expanding PayPal's distribution beyond the eBay platform is one of eBay's core goals. eBay has made investments in its PayPal platform and offerings to make backend payment processing for SMB owners faster and more simple. Additionally, eBay acquired VeriSign's payment gateway business, allowing it to become a single source payment solution for online merchants. Increasing PayPal's presence on portals (e.g., increasing the percentage of listings on Yahoo! Auctions that offer PayPal) is another way to further penetrate the off-eBay marketplace. As more products and services become available online, we believe the demand for alternative payment methods will increase and PayPal's relevance off-eBay will increase as well.

User Analytics
We believe there is significant user overlap between the large Internet players. comScore data suggests the largest eCommerce/Search overlap is between eBay and Google with 85% of the eBay visitors also visiting Google in April (and 43% of Google visitors visited eBay). Based on the user information eBay collects, it likely has information about each of those users' locations, purchasing habits, search history, etc. As such, we believe there is the potential for synergies between eBay and leading search players related to user analytics.

Table 25: Duplicate Users between Specified Web Proprieties

Unique Visitors in Common	
eBay/Google	84.9%
Google/eBay	43.1%
Yahoo!/eBay	40.8%
eBay/Yahoo!	78.4%
eBay/MSN	74.2%
MSN/eBay	42.5%
MSN/Google	80.5%
Google/MSN	71.3%
MSN/Yahoo!	75.4%
Yahoo!/MSN	68.5%
Yahoo!/Google	77.3%
Google/Yahoo!	75.4%

Source: comScore Networks

Growing SMB Customer Base
eBay has been steadily growing its SMB customer base, with approximately 900K sellers making their living selling on eBay. Additionally, eBay is growing its SMB base via its newly acquired payment gateway. We believe this growing asset could be the basis for partnerships between eBay and a search partner as additional SMB advertisers could help increase monetization, and could help bolster local and/or classified offerings.

Online Advertising Partnerships

In this section, we explore the specific areas in which we believe the online search and advertising companies (Google, MSN, Yahoo!) could work together to strengthen their position in the marketplace. The specific areas are outlined below, including 1) leveraging complimentary strengths in access point, 2) sharing user information for better targeting, 3) expanding geographic footprint, 4) broadening IM and VoIP interoperability, and 5) establishing industry standards and best practices.

Access Points

One of the primary reasons the large-cap Internet companies may be interested in working more closely is to leverage each others' user access points. Currently, Yahoo! has a leading position with DSL providers, giving it preferred access to users who connect through AT&T, Verizon, Rogers, and British Telecom. Meanwhile, MSN can leverage Microsoft's access point advantages in mobile (Windows Mobile), gaming (Xbox), and home entertainment (Windows Media Center). Google is trailing MSN and Yahoo! in terms of its ability to leverage access points, but the company has been aggressive in signing search distribution deals (i.e. Firefox, Opera, etc.) and toolbar alliances (Dell, Sun, etc.), which should help the company shore up its position. We believe a strategic partnership could provide each search and online advertising company with expanded access point coverage.

User Information

One of the benefits of online advertising is its ability to target consumers using behavioral, demographic, geographic and psychographic information. However, Internet companies can only target their users based on these variables if they have adequate knowledge of their users. For example, before Google added sign-on functionality to www.google.com, we believe the company had limited ability to target advertisements to its users (aside from IP-based geographic targeting). Additionally, *The New York Times* reported that Microsoft was in discussions to buy Claria Corporation. We believe the primary motivation behind such an acquisition would be Microsoft's desire to gain increased knowledge of its users, and Claria's 120+ terabyte Oracle database of user information would help in those efforts. We believe any partnership between the top search and advertising companies would include discussions over user information, and we believe Google, MSN and Yahoo! could all benefit from knowing more about their users.

Geographic Footprint

Another advantage of a partnership in the search space would be increased international presence. Although each company has their strengths and weaknesses in terms of international coverage, we believe MSN and Yahoo! would have the most to gain from working together. Aside from a few countries in the Asia-Pacific region (namely Korea), we believe Google owns a leading position in search in almost every other major market around the globe. However, MSN has a relatively weaker presence in Asia-Pac market, while Yahoo! is under penetrated in Europe. As such, we believe there may be some opportunities for the search companies to strengthen their standing outside the US through partnership.

Communication Interoperability

As discussed earlier in this report, we believe further IM interoperability agreements may be an outcome of a strategic event involving the search and advertising companies. Until recently, IM and VoIP users were only able to communicate with users of the same network, in most cases. However, two notable partnerships in recent months have altered the communications dynamic. On October 12, 2005, Yahoo! and Microsoft announced an agreement to open their IM platforms so users of MSN Messenger and Yahoo! Messenger will be able to interact with each other. On December 20, 2005, Google and America Online announced a similar interoperability agreement for Google Talk and AIM Instant Messenger. In our view, communications interoperability agreements lower the switching costs for users and open the doors for increased innovation. We believe future interoperability agreements are likely, and we believe communication interoperability is one of the types of agreements in which the leading Internet companies are likely to execute in the future.

Industry Standards

We believe the large Internet advertising companies would also welcome the adoption of further industry best practices. Although the Internet landscape is much more standardized than it was a few years ago, we believe it is still relatively unstructured in terms of technical protocols and best practices. For example, there are no standard specifications for voice and messaging communication, which has led to the proliferation of closed communication networks. Overall, we believe common standards will eliminate friction in the Internet economy and contribute to faster adoption of the Internet as a marketing and commerce vehicle. As such, we believe the large-cap Internet companies would likely be interested in working together to establish such standards.

Based on the preceding discussion of synergies between eBay and search players, we have explored the potential partnership scenarios between eBay and the three leading search players: Google, Yahoo!, and MSN. These discussions include potential financial implications as well as a strategic analysis of each scenario.

Scenario 1: eBay/Google

Monetization opportunities via distribution and sponsored search on eBay
In addition to securing its existing revenue stream from eBay, we believe Google could be very interested in powering sponsored listings on eBay's search results pages. Google is currently the largest distributor of paid search listings, with clients such as AOL, AOL Europe, and Ask.com. On average, Google takes home about 20% of the gross revenues generated from a search distribution partnership, and given eBay's high volume of commercially natured queries, we believe it could represent a substantial revenue opportunity for Google.

Securing Existing Ad Revenues
We believe the primary motivation that may drive Google to consider a deeper partnership with eBay is its desire to maintain its existing advertising revenue stream. eBay is widely believed to be the largest advertiser of Google Adwords. Our proprietary research shows that eBay advertises on more keywords than any other search advertiser (see Table 26 below). In fact, according to our proprietary tracking, eBay advertises on five times as many keywords as the second largest advertiser (bizrate). We are modeling eBay to spend $1.7B on sales and marketing in 2006. Of that, we estimate approximately $400M will be spent toward online advertising, with more than $100M being allocated to Google. A spend of $100M on Google would mean that eBay is responsible for between 1% and 2% of Google's net revenues, underscoring the motivation that Google would have to work to keep eBay as a top customer.

Table 26: Google Advertisers with Largest Keyword Coverage

% of keywords with an

Rank	Advertiser	% of Keywords w/Advertisements
1	eBay	25%
2	bizrate	5%
3	shopping.com	4%
4	Yahoo!	3%
5	toseeka.com	3%
6	collegeboard.com	2%
7	shopzilla.com	2%
8	target.com	2%
9	music.aol.com	2%
10	moviefone.com	2%

Source: JPMorgan proprietary survey

Both players have an interest in expanding communications platforms
We believe enhanced distribution of the Skype brand would aid both consumer and business awareness, especially in the US. We believe Google could be interested in partnering with eBay to leverage Skype's broad reach and user base. At the outset, we believe Google could potentially be interested in altering the Skype/Google Talk paradigm to enable interoperability between the two VoIP platforms. Currently, Skype users can only IM or talk with other Skype users. Given the relatively lackluster adoption of Google Talk (comScore suggests there are fewer than one million users in the US), reason suggests Google would be very interested in gaining interoperability with Skype.

Additionally, we believe a hypothetical Skype/Google partnership could involve pay-per-lead and pay per call technologies enabled by Skype and integrated into Google search results. As Skype plans to roll out Pay per Lead technology for its own local search functionality in 2H'06, Skype could drive significant incremental revenues from a partnership with Google for Pay per Lead on its own local search listings. Given Google's track record of building technologies in-house, we find it unlikely that Google would adopt Skype's VoIP technology to power its imminent pay-per-call offering.

Potential increase in PayPal distribution; payment processing for Google Wallet
As Google is in the process of developing a payment system for the execution of payments on its owned and operated websites, a theoretical affiliation with PayPal could generate significant revenue upside to facilitate the backend processing of these payments. In addition to helping Google process payments on its site, we believe PayPal could achieve additional upside from having PayPal shown as a payment mark on Google's site.

Much has been discussed about Google's pending launch of the Google Wallet, and whether or not the product will ultimately compete with eBay's payment platform, PayPal. Regardless, it seems clear that Google will officially launch Google Wallet in the near future, and it seems reasonable that Google would seek to enable payments to/from PayPal. Similar to auctions and communications platforms, we believe payment systems become stronger the larger the network of users. Additionally, we believe it may be difficult to grow a payment system from scratch, as it often necessitates a buyer and a seller both using the system. In the short-term, Google could be interested in offering PayPal as a payment option in addition to Google Wallet given PayPal's strong penetration among small businesses.

We believe a hypothetical payment partnership between PayPal and Google could be beneficial for both parties as it would help PayPal further penetrate into the off-eBay ecommerce market and it would eliminate margin drag for Google as the payments business is lower margin than its current business.

Gaining Insight to eBay's User Base
Google's history as a search engine that sought to deliver users to information as quickly as possible limited the company's ability to gain information about those users. Users were not engaged with Google aside from conducting a search and clicking through to the desired search result. Additionally, until recently, Google had only a few services that required or enabled login functionality. Google's lack of knowledge of its user base has not yet proven to be a weakness (since its competitors have not capitalized on the knowledge they have of their user bases in any meaningful way); however, it may limit the company's ability to offer better targeting capabilities in the future. We believe Google would be interested in gaining additional insight into its users, and a potential alliance with eBay could help deliver that insight. Using IP-based technology, Google could learn a good deal about users who are active registered users on eBay but conduct a substantial number of searches on Google. In 1Q, eBay reported 193 million confirmed registered users. According to comScore Networks, there is substantial overlap between eBay users and Google users (85% of eBay users also use Google on a monthly basis). Based on the user information eBay collects, we believe it is likely eBay has information about each of those users' locations, purchasing habits, search history, etc. As such, Google could possibly seek to leverage the information eBay has of its users.

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eBay/Google Potential Financial Implications

Though we believe an M&A scenario between eBay and Google to be unlikely, we have analyzed the potential financial implications in the table below.

Based on our current company-specific models, we estimate an eBay/Google combination could generate $18.9B in revenues in F'07, up from $13B in pro forma revenues in F'06 (based on eBay and Google's combined revenues for F'06E). Our revenue estimates assumes several factors in F'07: 1) an incremental $250M in advertising revenues from increased monetization of eBay search results pages, 2) an incremental $150M in payments revenue if PayPal were offered as a payment mark on Google and Google Base, and 3) an incremental $200M in auction revenues could be generated from inclusion in Google algorithmic search results. At this stage, we do not believe there would be a material impact on VoIP revenues because we don't think there would be significant adoption of Pay Per Call or Pay Per Lead in the wider local search market in the very near term.

Additionally, we estimate the combination would generate OIBDA of $7B in F'06 and $10.3B in F'07, which equates to flat operating margins at 54%. Taken together, we estimate Y/Y revenue growth of 45%, 44% Y/Y operating expense growth, and 47% Y/Y OIBDA growth.

Table 27: eBay/Google Financial Implications

$ in millions, except for percentages

	2006E	2007E	Y/Y Growth
Advertising	7,133	10,913	53%
Payment	1,400	2,049	46%
Auction	4,202	5,515	31%
VoIP	241	400	66%
Total Revenue	12,976	18,877	45%
Operating Expenses	5,990	8,618	44%
OIBDA	6,986	10,259	47%
Margins	54%	54%	

Source: Company reports and JPMorgan estimates

How feasible is an eBay/Google Partnership?

We believe a partnership between Google/eBay is possible. However, we believe a more involved strategic event between these to companies is less likely. We estimate that Google currently generates ~$100 million in revenue from eBay, and we believe Google would be willing to have discussions with eBay regarding expanding partnership opportunities to ensure that it does not see diminished advertising spend from eBay. Additionally, we think both companies would have a lot to gain if eBay were to select Google to serve sponsored listings on eBay's search results pages. Additionally, Google could be open to discussions involving both Skype and PayPal, although we do not expect Google to adopt either of those platforms on an exclusive basis within the Google ecosystem of products.

Overall, we find it strategically unlikely that Google would be involved in any major event with the other large-cap Internet companies. More likely, we believe Google will continue with its approach of acquiring small companies with unique technologies and solid engineering resources.

Scenario 2: eBay/MSN

Many of MSFT's online initiatives are still nascent, which renders a somewhat vague discussion of some of the following synergies—but there are several assets that MSFT could bring to eBay that could provide downstream value in a potential partnership or merger.

Enhanced Collaboration: Email & VoIP, and web collaboration
As Hotmail has the largest email install base, we believe there could be a potentially interesting opportunity for interoperability/integration between Skype and MSN's Hotmail service. Additionally, we believe there are opportunities for collaboration between Skype and Groove Networks (e.g., for product demonstrations by eBay sellers). We believe the ability for sellers to be able to show buyers their products in an interactive demonstration including voice would be a very powerful tool for higher touch categories.

Expanded Advertising Relationship
MSN has incorporated current eBay listings in its search results pages since 2003. The existing relationship could be expanded further now that eBay has launched eBay Express. Specifically, on the left hand side of MSN's search results pages, we believe adding eBay Express to the list of sellers (as applicable) would differentiate for potential buyers that the item they are seeing in search results is being sold at a fixed price, and could also drive incremental traffic to eBay Express.

In tandem with continued inclusion of eBay listings in MSN search results, MSN could be interested in serving sponsored links on eBay search results pages.

Fee-Based Partnerships and PayPal Distribution
As MSN has various fee-based services, we believe a potential partnership between PayPal and MSN could make strategic sense for both companies. In particular, there may be meaningful synergies between Media Center and PayPal (e.g., music and video downloads). As PayPal continues to further penetrate the off-eBay market (including large enterprises), we believe a partnership could be beneficial for PayPal and Microsoft if Microsoft were to include PayPal as a payment option for its retail customers, which would help drive payment volume.

Additionally, the two companies could collaborate on an ITV initiative, which eBay is currently testing. Media Center could be another distribution channel for eBay, primarily in the classifieds category as eBay builds up their high-price ticket listings.

Synergies from eBay's Large SMB Base
eBay has approximately 900K sellers who make their living selling on eBay. Additionally, through its recently acquired payment gateway business, eBay has relationships with more than 100K SMBs. We believe one of the areas where MSN struggles is increasing its base of SMB advertisers. However, a potential partnership between eBay and MSN could help MSN further monetize this segment of advertisers by incorporating them into its paid search platform.

Real Time Collaboration Could Improve Conversion
MSFT has expanded online file sharing capabilities with Windows Live and well as hosting and application delivery with Office Live—and these initiatives should only

accelerate as priorities in FY07. There is clear value here for eBay sellers, as well as potential synergies with SOHO businesses that could benefit from MSFT's website creation, hosting, and commerce management.

Integration with Desktop will Reduce Friction
As MSFT continues to build out search technologies—and improve the synergies with desktop search, eBay could both reduce the cost of its current search platform and provide both sellers and buyers with a better experience across transactions (with document management capabilities for example).

Improved Security will Lead to Listing Growth
eBay could provide MSFT with a distribution platform for its expanding security suite, which now includes firewall, anti-virus, a more secure browser, code isolation tools and management infrastructure. In return, eBay's transactional infrastructure would be more secure. As trust & safety is a critical initiative for eBay's continued success, we believe enhanced security offerings will help drive listing growth.

eBay/MSN Potential Financial Implications

Although we do not believe and eBay/MSN partnership is the most strategically likely scenario, we have analyzed the potential financial implications based on our current company models in the table below.

We estimate a hypothetical eBay/MSN combination could generate $10.2B in revenues in F’07, up from $8.3B in pro forma revenues in F’06 (based on eBay and MSN’s combined revenues for F’06E). The revenue estimates contemplate several factors in F’07: 1) an incremental $50M in advertising revenues from increased monetization of eBay search results pages, 2) an incremental $100M in auction revenue due to the inclusion of eBay auction results in MSN’s algorithmic search results, 3) an incremental $25M in payment revenues due to cross-selling PayPal to MSN's user base, and 4) an incremental $25M in VoIP revenues due to cross-selling of Skype to Microsoft's user base. At this stage, we do not believe there would be a material benefit to access or fee revenues.

Additionally, we estimate the theoretical combination would generate OIBDA of $2.2B in F’06 and $3.1B in F’07, which equates to a 300 bps operating margin improvement Y/Y. Taken together, we estimate Y/Y revenue growth of 24%, operating expense growth of 19%, and 39% OIBDA growth.

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Table 28: eBay/MSN Potential Financial Implication

$ in millions, except for percentages

MSN/eBay			
	2006E	2007E	Y/Y Growth
Access Revenue	458	424	-7%
Advertising Revenue	1,757	1,925	10%
Fees	229	235	3%
Auction	4,202	5,315	26%
Payment	1,400	1,924	37%
VoIP	214	425	98%
Total Revenue	8,260	10,248	24%
Operating Expenses	6,012	7,125	19%
OIBDA	2,249	3,123	39%
Margins	27%	30%	

Source: Company reports and JPMorgan estimates

How feasible is an eBay/MSN Partnership?

Though we believe a hypothetical partnership between eBay and MSN is possible, we do not believe Microsoft will sell its MSN division and as a result feel that M&A activity between these to companies is relatively unlikely. That said, we also believe from a partnership standpoint, there are more partnership benefits for MSN than there are for eBay. As such, we feel that should eBay decide to enter into a more defined relationship with a search player, the likelihood of eBay choosing MSN is lower than that of the other two discussed in this report.

Scenario 3: eBay/Yahoo!

In the following section, we explore potential areas where eBay and Yahoo! could benefit from a hypothetical combination including 1) the combined company would be leader in auctions, graphical advertising, payments, VoIP and a top search player; 2) it would increase international footprint, 3) it would enjoy potential synergies on Yahoo! from eBay's large SMB base, 4) it would create R&D leverage, and 5) it would enable better monetization on eBay pages.

Potential Combination Could Create Market Leading Company: The potential combination of eBay and Yahoo! could create a company that leads the market in auctions, graphical advertising, payments, VoIP and that would be the second largest search player behind Google. Additionally, we believe the potential combination between Skype and Yahoo!'s communications products (email, IM and VoIP) would make the company the leader in online communications, with more reach and user activity than both Google and MSN.

Leveraging Each Other's Brand Globally: Yahoo! has a strong position in Asia through its owned properties in Korea and Taiwan and through its joint ventures in China and Japan. If there were a strategic event between Yahoo! and eBay, eBay would be able to leverage Yahoo!'s strength in Asia as Yahoo! (especially in China) would help eBay understand the local culture. Further, we believe that Yahoo! could benefit from eBay's distribution and reach in Europe, especially in countries such as Germany where we estimate Google has more than 80% of search market share.

Potential Synergies from eBay's Large SMB Base: We believe that Yahoo!'s search monetization efforts could benefit from eBay's large base of small-medium businesses (SMB) as Yahoo! could incorporate these enterprises into its paid search platform, increasing coverage, relevance of paid search results and potentially pricing (more bidders on a keyword typically leads to a higher PPC).

Operational Leverage: A hypothetical eBay/Yahoo! combination could have significant operational benefits. This combination could allow the companies to consolidate their respective R&D and marketing spend in China, saving the combined entity approximately $200M per year. Second, the companies could combine their comparison shopping and classified efforts, leading to potential cost savings as well as revenue synergies as best aspects of each platform are adopted. Finally, Yahoo! would be able to leverage Skype's R&D efforts, making its VoIP offering more competitive.

Better Monetization of eBay's Pages: comScore estimates eBay generated global 44.6B page views in March, roughly 39% of Yahoo!'s 144.6B global page views. Were an alliance to occur, Yahoo! could help eBay better monetize its pages in two ways: 1) through graphical advertising, where large marketers could brand their products on targeted pages (e.g., Nike branding on a running shoe auction), and 2) through search, where Yahoo! could place its search on box on eBay, taking traffic that would have otherwise left eBay to search engines such as Google or MSN.

eBay/Yahoo! Potential Financial Implications

Based on our current company-specific models, we estimate a hypothetical eBay/Yahoo! combination could generate $13.85B in revenues in F'07, up from $10.65B in pro forma revenues in F'06 (based on eBay and Yahoo!'s combined revenues in F'06). Our revenue estimate assumes several factors in F'07: 1) $100M in incremental spending on Yahoo!'s search properties and network from eBay's small merchants, 2) $100M in incremental revenues for eBay's and Yahoo!'s shopping comparison engines as they benefit from cross promotion and increased inventory selection, 3) $50M in incremental Skype revenues as it benefits from marketing across Yahoo!'s properties, 4) $100 million in incremental revenues from using Skype across Yahoo!'s properties, and 5) any theoretical deal would close prior to beginning of F'07.

Additionally, we estimate the combination would generate operating income before depreciation and amortization (OIBDA) of 4.61B in F'06 and $6.55B in F'07, which equates to operating margins of 43.3% and 47.2% in F'06 and F'07, respectively. The F'07 OIBDA estimate takes into account 1) $150M in back office and sales force cost savings, and 2) $200M in cost-savings in China as there is no longer a need for eBay to spend to compete with Alibaba.

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Table 29: eBay/Yahoo! Financial Analysis

$ in millions, except for percentages

	2006E	2007E	Y/Y Growth
Net Advertising	4,031	5,106	27%
Fee	804	983	22%
Auction/eCommerce	4,202	5,315	27%
VoIP	214	450	110%
Payment	1,400	1,999	43%
Total Revenue	10,651	13,853	30%
Operating Expense	6,043	7,321	21%
OIBDA	4,608	6,533	42%
OIBDA Margins	43.3%	47.2%	

Source: Company reports and JPMorgan estimates.

How feasible is an eBay/Yahoo! Partnership?

In our view, a partnership or merger between eBay and Yahoo! is strategically the most feasible of the six scenarios we present in this report it could help both companies maximize their respective business strengths. We believe that both companies would benefit from a potential strategic event for the following reasons: (1) leadership in auctions, VoIP, payments, graphical advertising, and search; (2) a broad geographic footprint as Yahoo! and eBay will be able to leverage each other's geographic strengths; (3) better knowledge of its combined user base; (4) increased penetration in the SMB market; and (5) leveraged R&D facilities.

Scenario 4: MSN/Yahoo!

In the following section, we explore the following areas where Yahoo! and MSN could benefit if they were to expand their relationship and/or work more closely with each other in a partnership: 1) advertising scale, 2) increased international footprint, 3) complimentary access points, 4) organizational synergies, and 5) deeper customer relationships.

Increased Advertising Scale Could Drive Upside: One of the biggest challenges facing MSN and potentially Yahoo! is the lack of scale in terms of search traffic compared to Google. We believe that a potential combination between the two companies could solve this issue and close the gap with Google from a search inventory and advertiser perspective. On a global basis, MSN/Yahoo! could reach approximately 600M unique users and have approximately 28.3% of all searches. Further, we believe the increased scale of the combined search entity would lead to improved monetization due to a number of advertisers, which positively impact coverage, click-through rates, and pricing.

Global Standing Should Improve: MSN is the second largest player in Europe behind Google, with broad-based strength spread across a number of countries, while Yahoo! is very strong in Asia, especially in Korea and Taiwan and through joint ventures in China and Japan. A theoretical strategic event between MSN and Yahoo! could create a competitor with strong market share across North America, Europe, and Asia.

Complimentary Access Points: As stated earlier in this report, Microsoft has strength on the desktop through its browser and applications and potential to gain share as access points shift towards mobile devices, gaming consoles (Xbox) and media center. Yahoo! has strong relationships with DSL providers, which are in the process of offering television services over the Internet. A combination of Yahoo!'s relationships and Microsoft's applications and devices could create a very well-positioned potential competitor. The combination of Yahoo!'s relationships and Microsoft's applications and devices could create a very well-position competitor, with access points across many applications and devices.

Organizational Synergies: Many of MSN's and Yahoo!'s efforts are duplicative, including search monetization and technology, selling efforts and content acquisition. A possible combination could allow the company's to streamline duplicative efforts, either leading to increased margin potential or allowing business development, engineering and sales teams to focus on new initiatives and markets. Additionally, we believe the potential combination would benefit from a realigned sales force, as it would have broader reach as well as the potential for a more selling efficiencies as it could choose between the top producing sales representatives.

Deeper Customer Relationships: A potentially closer relationship between Microsoft and Yahoo! could deepen customer relationships. The companies would be able to accelerate the compatibility of their respective communication platforms, and Yahoo!'s customers would benefit from integration into Microsoft's applications. Further, we believe the combined entity would have access to significant amounts of user data, allowing it to better target advertising and user experiences. The combination would represent 12% of US page views, giving it approximately 4x and 5x the pages of eBay and Google, respectively. We believe scale would make the new entity the leader in behavioral targeting due to the large reach and user data.

MSN/Yahoo! Potential Financial Implications

We believe that a MSN/Yahoo! partnership makes sense at a strategic level. As such, we have analyzed the potential financial implications in the table below.

Based on our current company-specific models, we estimate a hypothetical MSN/Yahoo! combination could generate $8.6B in revenues in F'07, up from $7.1B in pro forma revenues in F'06 (based on MSN and Yahoo!'s combined revenues in F'06E). The revenue estimates contemplates the fact that there may be substantial cross-selling opportunities between MSN and Yahoo! in their core advertising businesses. As such, we have included an incremental $200M in advertising revenues for F'07 in our scenario.

At this stage, we don't believe there would be material benefit to revenues for their access revenues or fee-based revenues. However, we do believe there may be cost savings of ~$100M due to better sales force productivity and increased advertiser scale.

Additionally, we estimate the potential combination could generate OBIDA of $1.6B in F'06 and $2.5B in F'07, which would equate to 29% OBIDA margins in F'07, up 600 bps Y/Y. Taken together, we estimate Y/Y revenue growth of 21%, operating expense growth of 11%, and OIBDA growth of 54%.

Table 30: MSN/Yahoo! Financial Analysis

$ in millions, except for percentages

MSN/Yahoo!	2006E	2007E	Y/Y Growth
Access Revenue	458	424	-7%
Advertising Revenue	5,634	6,951	23%
Fees	1,033	1,218	18%
Total Revenue	7,124	8,593	21%
Operating Expense	5,481	6,065	11%
OIBDA	1,643	2,528	54%
Margins	23%	29%	

Source: Company reports & JPMorgan estimates

How feasible is an MSN/Yahoo! Partnership?

Yahoo! CEO Terry Semel recently stated in *The Financial Times* that there have been no discussions with Microsoft regarding an outright acquisition and that Yahoo! rejected Microsoft's proposed stake in Yahoo!'s search business; however, we believe a Microsoft/Yahoo! combination is a strategically feasible scenario, given current competitive dynamics. Additionally, if both companies are unable to alter their trajectories versus Google over the next 12 to 18 months, we believe the potential for consolidation between the two players could increase. From a partnership standpoint, we believe both companies could benefit from an expansion of their existing communications interoperability agreement.

Scenario 5: Google/MSN

Aside from teaming up on Net Neutrality and working together to establish industry standards and protocols, we believe it strategically unlikely that Google and Microsoft will partner or consider a strategic event with one another. In the distant past, Microsoft may have considered buying Google outright, but given Google’s market capitalization and Microsoft’s investments in algorithmic search and AdCenter, we view an outright bid to be unlikely. Additionally, we believe there are philosophical, cultural, managerial, and personal reasons why a strategic event is unlikely to occur between Google and MSN. In this section we explore areas where each company may be interested in working together and then highlight why such cooperation is unlikely.

Google Needs Better Reach in Communications: As we discussed in Google’s company profile, the company trails AOL, MSN, Skype and Yahoo! in the communications segment of the Internet. Although Google is currently fourth in terms of email audience size in the US, the company is well behind the leaders in IM and VoIP. Consequently, Google would probably like to reduce the vendor lock-in and switching costs through interoperability. But we believe MSN, who is operating from a position of strength in communications, has little to gain by making its products interoperable with Google’s. IM and VoIP are networks that increase in value in correlation with the size of the network, creating a substantial barrier to entry for the communication providers with small networks. Given that, we believe

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MSN would have minimal interest in removing an important barrier that may be limiting Google's ability to grow adoption of its communication products.

Google Could Provide Supplemental Sponsored Listings: In the short-term, we believe Microsoft could benefit from supplemental listings from Google or Yahoo! due to AdCenter's lower coverage and lower average bid price. Although Google only garners ~20% of the revenue generated from such a distribution partnership, we believe the company would welcome the additional high margin revenue. But again, we believe Microsoft would be unwilling to accept such an arrangement. First, given their history of working together, we believe Yahoo! would be a more logical choice. Additionally, we believe there are technical limitations related to optimizing two competing ad platforms in one integrated package. Finally, Microsoft has shown a propensity toward not optimizing its online businesses for near-term profitability (the development of algorithmic search and AdCenter cost the company hundreds of millions of dollars) as displayed in its recent financial results.

Google Could Leverage Microsoft's Access Points. Through its Media Center, Windows Mobile, Internet Explorer and Xbox products, Microsoft controls a number of web access points. On the other hand, Google controls very few access points, and most of Google's access points have been obtained through revenue sharing deals with mobile carriers, PC manufacturers, and companies with second-tier web browsers. As such, it makes sense that Google would be interested in obtaining some of the access points that Microsoft has access too. However, we see no reason that Microsoft would be willing to cede this advantage, and as such, see any sort of access point related partnership as unlikely.

Microsoft Needs Scale. One of Microsoft's biggest weaknesses in search is its lack of scale. MSN currently owns ~13.5% of the US search market, and an even smaller percentage of the global market. Additionally, Microsoft has yet to sign up a critical mass of AdCenter advertisers, in our view. Consequently, we believe MSN will show lower levels of monetization and therefore lower search revenues than Google. Microsoft would be in a much better position of it could increase the size of its search network, and Google could certainly help. However, as we've stated before, we don't believe Google needs MSN to succeed in search and we view it as highly unlikely that Google do anything to help MSN gain global scale.

Scenario 6: Google/Yahoo!

We believe a strategic partnership between Google & Yahoo! is strategically unlikely. A Google and Yahoo! merger would clearly reduce the level of competition in the Internet space, but we believe neither company needs the other to survive in this space. Further, we believe a strategic event is unlikely to occur due to the following:

Competing Visions. Google's vision is "to organize the world's information and make it easily accessible and useful." Google aims to do tackle this objective by leveraging its expertise in technology. Accordingly, the majority of Google's management team and founders have backgrounds in technology. Google News is a good example of a product for which Google used technology to make news information easily accessible and useful. Meanwhile, Yahoo! employs a number of editors and has undertaken content creation initiatives in its effort to "be the most essential global Internet service for consumers and businesses." Although both companies have been developing along the similar product roadmap (IM, email, VoIP, search, paid search, news, etc.), we believe they have approached it quite differently. As such, we believe these varying approaches may be a limitation to a potential strategic partnership.

Recent Product Developments. Over the past several years, Yahoo! has acquired a number of search companies (Inktomi, Overture, Alta Vista, Fast, etc.) and overhauled its paid search platform. Meanwhile, Google has been busy rolling out Google Finance, Gmail, Google Talk, Google Calendar, Google Base and more. In our view, if Yahoo! had been contemplating a strategic event with Google, it would have made sense to act on it before undertaking such massive investments in web search and search monetization. Similarly, we believe Google would not have undertaken such investments in vertical channels and communication platforms if it felt a partnership with Yahoo! was likely. As such, we believe aggressive R&D expenditures for overlapping product portfolios is an indication that a Google/Yahoo! strategic event is unlikely at this late stage.

Potential Anti-trust Implications. In 1Q'06, Google and Yahoo! had a combined search market share in the US of just over 70%, according to comScore Networks. Additionally, we believe the two companies generate more than 75% of search industry revenues. As such, we believe a strategic event between the #1 and #2 competitors in what we believe will be a $8 billion market in 2006 may lead to anti-trust concerns.

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Companies Recommended in This Report (prices as of COB 19 May 2006)
eBay, Inc (EBAY/$29.70/Overweight), Google (GOOG/$370.02/Overweight), Microsoft (MSFT/$22.56/Overweight), Yahoo Inc (YHOO/$29.53/Overweight)

Analyst Certification:
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- **Market Maker:** JPMSI makes a market in the stock of eBay, Inc, Google, Microsoft, Yahoo Inc.
- **Analyst Position:** The covering analyst, research associate, or member(s) of their respective household(s) have a long position in the securities of Microsoft.
- **Client of the Firm:** eBay, Inc is or was in the past 12 months a client of JPMSI; during the past 12 months, JPMSI provided to the company non-investment banking securities-related service. Google is or was in the past 12 months a client of JPMSI; during the past 12 months, JPMSI provided to the company investment banking services and non-investment banking securities-related service. Microsoft is or was in the past 12 months a client of JPMSI; during the past 12 months, JPMSI provided to the company non-investment banking securities-related service and non-securities-related services. Yahoo Inc is or was in the past 12 months a client of JPMSI.
- **Investment Banking (past 12 months):** JPMSI or its affiliates received in the past 12 months compensation for investment banking services from Google.
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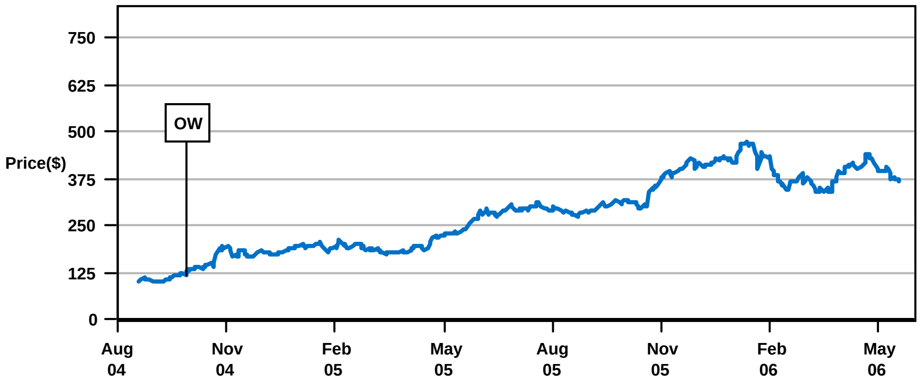
eBay, Inc (EBAY) Price Chart

Date	Rating	Share Price ($)	Price Target ($)
07-Jun-04	OW	44.04	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
Break in coverage Aug 30, 2001 - Apr 09, 2003, and Apr 30, 2004 - Jun 07, 2004. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

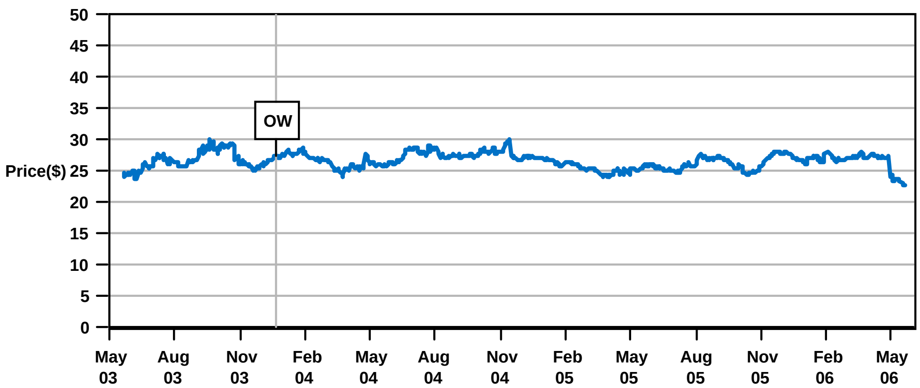
Google (GOOG) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
28-Sep-04	OW	118.26	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
Initiated coverage Sep 28, 2004. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

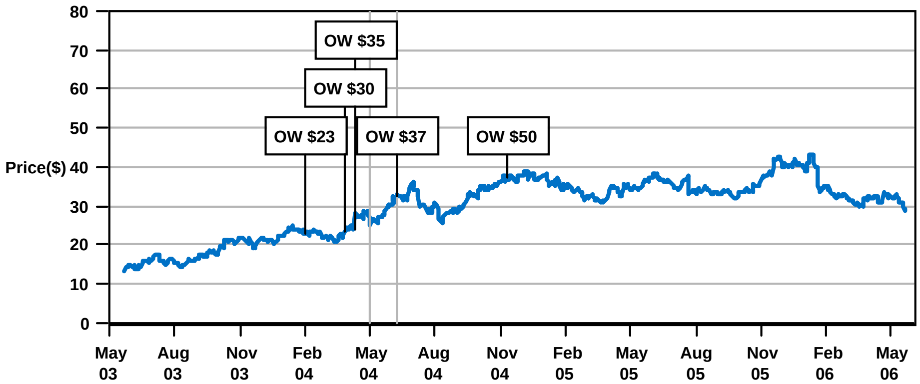
Microsoft (MSFT) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
19-Dec-03	OW	27.40	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
Break in coverage Feb 11, 2003 - Dec 19, 2003. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

Yahoo Inc (YHOO) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
30-Jan-04	OW	23.04	23.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
Break in coverage Dec 30, 2001 - Apr 09, 2003, and Apr 30, 2004 - Jun 07, 2004. This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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