China.com, the first listed operator of an Asian integrated portal with its focus on Greater China, reported strong 2Q99 and 1H99 results. The company achieved strong growth in all of its major operating metrics, with page views and advertising revenue growth exhibiting particular strength.

We attribute China.com’s market leadership and notable brand presence as a result of the company’s innovative strategy of integrating its three synergistic business lines: its Greater China focused portal business, its pan-Asian 24/7 Media Asia advertising network and its comprehensive Web solutions business. The company also benefits from its strong brand identity through its ownership of the URLs www.china.com, www.hongkong.com, www.taiwan.com and www.cww.com.

Three key factors underpin China.com’s aggressive growth and development strategy:

- The explosive growth forecast for Web usage in Greater China and Asia.
- The company’s impressive array of content and co-branding alliances, including global content brands such as Netscape, AOL, Yahoo! and Xinhua, which enhance the appeal of its content, community and commerce products and services.
- The company’s aggressive pan-Asian expansion strategy. During the past few months, the company has consummated several advertising network acquisitions in Korea, Japan and Singapore in addition to Web solutions acquisitions in Japan, Hong Kong and Taiwan.

As the first Greater China and Asia-focused portal to achieve a NASDAQ listing, we anticipate that the company is now in a position to capitalize on its leadership position through the use of its equity as an effective acquisition currency.

The position of America Online (AOL) as a key strategic investor with an 8% equity interest in China.com is a clear demonstration of the company’s strong competitive position in the Greater China market. As a strategic partner of China.com, AOL provides leading-edge technological expertise as well as significant user traffic to China.com’s portal network.
China.com: Exceeding Expectations

October 7, 1999

Ravi Sarathy/Juliette Chow/Stephen McKeever

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Valuation and Recommendation

We have initiated coverage of China.com with a 1-Buy rating.

Our stock valuation, based on DCF, implies a 2000 EV/revenue multiple of 39x, falling to 24x in 2001. These multiples would put the company at a significant premium to its U.S. portal comparables, which currently trade at an estimated 17x 2000 on average. We believe that the company’s premium valuation relative to its U.S. comparables is justified given the following:

- The Asian Internet sector is, broadly speaking, at the same stage of development as the U.S. about three to four years ago (slightly longer for developing Asia). For China.com, this translates into growth rates that are two to three times those expected for the company’s U.S. portal comparables in the medium term. Moreover, we believe that China.com is well positioned to capitalize on outstanding regional acquisition opportunities.

- China.com is a first mover in the Chinese-language portal space as well as being a first mover in terms of having a NASDAQ listing. This leaves the company well-positioned to emerge as the pre-eminent Chinese-language portal brand and gives the company an effective equity currency to consummate acquisitions and attract and retain key staff.

- There is currently a notable shortage of Chinese-language content in the Internet space, a shortage that we believe gives such content “proprietary” economic value. We believe that China.com’s current content partnerships, in addition to the company’s access to a stream of further content through leveraging its significant presence in the advertising network and web solutions business, will translate into structurally higher margins for the company over the medium term. Given that this additional potential upside, relative to the company’s U.S. peers, is not currently built into our forecasts, we believe that this factor gives further scope for upside to our forecasts and our valuation of the stock.

Business

We believe China.com is emerging as the leading Greater China and Asia-focused integrated portal operator. By integrated portal, we mean that the company delivers content, community products and commerce through the integration of its three business lines. It exploits the significant cross-business synergies that arise between the portal network of china.com, hongkong.com and taiwan.com, the 24/7 Media Asia advertising network and a Web solutions business which can be seen as an Asian hybrid of USWeb and Razorfish.

China.com’s business is expected to benefit from the explosive Internet growth opportunity apparent in Greater China and the wider Asia region. Notably, we forecast that Internet usage growth in mainland China will be towards the top of the global range. We estimate a 50% CAGR for the number of Internet users in mainland China between 1998 and 2002 and an Asian user CAGR of about 45% for the same period. This compares with a consensus forecast CAGR for the U.S. of 27% and 35% for Europe in the same period.

Integrated Approach is Favorable for Asia

We favor China.com’s integrated approach, with its multiple revenue streams, over a pure-play structure given the relatively nascent nature of online advertising, e-commerce and Web usage in Asia. We believe that an integrated approach should provide a higher, more consistent and more reliable growth profile (relative to a pure-play strategy) for the
company over the long term through a combination of the different growth profiles and financial contributions of each business over time. In particular, the integrated approach allows the company to enter markets and establish an early and leading strategic position through its synergistic model. In contrast, a business plan predicated on a single revenue stream may not justify entry on an attractive commercial basis.

**First Mover, Market Leader and Consolidator**

As the first integrated portal company in Asia to have a NASDAQ equity acquisition currency and an estimated net cash war chest of US$150 million, we believe that China.com is in a unique position to consolidate the advertising network and portal sectors in Asia.

Given the relatively nascent and capital-constrained nature of the Asian Internet sector, we anticipate China.com has the ability to consummate acquisitions at attractive take-out prices, similar to transactions seen in the U.S. three to four years ago.

On this basis, the company’s already aggressive attitude toward expansion through acquisition gives us comfort that our “organic expansion” base case for the company will prove to be conservative.

Based on recent discussions with management, we expect the company to consummate a number of value-accretive acquisitions in the near term.

**Aggressive Expansion Strategy**

China.com is currently implementing an aggressive pan-Asian expansion strategy through its 24/7 Asia advertising network. During 1H99, the company expanded into Japan, Singapore and Korea through acquisitions or joint ventures. China.com is targeting further expansion in 1999 in the U.S. (for Asia-focused sites), Taiwan, Australasia and the member countries of ASEAN in each of its three business lines.

**Regulatory Risks Minimized**

We believe that regulatory risks related to an Internet company’s operations in mainland China are reduced in the case of China.com as a result of the company’s close relationship with the mainland authorities. This relationship is evidenced by the presence of Xinhua, the official Chinese government news agency, as a significant shareholder in the company.

Although there have been suggestions recently of a possible ban on foreign investment in Internet content businesses targeted at mainland China, we do not view this type of development as likely. The detrimental effect such a policy would have on the development of the Internet in China would be contrary to the government’s oft-stated commitment to the rapid development of the industry. For a more detailed discussion of this issue in light of recent developments, please refer to page 21 of this report.

**Support From Strong Shareholders**

As China.com continues to execute its aggressive expansion and acquisition strategy going forward, the company will have the opportunity to leverage the significant experience, relationships and other resources of its strategic investor base. China.com’s strategic shareholders include AOL, 24/7 Media, Xinhua, NWI, LibertyOne, CMC Magnetics and Sun Microsystems.
Explosive Financial Growth Profile

We expect the company to experience explosive financial growth in the next five years. We forecast a CAGR in revenue of 108% for 1998-2003. We forecast China.com to break even in 2001.
China.com announced results for 2Q99 and 1H99 on August 19 that were significantly ahead of our forecasts.

- 1H99 revenue of US$4.02 million was 13% ahead of our expectations.
- Online advertising revenue, at US$1.1 million in 1H99, was 26% ahead of our forecast of US$0.88 million.
- Affiliated average daily page views were 30 million in June, 76% ahead of our forecast of 17 million.

A stream of acquisitions is expected in the short and medium term.

**Total Revenue**

1H99 revenue was US$4.02 million versus our forecast of US$3.56 million, 13% above expectations. 2Q99 revenue rose 50% quarter on quarter and 174% year on year.

Of the company’s total revenue in 1H99, online advertising revenue represented US$1.1 million versus our forecast of US$0.88 million, giving a total online advertising revenue figure that was a substantial 26% above our forecast. This impressive revenue contribution was primarily driven by two factors:

1. **Web usage growth in mainland China was significantly above expectations.** Internet user growth in mainland China has significantly exceeded forecasts, with the number of Web users at the end of 1H99 at approximately 4 million (compared with our forecast of 2.7 million and a December 1998 figure of 2.2 million).

2. **Significantly higher-than-forecast growth in affiliated page views.** Average affiliated page views for the company’s 24/7 advertising network in June 1999 were 30 million per day, 76% above our forecast of 17 million.

**Portal Network Page View Traffic**

Exiting month average page views on the company’s portal network for 2Q99 was 1.3 million, up from 1.0 million in 1Q99. These figures were in line with our forecasts, putting the company on track to achieve our 4Q99 forecast of 3.14 million average page views per day. This run-rate is important as it would put the company above the figures we forecast for each of Sina, Sohu, Neteaze and Netvigator in 4Q99.

**Blue-Chip Advertisers**

Advertisers on China.com’s portal and advertising network include many blue-chip global and local brands, such as: Compaq, Sony, HKTA, KLM, Mitsubishi, IBM, Sunday, AL-Vision, Jobsasia, CV Net and Ladbroke. In addition, the company gained a number of notable new advertisers on its portal and advertising network during 2Q99, including Microsoft and AT&T.

In our view, the company’s impressive and growing list of online advertisers provides further validation of China.com’s increasing brand presence and mind-share in the Asia Portal and online advertising space.
Web Solutions

Web solutions revenue for the company, at US$2.7 million in 1H99, was slightly ahead of our forecast of US$2.6 million. During 2Q99, the company’s web solutions business gained a number of new customers including: Cable & Wireless HKT, CGU Insurance, Dresdner RCM, Guardian Insurance, Cathay Pacific and Sun International.

China.com’s 2Q99 net loss (ex one-time gains and charges) was in line with our forecast at US$2.2 million.
China.com, as a leading Greater China and Asia-focused integrated portal provider, has three integrated business lines:

2. A pan-Asian Internet advertising network, 24/7 Media Asia, created in partnership with 24/7 Media of the U.S.

We believe that given the relatively embryonic stage of the development of web-based advertising in Asia, entry into the company’s chosen markets based on a pure-play advertising network or portal model would be difficult to justify on a similarly attractive commercial basis. Hence, we believe the company’s integrated approach is critical to China.com attaining early brand development, critical mass and other first-mover advantages.

We present a concise summary of the salient features of the company’s business model in the following pages. A more detailed and comprehensive analysis of the company’s business and strategy begins on page 23.

Figure 1: China.com
The “Integrated” Portal Strategy
1. The Portal Network


Business Model

Given the nature of the portal ad-commerce business model, we believe that the success of the company’s portal network depends on China.com’s successful maximization of targeted Internet “eyeball” traffic on its portal sites. By targeted we mean that this traffic must be channeled to specific content sites of interest, and preferred e-commerce and community sites.

The “Volume Effect”

By channeling traffic to sites that satisfy users’ specific needs, China.com is able to attract and retain users on its portal network and, as a result, increase the total number of page views on its portal sites (the “volume effect”). As a key metric in measuring performance of portal companies, the increased number of page views for China.com represents additional advertising dollar potential, which is a critical component of China.com’s revenue, earnings, cash flows and capital value. We forecast China.com’s average daily portal page views to increase from an estimated 600,000 in 4Q98 (800,000 average for 1Q99) to 3.1 million in 4Q99. By 2003, we cautiously forecast China.com’s average daily portal page views to total around 20 million.

The “Price Effect”

The provision of targeted content and community products facilitates the company’s ability to sell advertising directed at users with defined interests and specific demographic and geographical profiles. This ability to sell targeted advertising will be important in maintaining/enhancing the advertising rates that the company achieves for the sale of its page-view inventory (the “price effect”) against the backdrop of an increasingly competitive market environment in the coming years. Therefore, the targeting of page views is also an important part of China.com’s strategy to drive its financial and capital value.

The average advertising CPM (advertising rate per 1,000 page views) for the major U.S.-based portals currently runs at around US$20. Given the relatively early stage of the development of Web advertising in Asia, we have estimated that China.com will achieve an average CPM of US$10 for China.com, US$12 for Taiwan.com and US$13 for Hongkong.com. We have further assumed that these figures remain flat in the medium term. We believe our forecasts are cautious. From one standpoint, given the low barriers to entry, we do anticipate incremental competitive price pressures in the medium to long term. However, two factors should offset this:

• Upward pressure on advertising rates emanating from the increasing demand from advertisers to utilize the targeting functionality of Web advertising.
• China.com should benefit from the “popularity effect,” or advertising rate premium, that the perceived market leaders receive, as is currently the case in the U.S. market.
Portal Strategy

In order to accomplish the three goals of maximizing page-view volumes, maximizing advertising rates and driving higher margin revenue, each of the “three C’s” of portal provision — content, community and commerce — must be delivered effectively.

Content

The need for web users to be able to sort through the plethora of “junk sites” and so-called “background static” of the Internet heralded the birth of the portal concept in the U.S. This concept was pioneered by the major search and navigation sites that users now turn to, such as Yahoo! and Lycos. Content for China.com is arranged in a comprehensive set of “channels” that facilitate a user’s ability to locate content of interest quickly and easily.

China.com’s strategy to enhance its content offering is underscored by its participation in an increasing number of content alliances and co-branding alliances. The company currently has content alliances with Netscape, AOL, Yahoo!, Xinhua and Goyoyo (a premier Chinese-language search engine), among others. This range of content enables the company to attract a broad range of online users to its portal network. A user typically moves from a wide range of content choices displayed on the portal’s “front end” towards more specific content through a series of mouse “clicks.” It is at the specific content end of this clicking stream that China.com’s ability to sell targeted advertising is greatly enhanced.

Community

In order to enhance the loyalty of it users and to maximize traffic on its portals, the company’s strategy is to provide a comprehensive suite of community products. China.com currently offers free e-mail, chat rooms and message boards. The company plans to add personalization, free home pages and instant messaging to this list in 1999. While this suite of community products offers users a “home on the Web,” the registration process by which a user accesses these products allows China.com to collect valuable demographic and other data on its users, such as age, location, occupation and interests. In this way, community products arranged around a number of themes and specific subjects, as with content, not only enhance the value-added a user derives from China.com, but also provides an opportunity for China.com to sell highly targeted advertising.

Quality Over Quantity

Underpinning the importance of the community suite of products is our anticipation of a gradual change in focus for the major global portals. Looking to the current U.S. portal experience, we expect that an increasing focus will come from a de-emphasizing of total page-view inventory as a financial driver (given that current fill rates run at 15% to 30% for most major portals) and a shift in focus towards registered users and their page views.

Although headline registered user figures may need significant adjustments to reflect actual regular users, the point here is that, in a similar way to ISP subscribers, these registered users may be perceived as the steady customers which the portal can depend on for regular visits and page views. On this basis, once a user registers with an e-mail service, for example, that user then incurs a “switching cost” (although non-financial) to change to another portal. Registered users are increasingly valuable as a result of this “stickiness” (loyalty and propensity to return) as well as the fact that the portal provider typically has targeted information about the profiles of registered users that is gathered through the registration process, which facilitates highly targeted advertising sales.
In recognition of the importance of this theme in the U.S., a number of portals are wrapped around communities such as Globe.com, Geocities and WhoWhere (now part of Lycos).

**Commerce**

In our view, the creation of an electronic commerce platform and e-commerce content aggregation is an important part of the portfolio of services that China.com must offer. China.com’s strategy in e-commerce is to partner with merchants to integrate their products into the China.com Portal Network and to make these products available for online sales.

In the medium term, as e-commerce becomes increasingly accepted as a transaction medium in Greater China, we believe that China.com is well positioned as the market leader given its early moves in this area. The company is developing its e-commerce platform with leading e-commerce providers, including Intel, Intershop and CyberSource.

**High-Margin Revenue Generation**

With the China.com portal sites beginning to generate significant page views (peak page views of 1.3 million in the 2Q99), we believe that company will start to attract major e-commerce players as partners. We anticipate that these may include international players, such as the e-commerce companies Amazon.com, CDNow and Ebay, as well as local players. As we have seen in the U.S. market, we anticipate that China.com will be able to generate significant higher-margin revenues from these partnerships through these companies “sponsoring” certain sections of its portal sites. An example of this would be the integration of e-commerce content into the portals’ search functions, which would give search-topic related e-commerce links to chosen partners.

Starting in 2H97, most of the major U.S. full-service portals (i.e., Yahoo!, Excite, Lycos, Infoseek and Netscape) began consummating e-commerce relationships, which resulted in an incremental revenue contribution of about 20%-30% of total revenue by the end of 1H98. This revenue contribution is forecast to increase. Therefore, we forecast e-commerce-oriented revenue to make up a material portion of China.com’s total revenue in the medium to long term. Our forecasts cautiously indicate that E-commerce revenue will account for 8% of total revenue in 2000, rising to 15% in 2003.

**2. The Advertising Network**

China.com wholly owns and operates the 24/7 Asia advertising network business created in partnership with 24/7 Media of the U.S. Within this partnership, China.com has the exclusive right to use the 24/7 Media brand name, technology and business model. The geographical coverage of this partnership includes Greater China, the ASEAN nations, Australia, New Zealand, Korea and Japan. Currently, 24/7 Asia has more than 175 affiliated Web sites throughout Asia.

As the Greater China Internet user population grows in the coming years, China.com intends to piggy-back on the successful business model of 24/7 Media in the U.S. and leverage the relatively developed online advertising markets of Australasia and Japan. The business created on this basis will be used as a solid base for expansion throughout Greater China and much of the rest of Asia as the online advertising markets in these areas develop.
Business Model

The strategic goal of China.com’s advertising network is to maximize its share of online advertising expenditure in Asia. As with the portal paradigm, the business model for the advertising network calls for the maximization of page-view inventory (the volume effect) and advertisement targeting ability (the price effect). To accomplish this, China.com needs to sign up more affiliated Web sites — sites that allow China.com to sell their page view inventories to advertisers. The company then arranges its total affiliate page view inventory into notional “channels” driven by subject matter, user demographics and geographical profiles to facilitate the sale of targeted advertising.

By way of illustration of the dynamics of this business, we estimate that for every US$100 of advertising sold on affiliated sites, we would expect China.com to retain between US$35 and US$45 in the long term. These figures are broadly comparable with the consensus range for similar businesses in the U.S.

Regional Expansion Strategy

China.com is currently embarking on an aggressive regional expansion plan for its advertising network. To date, the company has established 24/7 Media Asia operations in China, Hong Kong, Taiwan, Japan, Singapore and Korea with plans to enter Australia and the U.S. (to target the Asian-American population) during 1999. Notably, the company’s recent entry into Japan, Korea and Singapore was the result of acquisitions made in each of these countries. Given the company’s track record of successful acquisitions, combined with the company’s continued focus on acquisitions in the region, we are increasingly confident that our forecasts, based on an organic expansion base case, could prove to be conservative.

While there are a number of competitors in the advertising network business in Asia, 24/7 Media Asia is currently the only Pan-Asian network that provides advertisers with the flexibility to target individual countries, multiple countries or global advertising, or a combination of these. We believe this ability to provide a local, regional or global advertising platform is a key unique selling point for the business, which should enhance the success of China.com’s business in this area.

3. The Web Solutions Business

China.com’s Web solutions business provides the full spectrum of Web strategy consulting products and services. These range from digital strategic consulting and creative design services to technology integration and online integrated marketing. The company also provides turnkey solutions for businesses that want to begin e-commerce operations.

China.com’s portal and advertising network businesses provide China.com with an impressive medium- to long-term growth profile. While accepting this, we believe the Web solutions business is critical in two aspects: (i) providing a steady stream of cash in the near term; and (ii) facilitating the growth of the portal and the advertising network. In our view, the Web solutions business should be viewed as the “glue” of the integrated portal. The Web solutions business offers content and editorial to the portal while offering advertising affiliates and potential advertisers to the advertising network. At the same time, the Web solutions business will likely help stimulate the growth of Web usage, e-commerce and online advertising across the region.

The Web solutions business currently operates in Hong Kong, China, Japan and Taiwan. We anticipate that as the company rolls out its advertising network across the region, the company will also roll out its Web solutions business to exploit the cross-business synergies that arise between the advertising network and the Web solutions businesses.
The Importance of Being an “Integrated” Portal

We use the term “integrated portal” to describe the integration of the company’s portal, advertising network and Web solutions business. In our view, China.com is able to offer a comprehensive range of products and services through the company’s joint development and marketing of these three integrated businesses. China.com’s clients include Internet users, online advertisers, Web-based enterprises and traditional off-line companies.

We also believe that there are a number of clear-cut opportunities for the company to leverage cross-business synergies, including the following:

- Web solutions’ clients represent potential affiliate sites for China.com’s advertising network.
- Web solutions’ clients and advertising network affiliates represents an attractive source of additional content for China.com’s portal sites.
- Web solutions; clients and advertising network affiliates represent a source of additional page-view traffic that can be directed to China.com’s portal sites.
- Web solutions clients and advertising network affiliates present a potential source of future e-commerce operators for China.com to partner with and aggregate on its portal network.

Developing the Market

We believe that given the embryonic nature of the Internet in Asia, it is important that China.com not only takes advantage of the growth of the market in the coming years but also plays a role in promoting the development of the market from which the company will inevitably benefit. China.com can help to achieve this through operating each of its three integrated business lines, with the most immediate stimulation of the market coming from the company’s Web solutions business.

Growth Profile and Revenue Mix

Moreover, given the rapidly growing number of Web users, e-commerce sites and online advertisers in Asia, we believe it is essential for the company to have an integrated strategy across a number of business lines. In adopting this approach, we think China.com will be able to realize impressive and relatively consistent growth in the long term through a combination of the different growth curves from its different business lines. As testament to this strategy, we forecast a total revenue CAGR of 108% between 1998 and 2003. In 1998, the great majority (78%) of revenue came from the Web solutions business. We forecast Web solutions business revenue to grow at 60% per year in 1998-2003. As the growth of the Web solutions business begins to taper off, we believe China.com’s advertising network and portal-generated revenue will make up the difference. As a result of these growth dynamics we expect these two businesses to contribute the majority of revenue over the medium term. We expect advertising and portal-generated revenues to account for 79% of the company’s total revenue line in five years time.

Broadly speaking, we believe that the integrated business approach used by China.com is preferable in strategic terms to pure-play operations in the Asian market. In particular, the integrated business model allows the company early market entry for its three businesses, on a revenue and cost sharing basis, whereas a stand-alone model for any one of these businesses may be significantly less commercially attractive.
We believe that the adoption of this dynamic integrated strategy means that China.com will be able to build on its current market leading position by facilitating the company’s ability to exploit its first-mover acquisition and branding advantages.

**Acquisition Opportunities Abound**

As was the experience in the U.S. about three to four years ago, we believe that there are currently a large number of cash-strapped Internet start-ups in Asia. In our view, a number of these start-ups would be prime acquisition targets for a strategically synergistic market leader. Therefore, we anticipate that the frenzy of M&A activity seen in the U.S. will be repeated in Asia in the coming months/years.

Notable among the first-mover/market leader advantages enjoyed by China.com is that, as a result of its successful NASDAQ listing in July 1999, the company is the first integrated portal operator in Asia to have an acquisition currency in the form of equity. We believe that China.com will use this substantial equity currency to build its business and expedite its growth.

In our view, as a market leader China.com is ideally positioned to enjoy the benefits of a potentially value-enhancing acquisition-led growth phase. The company is currently reviewing a number of acquisition opportunities to expedite its expansion strategy in Japan, Korea and Singapore and to further build on the company’s existing presence in these markets.
The rapid growth of Internet and PC penetration, the growth in the number of Internet users, the growing amount of time users spend on the Internet, and the increase in the number of Web sites is, broadly speaking, currently driving (and being driven by) two main categories of business model:

1. The subscription business model — primarily related to the provision of Internet access by so-called Internet Service Providers (ISPs).

2. The proliferation of content-based commercial models related to a growing acceptance of the Internet as:
   - An advertising medium.
   - A product and service distribution channel.
   - An entertainment medium.
   - An information resource.

Business models in this category are driven by either a transaction model (e.g.: Amazon.com or CDNow), an advertising revenue model or a combination of the two (e.g.: Yahoo!, Excite and MarketWatch.com).

Advertising

Advertisers are increasingly identifying the Internet as a highly effective medium for the communication of an advertising message. In some ways, Internet advertising is similar to the use of advertising in traditional media such as broadcasting and print publishing, given the large audience. While accepting this, we believe the Internet is differentiated from traditional media by the fact that it can be used as a highly focused advertising and communication medium with interactive capabilities, attributes which are absent from the traditional media.

The “focusing” ability of Internet advertising is critical to our expectation of rapid growth and the proliferation of the Internet as a broadly accepted advertising medium. In our view, this “focusing” quality has positive implications for both advertising volume growth and advertising prices (on a CPM or other basis) in the coming years. From this perspective, we believe the Internet has a number of defining characteristics vis-à-vis traditional advertising media:

1. The Internet allows advertisers to present messages to specific, targeted audiences. In part, this is due to the rapid development of ad-serving technologies that interface with the functionality of the Internet to allow targeting of “eyeballs”/page views around specific demographic, geographic and Internet domain profiles.

2. The nature of the Internet enables users to interact with advertising information presented in Web pages, leading to greater impact and recall rates.

3. The “point-to-point” nature of the Internet allows advertisers to measure precisely the number of advertisement impressions, or the number of times that an advertisement appears in page views downloaded by users, through verification by an independent third party auditor.

4. Advertisers can measure the effectiveness of advertising in generating “click-throughs.” The term “click throughs” in this context relates to user requests for additional information made by clicking on advertisers’ banners which link the user to advertisers’ Web sites.

5. Where advertising is linked to e-commerce sites/services, advertisers can quantify the number of users arriving from a particular advertisement and the amount of sales generated by these users. Therefore, this allows advertisers to quantify the efficacy of their advertising through such measures as the revenue generated per dollar of advertising cost for different online advertising strategies.
In the future, we envisage that the following factors will increase the functionality of Internet advertising and make the Internet an increasingly attractive advertising medium:

- **Increasing Penetration.** Continued rapid growth of Internet penetration globally will increase the number of people and potential customer segments represented on the Internet.

- **Increasing Access Speeds.** Internet pages will be able to be downloaded to users’ computers much more quickly as a result of increases in transmission bandwidth and higher-speed Internet connections for users via leased lines, broadband access and third-generation wireless technology.

- **Content Technology Evolution.** Wider adoption of advanced content delivery technologies for the Internet, such as Java, VRML and other interactive-multimedia enabling technologies, will increase the utility and attractiveness of Internet content.

- **Third Generation Wireless Technology.** We expect wireless data and Internet applications to play an increasingly important role in fundamentally evolving the nature and use of the Internet into an immediate resource for mobile users.

- **Convergence of PC and Television Technologies and Products.** This trend is expected to increase significantly the number of Internet-capable devices and evolve the nature of content, user demands and commercial models adopted on the Internet.

### Market Size and Growth

Expenditure on television, newspaper and magazine advertising in Asia, including Japan, in 1997 was approximately US$47 billion. In 1998, expenditure on television, newspaper and magazine advertising in China, Hong Kong and Taiwan was US$5.3 billion, US$2.5 billion and US$2.5 billion, respectively, representing a 45%, 3% and 19% increase over 1997 despite the economic difficulties experienced in the region.

Although online advertising currently represents a small percentage of overall global advertising expenditures, we expect that the broader acceptance of the Internet as an advertising medium will significantly increase online advertising expenditures both globally and in Asia.

### E-Commerce

The Internet is already having a significant impact on the methods by which consumers and businesses evaluate and buy goods and services. From the Web-merchant standpoint, the Internet provides the potential to reach a global audience and to operate with minimal infrastructure costs and reduced overheads. From a customer standpoint, the Internet offers the potential (compared with the traditional “bricks and mortar” companies) for a broader selection of goods and services, lower prices and greater convenience.

### Market Size and Growth

In 1998, IDC estimated the total amount e-commerce revenue generated worldwide at US$32.4 billion. IDC estimates that global e-commerce revenue will grow at a CAGR of more than 100% in the next three years and to exceed US$425 billion in 2002. In 1998, e-commerce revenue in China, Hong Kong and Taiwan was estimated to be US$8 million, US$61 million, and US$45 million, respectively. IDC projects that e-commerce in China, Hong Kong and Taiwan will grow at a CAGR of 243%, 109% and 129%, respectively, reaching approximately US$3.8 billion, US$2.4 billion and US$2.8 billion, respectively, by 2003.


Entertainment

The Internet is becoming increasingly popular as an entertainment medium. Through the wide array of content offerings available, Internet users are able to view photographs, videos, listen to music, play interactive real-time games with third parties and communicate with others.

Information Source

New Web-based authoring software tools have lowered the cost of publishing content on the Web relative to conventional publishing methods. In addition, the proliferation of “community” and “personalization” products by portals and other Web companies has reduced the cost and increased the ease with which individuals and organizations can create their own Web pages. The Internet also provides a forum where content can be specifically targeted at distinct user groups (see above) as well as being more interactive compared with traditional media, stimulating the amount of content posted on the Web.
THE INTERNET IN MAINLAND CHINA

A recent reorganization of government departments in China resulted in the creation of a new ministry, the Ministry of Information Industry, which has taken over the responsibilities of the former Ministry of Posts and Telecommunication and the Ministry of Electronics. The development of the Internet in mainland China falls within the new ministry’s sphere of responsibility.

Access to the Internet outside mainland China by China’s domestic networks is accomplished by way of a backbone of largely separate national interconnecting networks that own and operate gateways to the Internet outside mainland China. The current interconnection networks are:

- ChinaNet, China’s primary commercial network, owned by the Ministry of Information Industry.
- The Golden Bridge Network, a smaller, competing commercial network owned by Jitong Corporation.
- The China Science and Technology Network, a high-technology research network owned by the Chinese Academy of Science.
- The China Educational and Research Network, owned by the Ministry of Education, which links academic and learning institutions in the country.

ChinaNet offers access to a nationwide Intranet with local content in Mandarin and other Chinese dialects and restricted access to the Web. Of China’s 31 provinces, about 25 offer dial-up services. ChinaNet’s “163” dial-up service automatically routes an Internet dial-in call to the closest POP (point of Internet network presence) in that province. China is also building a “169” network, which is designed to offer fast Internet access and other broadband applications.

Despite the rapid increase in Internet usage in China in the past two years, we assess that there are currently seven key bottlenecks constraining even faster growth and the development of Internet access and Internet-related services in China, as detailed below. Notably, points one to four below are related to the telephony market:

1. A lack of competition in the provision of telephony services.
2. Antiquated last-mile networks.
3. Long waiting lists for leased-line provision from China Telecom or China Unicom.
4. Poor coordination between regional Posts and Telecommunications Administrations, digital data networks and ISP departments within and between provinces.
5. Governmental restrictions on Web access.
6. The current lack of local content.
7. From an e-commerce perspective, there is an additional constraint surrounding the lack of credit card availability in mainland China.

Moreover, usage costs for Internet users in mainland China are relatively high, there is a preponderance of multi-user Internet terminals in businesses and cyber-cafes and access speeds remain constrained.

There are a number of independent Internet Service Providers in China. However, these companies have marginal market shares, partly due to the difficulties they experience in leasing digital trunk lines.

With regard to access technologies, the number of ISDN (integrated services digital network) subscribers in China remains small. While various cable modem trials are ongoing, at present there are only 2,000 cable modems installed in the country.
Regulation

China has enacted regulations governing Internet access and the distribution of news and other information. Xinhua, the official government news agency, which has exclusive regulatory authority over foreign news agencies and their subsidiary information networks in China, has published detailed regulations. These regulations subject online information providers to potential liability for the content included on their portals and the actions of subscribers and others using their systems. The scope of this liability extends to the possibility of violating Chinese laws prohibiting the distribution of content which is deemed to be socially destabilizing.

Periodically, the Chinese government has taken action to stop the distribution of information on the Internet which the government believes may be socially destabilizing. Recent examples of this type of action include:

- The use of firewall technology to prevent Internet users in China from viewing a number of sites hosted outside China.
- The criminal prosecution of people in mainland China involved in the distribution of e-mail to Chinese nationals containing material critical of the Chinese government.
- The closure of Internet forums maintained within mainland China where users have discussed political and other issues deemed sensitive by the Chinese government.

The Chinese government has also expressed its intention to closely control possible new areas of business presented by the Internet, such as Internet telephony.

The Chinese government also regulates access to the Internet by imposing strict licensing requirements and requires ISPs in China to use the international inbound and outbound backbones provided or authorized by the Ministry of Information Industry.

Growth Catalysts for the Mainland China Market

To date, while accepting that there have been a number of constraints on the growth of internet usage in mainland China, we believe that there are three clear catalysts that will drive explosive growth of the Internet in China in the coming months and years as follows:

1. Official Prioritization of Internet Development

The Chinese government has prioritized the growth of the Internet as being critical to the global competitiveness of the Chinese economy and as a means to increase the efficiency of the public sector. As a symbol of the importance attached by the authorities to the development of the Internet, 1999 was declared the “year of the Internet” in China.

An example of the official importance of the development of the Internet would be the evolution of the “E-Government” initiative, which involves moving many of the government’s administrative functions onto the Web. These Web-based processes include applications for driving licenses and passports and the dissemination of official information.

We anticipate that China.com will play a key role in designing, developing and implementing the E-Government strategy. Potentially, the company could also provide hosting, marketing and maintenance services for the E-Government sites.
Technology to Leapfrog to Web TV

Although we estimate that household PC penetration in China is currently about 15% in the major metropolitan areas, we anticipate that Internet access technology in China will leapfrog from being primarily PC-based to being PC and television based.

Household color television penetration in the major metropolitan areas and the three wealthiest provinces of Guangdong, Zhejiang and Jiangsu is currently close to 100%. Already, a number of domestic equipment manufacturers are offering set-top boxes to facilitate TV Internet access for less than US$50 per unit. Moreover, global technology companies, such as Intel and Microsoft, have been driving the global development of television-based Internet products.

Official Prioritization of the Development of Telephony Infrastructure

China has witnessed rapid growth in its telephony infrastructure in the past five years with the addition of an average of 19 million wireline subscribers per year, which has pushed wireline penetration from 1.4% in 1993 to 8.7% in 1998.

The wireless market has experienced equally impressive growth, with the number of wireless subscribers growing by more than 90% in each of the past three years. In addition, we anticipate the stimulation of further growth as a result of increased competition, initially from China Unicom and eventually from a multi-player environment.

Cellular ARPs in mainland China remain high by global standards at more than US$50 per subscriber per month.

We see the growth of the telephony sector in mainland China as being important for the growth of the Internet sector for three main reasons:

1. Since the authorities prioritized the development of the telecom sector in the early 1990s the results have been impressive, with the number of line additions each year being the equivalent of the creation of one U.S. RBOC. We believe this bodes well for the growth of Internet infrastructure, services and usage in mainland China given that the Internet has received an even higher level of prioritization from the authorities this year.

2. In the absence of reliable income distribution data for mainland China, we view cellular subscriber growth and ARPs as interesting proxies for the affordability of Internet access and services. We think these metrics could be a gauge of the propensity of the mainland China market to embrace new technology. On this basis, the relatively high levels of growth and ARPs seen for the cellular product bode well for the growth of the Internet sector in mainland China.

3. The rapid rollout of wireline infrastructure, cellular infrastructure and the increase in competition in the telecom sector will increase the size of the addressable market, increase the speed and reliability of Internet access and put downward pressure on the price of access to the Internet. In turn, we anticipate that these factors will provide a significant catalyst for the growth of Internet access, online advertising and e-commerce in mainland China.
China.com

We believe that the provision of Internet services in China carries with it a higher regulatory risk than, for example, the provision of similar services in the U.S. or Europe. In our view, the higher risk is outweighed by the superior growth opportunity offered by the mainland China market given the 50% CAGR we estimate for the number of Internet users in mainland China between 1998 and 2002. This compares to a consensus growth forecast for the U.S. of 25% in the same period.

In the case of China.com, we believe that the regulatory risks are reduced as a result of Xinhua’s 11% stake and the company’s strong relationships with other official bodies in mainland China. As a result of these relationships, China.com is often apprised of the government’s Internet-related regulations in a more efficient manner than may be the case for other companies in the market. From this standpoint, we assess that China.com has a clear advantage over many of its rivals.

Restrictions on Participation in Internet Content Unlikely

Recently, a number of media sources reported comments by Wu Jichuan, the Chinese Minister of Information Industry, where Mr. Wu allegedly stated that foreign participation in the ownership of mainland ISP’s and Chinese Internet content providers was prohibited.

As far as ISPs are concerned, we were not surprised by the news given the direct relationship between an ISP and telecommunications infrastructure owners/operators, as well as the ease with which this ruling could be enforced given the “local” nature of an ISP’s activities (these companies must typically be based on the mainland).

However, in the Internet content area, which is the area of relevance for China.com, we do not view a bar on foreign ownership of mainland China-focused Internet content as likely for the following reasons:

1. We assess that mainland authorities see the development of the Internet as critical to China’s economic growth and development. As such, we believe that regulations that serve to stymie the development of the Internet in China would prove to be unpalatable to the mainland authorities. We believe that given the nature of the Internet, enforcement of such a regulation would effectively mean barring the multitude of Internet sites, based on servers around the world, from being accessed by mainland Internet users. We think this would ultimately have the effect of reducing the amount of local-language Internet content available to Internet users in mainland China by more than 65%, a development that would significantly slow the growth of Internet usage in the country.

2. Implementation of such a policy, in our view, would be extremely difficult, if not impossible without effectively cutting off mainland China from the World Wide Web. On this basis, the Internet in China would be reduced to a national intranet. We do not believe that this option is under realistic consideration by the authorities.

3. It is not clear that the MII has full responsibility for regulating the Internet content sector in China, nor is it clear that Mr. Wu is speaking with the full authority of a government hierarchy that we believe would like to see China more fully integrated into the international economic and IT community.

Consequently, we view the situation as unlikely to develop in a way that would significantly threaten China.com’s business. In addition, given Xinhua’s 11% stake in the company, China.com enjoys the support of strong relationship with the China’s official news agency.
As a result, even under a worst-case scenario, where mainland China did take steps to block access to particular content providers, we believe that China.com would be able to continue to operate its business unfettered given the official sanction of the company that the Xinhua stake implies.

Our position that China.com’s business was safe from the threat of a more restrictive regulatory regime was supported by comments which later emerged from Mr. Wu’s own ministry that the Internet market in China would be made ‘more open and more standardized’. According to official sources, the MII is currently drafting new regulations on the Internet to be promulgated by the end of this year.

We view this statement as an attempt by the Chinese authorities to correct the negative perceptions that may have been created by earlier reportage that foreign investment in China’s burgeoning Internet industry was prohibited.

**Official Media Praise Role of Foreign Investment**

Moreover, the importance of the Internet to the development of China’s economy was explicitly recognized by a spate of articles which appeared in the official press in the days after Mr. Wu’s alleged comments enthusing about the Internet and praising the role of foreign investment in stimulating the growth of the Internet sector in China.

For example, the *Beijing Evening News*, a paper published by the Communist Party’s Beijing branch, stated that the value of the mainland Internet market would reach RMB10 billion (around US$1.2 billion) in 1999 and would triple in size in the next few years. The paper also noted that Internet industry leaders would be in Shanghai at the end of September to attend a forum organized by *Fortune* magazine. Among those attending are the CEOs of Yahoo! and America Online.

In another article, the *Beijing Youth Daily*, which is published by the Communist Youth League, praised the contribution of foreign investment to the development of the mainland Internet sector. The article said that the market would not have grown at such a rapid pace without foreign involvement. The article also pointed out that when the existing regulations (referred to by Mr. Wu) were drawn up in 1993, there was no such concept as an Internet Content Provider, or ICP.

The implication of these articles is that Mr. Wu’s alleged comments were out of synch with the views of other important power centers in China. We believe the appearance of such articles in the official press supports our view that Mr. Wu’s comments did not necessarily reflect the views of those further up the decision-making tree in mainland China. It is also important to note that Mr. Wu’s alleged comments did not appear in the local press, despite the great interest generated outside China by the report.
China.com’s Portal Network is organized around the “three Cs” that we believe are critical to the success of any Internet portal: content, community and commerce. Successful execution of the “three Cs” would be expected to enhance the company’s business in the following ways:

1. Maximize Page-View/“Eyeball” Traffic (the Volume Effect)

Effectively combining the three Cs creates a variety of online products and services that enhance the attractiveness of a site to Internet users as a one-stop shop for satisfying most of a user’s internet needs. This is likely to increase traffic, generate page views and, as a result, increase advertising inventory, revenue and cash flow.

2. Maximize Advertising Rates (the Price Effect)

By adding content, community and commerce channels around specific subjects, China.com creates not only a richer variety of content for users (and increased popularity for the site), but also engenders opportunities for higher impact advertising that could lead to higher advertising prices and revenue. From an advertising standpoint, the development of communities targeted at specific topics/subjects allows China.com to sell advertising aimed at a targeted audience. This type of targeted advertising commands higher rates.

To illustrate this point, we have compared advertising rates for specifically targeted “eyeballs” versus “Run-of-Network” (RON) advertising, (i.e., advertisements that appear in sequence regardless of who is accessing the site and what pages are being viewed). At present, RON rates for China.com and for other portal providers around the world are currently about US$5-US$7 CPM (advertising rate per thousand page views) compared with targeted advertising rates of up to US$100 CPM.

Figure 2: China.com
The "Three C’s" of Portal Provision

Source: Company data.
3. Generate Higher-Margin Revenue

By integrating e-commerce content into the company’s portal functionality through sponsorship by e-commerce companies or other agreements (e.g. search topic-related e-commerce links), the company should be able to lever incremental e-commerce/transaction-oriented revenue. This type of revenue carries a significantly higher margin than traditional advertising revenue.

Most of the major U.S. full-service portals (e.g.: Yahoo!, Excite, Lycos, Infoseek and Netscape) consummated e-commerce relationships starting in 2H97 that resulted in an incremental revenue contribution of about 20%-30% of total revenue by the end of 1H98. These revenue contributions are forecast to increase in time. In the case of China.com, we forecast this e-commerce oriented revenue to make up a material portion of total revenue in the medium to long term. Our forecasts, which we consider to be cautious, call for e-commerce revenue to make up 8% of total revenue in 2000, rising to 15% in 2003.

China.com aims to provide a one-stop gateway to the Internet that aggregates, organizes and delivers information to users who are interested in localized Greater China content and services. This localized content is delivered through the company’s network of four portals — china.com, hongkong.com, taiwan.com and cww (China Wide Web). We have described below the three portals that we believe are the most representative of the company’s strategy.

**www.china.com**

china.com is the company’s primary portal for content, community and commerce products and services offered in English and simplified Chinese characters. This site offers:

- Search engines.
- A directory of Chinese-language sites.
- Electronic commerce (e-commerce) infrastructure capabilities.
- Other news and information from China and abroad via a number of content channels.

Through its editorial team and its content partnerships, China.com offers a broad range of localized information on news, travel, finance, business, sports, technology and entertainment. It also provides value-added community services including free e-mail, chat, message board, home pages and city guide services. In the near future, the company plans to offer personalization and free home pages.

**www.hongkong.com**

This site is based on the www.china.com site with similar products and services in traditional Chinese characters and English. hongkong.com also provides local Hong Kong content, such as the City Guide that provides detailed information on Hong Kong’s movies, restaurants, arts, sports and music. A forum for local interaction with other users is also offered through Hongkong.com’s community services.

**www.taiwan.com**

taiwan.com is modeled on the www.china.com and www.hongkong.com sites and offers similar services that are customized around a Taiwan theme.
**THE THREE “Cs”**

1: CONTENT SERVICES

**Content Partnerships**

Within its portal sites, which act as a destination for identifying, selecting and accessing services, content and information on the Web, China.com currently has a number of content alliances/partnerships. The basis for each alliance tends to be a combination of China.com’s licensing of content or technology combined with revenue sharing arrangements. China.com’s partners on this basis include some of the world’s leading news and information providers, including Xinhua, Agence France Presse, Bloomberg, Reuters, Dun & Bradstreet, Nikkei, Central News Agency, Thomson First Call and The Financial Times.

An example of the use of content alliances would be China.com’s integration of Reuters content with its CityGuide information product. China.com sells Reuters’ advertising inventory through its advertising network. In return, Reuters provides China.com with Asian news content. Another example would be the alliance with Bloomberg that provides China.com with its financial news in exchange for developing the Bloomberg brand and profile in China.

**Xinhua News Agency Relationship**

Xinhua is the official Chinese government news agency and employs more than 7,000 journalists and managerial personnel. Xinhua controls access to foreign news sources disseminated in China. Xinhua also provides regularly updated news and information through its communications and dispatch networks, satellite transmission networks and via the Internet to both print and electronic media in more than 130 countries.

As well as being a major shareholder in China.com, Xinhua and China.com have a strategic alliance which gives China.com access to Xinhua’s business-related content and translation services. The company also benefits from Xinhua’s expertise and involvement in the Internet regulatory regime in China.

**Co-Branded Search and Navigation Strategic Alliances**

To enhance the attractiveness (“and stickiness) of China.com’s portals, the company has a number of co-branded search and navigation alliances with global Internet companies, including:

- **America Online:** China.com provides links from its portals to localized sites provided by AOL. This gives China.com users access to one of the world’s largest online communities. In return, China.com provides AOL subscribers with its targeted Greater China portfolio of portal services. AOL is a major shareholder in China.com (with an 8% equity interest). In addition, as a strategic partner, AOL drives traffic to China.com’s portal network and contributes technological expertise.

- **Netscape:** China.com will host, manage and produce the Chinese language version of specific Netscape services such as Netscape Guide and NetSearch. Both services are provided in Chinese to users of China.com’s portal network. The Netscape Guide by China.com is a Chinese-language directory, listings and navigational service. Netscape Search by China.com is an Internet-based search utility for topical content and information.

- **Yahoo!** China.com currently provides Yahoo! with a co-branded Chinese-language news channel. China.com’s offering of Yahoo! as one of its Chinese-language search services featured on NetGuide, NetSearch and its portal home pages should drive increased traffic to China.com’s sites given the power of the Yahoo! brand name.
- **Goyoyo**: China.com has a strategic alliance with Goyoyo whereby Goyoyo provides search and navigation functionality in both simplified and traditional Chinese characters. In return, Goyoyo receives traffic-flow from the China.com portal sites.

### Channels

China.com, like other major portals, offers a portfolio of content channels aimed at providing users with the most efficient way to explore targeted content across a number of popular categories.

Figure 3 details each of China.com’s current channel offerings, content partners currently associated with each channel, and potential channel partners with whom the company is currently in discussions.

Each channel contains a topical news briefing and hypertext links to sites that allow users to find relevant information quickly. For example, CityGuide, which is offered on the China.com portal, offers details on movies, restaurants, entertainment and other information for the major cities of the Greater China region.

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**Figure 3: China.com**

### Current Channel Offerings

<table>
<thead>
<tr>
<th>Channel</th>
<th>Content Partners</th>
<th>Potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>News</td>
<td>Xinhua, Wiser’s, Reuters, Bloomberg</td>
<td>NA</td>
</tr>
<tr>
<td>Sports</td>
<td>AFP, Xinhua</td>
<td>NA</td>
</tr>
<tr>
<td>Technology</td>
<td>Hongkong.cnet.com, Ming Pao Hi-Tech Weekly, User Weekly, Hyper PC Player, Helix, Infocon, Chung Hwa Bookstore, O'Reilly (Publisher), Newell PR, Euan Barty Associates (EBA)</td>
<td>Xers, User Weekly, Hyper PC Player, Helix, Infocon, Chung Hwa Bookstore, O'Reilly (Publisher), Newell PR, Euan Barty Associates (EBA)</td>
</tr>
<tr>
<td>Entertainment</td>
<td>Cable TV, Edko, Broadway Cinematheque, Cine-art House, Gala, Newport, Panasia, Warner Brothers, UA, Arts Center, The Royal Garden, Hotel Concourse, Furama Hotel, The Peninsula, The Kowloon Hotel, Holiday Inn, Hotel Nikko, The Hongkong Hotel, Regal Kowloon Hotel, Regal Kai Tak Hotel</td>
<td>Men's Magazine, Express Weekly, Yongder Hall Group</td>
</tr>
<tr>
<td>Love</td>
<td>LoveMatch Taiwan</td>
<td>Dotlove.com</td>
</tr>
<tr>
<td>Travel</td>
<td>China Travel Services (CTS), Ananda Travel, Korean National Tourism Organization (KNTO)</td>
<td>NA</td>
</tr>
<tr>
<td>Finance</td>
<td>ii-Asia, Mansion House</td>
<td>NA</td>
</tr>
<tr>
<td>Government</td>
<td>NA</td>
<td>HK Government Information Center</td>
</tr>
<tr>
<td>Business</td>
<td>Sun Magazine, JobsDB, Sinotrade, Xenon Money Xchanger, PR Newswire</td>
<td>NA</td>
</tr>
<tr>
<td>Weather</td>
<td>Accuweather</td>
<td>NA</td>
</tr>
<tr>
<td>CityGuide</td>
<td>Hong Kong Theatres Associations (movie)</td>
<td>Hong Kong Tourist Association</td>
</tr>
<tr>
<td></td>
<td>- Chinesebook Cyberstore (book section)</td>
<td>- City Entertainment</td>
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<tr>
<td></td>
<td>- Communication Management Ltd</td>
<td>- Communication Management Ltd</td>
</tr>
<tr>
<td>Style</td>
<td>NA</td>
<td>Communication Management Ltd</td>
</tr>
<tr>
<td>Search</td>
<td>Goyoyo, Yahoo!</td>
<td>NA</td>
</tr>
</tbody>
</table>

Source: Company data, Lehman Brothers.
Special Event Sites

In addition to China.com’s ongoing channel offerings, the company provides specific channels or sites about key sporting and cultural events. An example of this was the Hong Kong handover site that provided information relating to news and events during the period before and after the return of Hong Kong to Chinese sovereignty on July 1, 1997.

Other examples include the range of sites relating to the 1998 World Cup and Asian Games that provided continuously updated exclusive information on results and league tables, news, as well as feature stories and pictures.

Given the company’s leadership position in the Greater China market, China.com has been successful in garnering support and sponsorship for its special event sites from corporations seeking exposure to the Greater China market. For example, the company received sponsorship from McDonalds for its 1998 World Cup site, which was the first time McDonalds had engaged in Web advertising on any site apart from its own.

Recently, China.com announced an agreement with Agence France-Presse to launch a Chinese language Olympic Games Web site on the China.com portal network. The next Olympic Games will be held next year in Sydney, Australia.

User Loyalty and Brand Recognition

Online communities are groups of Internet users congregated around specific topics or areas of interest in such a way that the users actively contribute to the dialogue, entertainment and content within the community. In our view, these products and services are becoming increasingly important in terms of a portal’s ability to enhance its brands and generate user loyalty against a backdrop of increasing competition.

Community-related products provided by the major U.S. portals include personalization of portal pages, free e-mail, message boards, chat rooms, news/discussion groups and free personal Web/home pages. These are often segmented into topical communities of personal Web sites such as Geocities’ “homesteaders” and Tripod’s “pods.”

In order for China.com to enhance the loyalty of its users and to maximize traffic on its portals, the company has adopted a strategy to provide a comprehensive suite of community products. China.com currently offers free e-mail, chat rooms and message boards. The company plans to add personalization, free home pages and instant messaging to this list by the end of 1999. The corollary of an effective community offering from China.com should be the development of an active and loyal user base where users frequently return to the portal site.

Community products grouped around a range of themes and specific subjects, as with content, not only increase the amount of value-added users derive from China.com, but also provide an enhanced opportunity for targeted advertising sales.

The Importance of “Stickiness”

Underpinning the importance of the community suite of products is our anticipation of a gradual change in focus for the major global portals. Looking to the current U.S. portal experience, we expect that there will be a continued de-emphasizing of total page-view inventory as a financial driver in favor of the maximization of targeted page-view inventory. Reflecting this, we see current U.S.-based portal fill rates at between 15%
and 30%, with a specific focus on increasing registered users and the number of page views generated by them.

Although headline registered user figures may need significant adjustment to arrive at a number for the actual amount of regular users, the key point is that, in a similar way to ISP subscribers, these registered users may be perceived as the steady customers on which a portal can depend for regular visits and page views. On this basis, once a user registers to an e-mail service, for example, that user then incurs a switching cost (although non-financial) to change to another portal/e-mail provider. We believe that registered users are being seen as increasingly valuable because of two key characteristics:

- Their “stickiness” or loyalty and propensity to return. Registered users represent a secure stream of inventory and revenue.
- The portal operator typically holds detailed information about the profile of its users gathered through the registration process, which facilitates highly targeted advertising and enhances the advertising rates that can be achieved.

As a function of these attractive characteristics, a number of U.S. portals are wrapped around such communities. Examples include Globe.com, Geocities and WhoWhere (now part of Lycos).

**China.com’s Community Products**

Online community products currently or soon to be provided by China.com include the following:

**Free E-mail**

China.com offers users a free personalized Web-based e-mail account, known as Freemail, that can be accessed from any computer with an Internet connection. Freemail has the advantage that users do not need a new e-mail addresses if they change their Internet Service Provider (ISP). China.com launched this service in June 1998, six months ahead of schedule, and by the end of July 1999 had a registered user base of 500,000 users.

**Message Boards**

China.com offers users the ability to post messages for general viewing by other users of the China.com portal sites, as well as the ability to facilitate dialogue on specific topics of interest among China.com users.

**Chat**

Chat creates a “virtual community” through which a participant can interact in a real-time group or in a one-on-one discussion. As with other major portals, China.com’s chat rooms are arranged around multiple topics of interest including romance, entertainment, sports and current events. Chat is generally regarded as one of the most popular community products/services offered by portal providers. As such, chat has become, for many Internet users, an integral part of their social lives, a factor that serves to enhance portal brand loyalty and targeted page-view numbers.

**Personalization**

In 1Q00 China.com plans to offer users the ability to personalize its portal pages according to users’ individual preferences and specifications, greatly enhancing user satisfaction. Once personalized, the portal will automatically deliver an array of specified content including news, weather, stock quotes and sports results.
By tailoring portals to individual preferences, personalization enhances the portal product by eliminating unwanted information and directing the most relevant information to a user’s own version of the China.com portal. Personalization is seen by other major portal companies around the world as an effective way of increasing customer/user loyalty to the portal brand, thus leading increased page views and, ultimately, higher advertising rates, margins and cash flows for the portal operator.

Homepage Builder
China.com intends to offer its users a simple, non-technical method of creating Chinese-language homepages hosted on the China.com portal network through the utilization of a variety of publishing tools provided by China.com. The company also intends to create “virtual communities” based on particular topics by segmenting these homepages into interest-based sub-communities. Creating this “home on the Internet” is a popular concept that has given rise to many of the most popular U.S. Web sites, such as Globe.com and Geocities. These services should also create additional content for China.com’s portal network, which we believe will increase traffic, user loyalty and the ability to sell targeted advertising inventory.

Instant Messaging
In the near future, China.com plans to roll out another value-added service that will alert a user to the fact that another specified user is also online. In this way, users are provided with the option to choose to participate in real-time dialogue. This service will be an extension of China.com’s online communication services such as e-mail and chat.

The Three “Cs”

3: E-COMMERCE

Importance
In our view, the creation of an electronic commerce platform and e-commerce content aggregation is an important part of the portfolio of services that China.com offers/will offer. China.com’s strategy in e-commerce has been, and will continue to be, one of partnerships with merchants to integrate their products into the China.com portal and Web solutions network, thus making them available for online sales and distribution.

Currently, e-commerce is at a much earlier stage of development in Greater China relative to the U.S. The low level of development of e-commerce in Greater China is primarily due to the difficulty in securing “impulse” online payment since credit cards are not commonly accepted, used or available in mainland China. However, we believe in the long term, with the increase in credit card usage and the development of other means of making online payments, e-commerce will generate significant revenue.

The relative absence of e-commerce in Greater China, combined with the fact that China.com is one of the first providers of e-commerce services in the market, should allow the company to brand itself as a market leader through the provision of the following services:

InterMerchant
China.com is a development and marketing partner (with Intel) for InterMerchant software InterMerchant is an E-Commerce software product that enables small and medium-sized enterprises to increase their presence on the Internet. InterMerchant allows users to create Web pages quickly and easily. The software also features inventory management functions to improve business efficiency. It also provides functionality to help businesses launch and manage an online ordering capability.
InterShop Communications Inc.

InterShop develops and distributes e-commerce software that integrates storefront creation tools, business management tools and hosting capabilities. InterShop’s technology enables merchants, developers, Web designers and hosts to use the business, creative and performance potential of e-commerce to enhance their businesses. China.com is an authorized InterShop solutions provider. This product provides the structure for some of the company’s strategic recommendations to clients who want to use the Web as a business tool, in addition to facilitating the implementation of these recommendations.

CyberSource Corporation

China.com also has a strategic partnership with CyberSource to deliver e-commerce services to Internet merchants in Asia that provide secure, real-time multi-currency transaction processing. These services offer important e-commerce facilitating infrastructure such as payment processing, fraud screening and order-fulfillment messaging.

PORTAL MARKETING

China.com’s marketing goal is to make the china.com, hongkong.com, taiwan.com and cww brands synonymous with the Chinese-language Internet space. To accomplish this goal, the company makes use of the following marketing vehicles:

1. The placement of advertisements in traditional media such as: newspapers, television, radio and magazines. China.com recently began a TV advertising campaign in Hong Kong, which should also reach people in neighboring Guangdong Province (total population 70 million) who receive Hong Kong TV.
2. The placement of online banner advertisements.
3. Marketing via targeted e-mail.
4. Having a presence at trade shows.
5. The encouragement of editorial pieces in industry publications.
6. Well-positioned China.com links on Web sites operated by China.com’s content partners, including America Online and Netscape.
7. The company has marketing relationships with a number of ISPs in mainland China, including Eastnet, China Online, Beijing Online, Homeway, Spark Ice and Shanghai Online. These relationships entail the China.com portal appearing as a button/link on the ISPs’ home pages when users log on.
8. China.com is currently negotiating with numerous Greater China computer manufacturers to offer bundled software for the company’s portal network along with newly manufactured PCs.

Portal Competition

Currently, China.com’s main portal competitors are:

- Chinese-language based Web search and information retrieval companies such as Sina, Neteaze, Sohu, Shanghai Online, China Byte and Yahoo! China.
- English-language based search engines such as Infoseek, Excite, Lycos, and Yahoo!
- Retrieval services and products offered by Alta Vista, HotWired Ventures, Inktomi’s HotBot and OpenText.
In December 1998, 24/7 Media acquired an interest in China.com. 24/7 Media is a leading (NASDAQ listed) U.S. online advertising company. In exchange for 24/7 Media’s stake in the company, China.com received US$3.0 million in cash and 203,851 shares in 24/7 Media (which were recently sold for US$8.9 million). The exchange was made to cement an agreement between the two companies to develop the 24/7 Media Asia advertising network, which is wholly owned by China.com.

The company’s partnership with 24/7 Media gives China.com the exclusive right to use the 24/7 name and its Adfinity ad-server technology in China, Taiwan, Hong Kong, Australia, New Zealand, Singapore, Southeast Asia, Korea and Japan. China.com’s sales force sells all advertising on the 24/7 Asia Network. Currently, 24/7 Asia has more than 125 affiliated Web sites targeting various Asian markets. Figure 4 details a selection of the company’s affiliated Web sites for each country.

Regional Expansion Strategy

China.com, through 24/7 Media Asia, is currently implementing an aggressive regional expansion plan for its advertising network business. The company intends to roll out both business development (to sign additional affiliated Web sites) and advertising sales teams in a number of countries in the Asia region.

Existing Business and Organic Expansion Base Case

China.com currently has both business development and advertising sales teams in China, Hong Kong, Taiwan, Japan, Korea and Singapore. The company’s organic expansion strategy is predicated on start-up plans for Australia, New Zealand, ASEAN countries and the U.S. (to target the U.S. Asian market). However, we anticipate that this expansion is likely to be accelerated through additional start-ups or acquisition-based expansion depending on the nature of the market and the availability of suitable opportunities.

According to the company’s organic expansion plans, we anticipate that the company will begin operations in Australia during 2Q99.

Figure 4: China.com
Affiliated Web Sites

<table>
<thead>
<tr>
<th>China</th>
<th>Hong Kong</th>
<th>India</th>
<th>Japan</th>
<th>Korea</th>
<th>Taiwan</th>
<th>Thailand</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beijing Scene</td>
<td>Cash</td>
<td>Star TV</td>
<td>Dragonfield Games</td>
<td>Chosun Daily</td>
<td>Acemail</td>
<td>Sanook</td>
<td>Singapore Press</td>
</tr>
<tr>
<td>Chinabyte</td>
<td>Finet Online</td>
<td>India World</td>
<td>Yu Yu Hakusho Mall</td>
<td>Hanmail</td>
<td></td>
<td>Bangkok.com</td>
<td>Stratas Time</td>
</tr>
<tr>
<td>Nanfang Daily</td>
<td>Sing Tao Electronic Daily</td>
<td>Doraemon Mail</td>
<td>Internet Classified</td>
<td>PCWorld Singapore</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alliance Consulting</td>
<td>HK America Online</td>
<td>Urusei Yatsura Mail</td>
<td>Flea Market</td>
<td>Singapore Directory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NetEase</td>
<td>HK Net</td>
<td>DragonBallz Mall</td>
<td>TipsData</td>
<td>IT Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goyo</td>
<td>Outblaze</td>
<td>JPOP Mail</td>
<td>Glay</td>
<td>CalendarOne.com</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Netscape Guide</td>
<td>Glay</td>
<td>Internet Now!</td>
<td>Channels Asia</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>HK Property</td>
<td></td>
<td>Asahi Shimbun</td>
<td>Car Mall</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>NextMedia Web</td>
<td></td>
<td>Noriko Sakai Mall</td>
<td>Malaysia Search</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Job Finder</td>
<td></td>
<td></td>
<td>Search Singapore</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sudden Weekly</td>
<td></td>
<td></td>
<td>Singapore Online</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Company data.
Acquisition or Organic Expansion?

Broadly speaking, we believe acquisitions should be seen as the preferred expansion strategy in countries where the Internet advertising model is still embryonic relative to the U.S. In these markets, Internet advertising and the registration of affiliated sites tends to be as much a function of long-standing relationships as it is of man-hours input. On this basis, without the key relationships in place, a start-up may incur significant hurdles, whereas buying an operation with relationships already in place should significantly expedite the growth of the business.

By the same token, in developed markets, where the advertising network model is understood by potential affiliates and where the Web advertising product enjoys greater acceptance among advertisers, there tends to be a more stable correlation between the number of qualified staff employed and the volume of revenue generated. In these cases, organic expansion may present an attractive alternative to an acquisition strategy.

Scope for Acquisitions

China.com is currently considering further acquisition opportunities as well as progressing with the hiring of additional advertising network executives in Japan, Korea and Singapore to build on its acquisition-driven base operation in each of these countries. The company has already hired a key figure to drive its Australian business. We believe that China.com is likely to build its Australian and U.S. business organically rather than through acquisitions.

In these two markets, the company is likely to compete with a number of other companies because the Internet advertising market in these countries is relatively developed, which means that China.com should have a larger pool of qualified candidates to hire from, thus facilitating an organic expansion strategy.

Japan, Korea and Singapore, while behind the U.S. in terms of growth, are significantly more developed than many parts of Asia. These countries already house a number of Internet advertising and related companies that China.com can either acquire or work closely with in order to accelerate its development. 24/7 already operates in Japan, Korea and Singapore, and is currently considering further acquisition opportunities in these countries to enhance its position and accelerate its growth. This should allow the company to leapfrog existing rivals in these markets. We believe that acquisitions, which may either supplement or become the backbone of China.com’s growth strategies in particular markets, are an integral part of the company’s growth strategy and should be monitored closely by investors in the next few quarters.

How Does the Advertising Network Business Work?

China.com’s advertising network business is modeled on the 24/7 business model used in the U.S. Other companies in this area include DoubleClick and ValueClick.

There are two main areas of focus (and client bases) for the advertising network business:

- Affiliated Web sites.
- Advertisers.
Affiliated Web Sites

One of China.com’s primary goals is to sign up an increasing number of affiliate Web sites, either commercial or personal, that are typically in the “second tier” of the market in terms of page views in a country-specific context. Affiliated Web sites represent the “inventory” of the advertising network model. Therefore, China.com has begun to aggressively sign up Web sites with various page-view volumes and topics, offering to sell the page view inventories of these affiliates to advertisers. The structure of an affiliate’s relationship with China.com can vary, as illustrated by the two examples below:

- **For larger affiliates**, the company may act as a third party sales force, acting as a supplement to the Web site’s existing in-house sales force to sell inventory that remains underutilized. Accordingly, China.com can work in conjunction with an affiliate’s sales force to work towards a 100% utilization/sell-through rate for a Web site.

- **For smaller affiliates**, the company may act as the primary or exclusive selling agent of the Web site’s inventory. In these cases, the Web site often does not have the critical mass of page views to justify running its own sales force. As such, China.com, through the 24/7 banner, becomes the web site’s “no-cost” value-added sales agent.

The company’s 175 advertising affiliated Web sites, as shown in Figure 4, include strong Asian brands such as HKNet, ChinaByte, InterAuct!, CASH, Hanmail, Netscape, the Straits Times, NextMedia and Asahi Shinbun.

Advertising Sales

Once signed, affiliated Web sites are aggregated and presented to potential advertisers as a “basket of page views” that offer “eyeballs” in various categories. Consequently, these Web sites are categorized into topics, or “channels,” of interest. For example, numerous sports-related Web sites may be aggregated and presented to a manufacturer of athletic equipment as a targeted advertising opportunity. Affiliate Web sites may also be categorized by geography.

As Asia’s only regional network advertising agency, we believe that China.com 24/7 has a significant value-proposition for advertisers that want the flexibility to advertise in a number of specific countries. For example, if an international producer of electronics is rolling out its product in Japan in 1Q, Korea in 2Q and Taiwan in 3Q, China.com can offer this client a flexible online advertising schedule that operates in conjunction with the product’s roll-out.

China.com’s current advertising network “channels”, in addition to geographical segmentation, include:

- Real Estate
- Business/Financial
- Search Directory/ISP
- Entertainment
- Sports
- Games
- Technology/Computers
- International
- Travel
- News/Information
Of the advertising revenue generated from affiliate page-view sales, China.com retains between 30% and 75% of the total, depending on the site, the type of advertisement and the advertiser. In the long term, we expect China.com’s retention to be between 35% and 45% on average, in line with consensus estimates for the company’s U.S.-based comparables.

China.com often enters into agreements with advertisers involving the guarantee of a minimum number of page impressions for a fixed fee. The company also charges higher fees for advertising on specific sites and for advertisements with other defined targeted audience groups. China.com’s advertising list prices for Run-of-Network, Run-of-Channel and Specific Site buys currently range from US$5-US$40 CPM (cost per thousand page views).

Actual average CPMs in the U.S. for this business model currently run at between US$5 and US$8 compared with run of network (RON) rates of US$3 to US$6. These figures compare with average CPMs for the major portals in the U.S. that are currently around US$20.

**Advertisement Format and Evolution**

Advertisements on affiliated Web sites are currently all in the form of advertising banners. As advertisers become more familiar with the subtleties and capabilities of online advertising, the company expects to offer button, sponsorship and other styles of advertisements.

A portion of China.com’s R&D expenditure is directed at continuously refining the company’s ability to respond to a web user’s interests with appropriate Web content and related advertising. China.com’s exclusive right to use 24/7 Media’s Adfinity ad-server technology, and the continuous refinement of this technology’s functionality and power, facilitates the company’s efforts in this direction.

**Advertisers**

China.com currently focuses its sales and marketing efforts on the leading Internet and traditional media advertisers and advertising agencies. The company’s sales force works closely with advertisers to enhance the effectiveness of their campaigns by customizing ad delivery either on a specific affiliate Web site, within a particular content channel or across the China.com advertising network.

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**Figure 5: China.com**

**Advertisers**

<table>
<thead>
<tr>
<th>Representative Advertising Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>DDB</td>
</tr>
<tr>
<td>Leo Burnett Ltd.</td>
</tr>
<tr>
<td>Zenith Media</td>
</tr>
<tr>
<td>Wunderman Cato &amp; Johnson</td>
</tr>
<tr>
<td>Grey Interactive</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Representative Advertisers</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT &amp; T</td>
</tr>
<tr>
<td>Dell Computers</td>
</tr>
<tr>
<td>Founder Computers</td>
</tr>
<tr>
<td>International Herald Tribune</td>
</tr>
<tr>
<td>Zirca, Inc.</td>
</tr>
<tr>
<td>Lucent Technology</td>
</tr>
<tr>
<td>McDonald’s</td>
</tr>
<tr>
<td>Mandarin Oriental Hotels</td>
</tr>
</tbody>
</table>
Currently, the lion’s share of online advertisements sold on the company’s affiliated Web sites are RON advertisements. In our view, this is a function of two factors:

- The nascent state of the Asian online advertising market and advertisers’ current lack of understanding of the potential efficacy and functionality of the online advertising product.
- China.com’s advertising network business is still in its first year of operation. The corollary of this is that relationships with advertisers remain relatively new. In time, as relationships develop, the sale of more complex and targeted online advertising products should become more common.

Therefore, the company’s strategy is to, in time, migrate advertisers to more targeted advertising placements that provide a more efficient means of reaching customers and, accordingly, carry a higher CPM.

**Competition**

The company’s competition in this market may be broadly described as operating in two areas, ad serving and ad hosting, as follows:

**Ad Serving**

China.com’s advertising network competes with a variety of Internet advertising networks, including DoubleClick and ValueClick, that have a similar business model and target customer base. The company also indirectly competes with other ad-serving solutions providers including NetGravity and Accipiter in marketing the company’s Adfinity ad-serving system to Internet publishers. Further competition will come from other Internet content aggregators who also have their own advertising sales networks and advertising agencies, as well as from the traditional advertising media.

**Ad Hosting**

As the Internet advertising model expands and gains credence in Asia, we expect the market to become increasingly competitive, which is likely to exert downward pressure on advertising rates and volumes of page views sold. However, we do anticipate a number of factors to offset these pressures:

1. We anticipate that the Internet will increasingly be perceived as an effective advertising medium (as we have seen in the U.S.) in Asia as the medium evolves and the profile of the typical Internet user changes from a technology-oriented male (the so-called geeks) towards a broader group of high-income households (in a developing Asian context) for whom the Internet is likely to become an integral part of daily life. With that, we anticipate a broader utilization of targeted online advertising strategies (as detailed above) that exploit ad-server functionality and carry higher CPMs.

2. Ad server technology, being dynamic in nature, should continue to evolve, allowing much more sophisticated targeting. This should exert upward pressure on advertising rates for a given inventory of page views.

3. As the company continues to grow its brand, China.com has the potential to be able to demand a premium to the market average CPMs or other cost structures. This is in line with the premium that leading portals in the U.S. currently enjoy as a result of their branding and broader targeting ability.
**WEB SOLUTIONS**

**Background**

In January 1998, China.com’s parent acquired a 51% interest in Web Connection (a Hong Kong-based Web site design and development company), which was subsequently injected into China.com in January 1999. This business created a base on which the company has built its Web solutions business. In December 1998, China.com acquired the remaining 49% of Web Connection, making the company a wholly-owned subsidiary of China.com.

Through its Web solutions business, China.com provides its clients with a wide range of Internet solutions tailored to its clients’ aspirations for the role of the Internet within their businesses. These products cover the development of the client’s Internet strategy and the refinement, testing and execution process. As such, the company’s products/services include:

- Internet strategy analysis and design.
- Web site design, production and testing.
- Technology development.
- Strategy implementation and integration.
- Web site audience development.
- Web site maintenance.

**Development of the Market**

Given the relatively embryonic stage of development of the Internet in Asia, China.com’s Web solutions business plays an important role in encouraging and generating incremental penetration and use of the Internet in the markets in which it operates. This is accomplished by encouraging businesses to have an online presence, the facilitation of E-Commerce activities among potential Web merchants and increasing the amount of local content on the Web. In turn, these activities encourage users to get online and stimulate the broader development of the Internet. We believe that by encouraging the development of the Internet through its Web solutions business in each of the countries where it is operating or expanding, all three of China.com’s integrated business lines should benefit.

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Figure 5: China.com

**Web Solutions Strategy and Services**

![Diagram of Web Solutions Strategy and Services]

Source: Lehman Brothers.
Regional Expansion Plans

China.com is currently pursuing a regional expansion strategy to jointly build both its advertising network and e-business solutions businesses in most of the Asian region’s main Internet markets given the cross-marketing opportunities between these two business lines. The Asian Web solutions business model is currently the most developed (in terms of revenue and market acceptance) of China.com’s three integrated businesses. Therefore, it is often easier to rapidly expand this business into a new country than it is for the advertising network and consequently provide a platform of revenues and a brand presence from which the company’s other businesses can be developed.

While accepting the co-expansion advantages of rolling out the Web solutions business along with the advertising network across most of Asia, there are two exceptions to the company’s strategy in this area. In Australia and the U.S., where the Web solutions business is relatively mature and there is a high degree of competitive pressure, the company plans to execute a more cautious approach in developing the Web solutions line. We anticipate that demand for the company’s products in these markets is likely to be concentrated on Chinese and other Asian language design and development work for existing Web sites. This is in contrast to China.com’s business in the less developed markets, which tends to be weighted towards the evolution of Web strategies for companies that are relatively new to the Internet.

Broadly speaking, the corollary of this is that by entering markets with both the Web solutions product as well as the advertising network model on a cost and revenue sharing basis, China.com will be able to gain early entry into many Asian countries, that otherwise may have been unattractive on a commercial basis should the company have adopted a stand-alone strategy for its individual business lines. In our view, China.com’s regional expansion activities should allow the company to gain first-mover branding and acquisition advantages, while serving to underpin the attractiveness of its integrated business model.

The Web solutions business currently operates in Hong Kong, China, Taiwan and Japan (following market entry through a recent acquisition). From this base, the company has said that it plans to expand its business first into Korea and then into Singapore before the end of 1999.

Products

1. Web Site Design and Development

China.com translates a client’s strategic requirements into a process design architecture (strategy blueprint) that describes how the proposed solution will meet the client’s needs. In executing this task, China.com typically researches, tests and evaluates a broad spectrum of Internet technologies and tools to design a system and process architectures that meet the client’s needs.

2. Web Solutions Consulting

The company works closely with its clients to conduct a comprehensive study of the clients’ strategic market position, business requirements and existing systems and capabilities to determine the ways in which Internet solutions can best improve the client’s business processes. Recommendations and proposed solutions developed on this basis are also tailored to the client’s budgets, schedules and available resources.
3. Implementation and Integration

China.com offers a Web strategy implementation product that spans organization, testing and full implementation. In addition, China.com benefits from a number of third-party vendor relationships through which its clients have access to high-availability Intranet and Web site hosting. These third-party vendor relationships offer access to integrated services for relational databases, work group collaboration, streaming audio and video, management and monitoring, e-mail and secure electronic commerce.

4. Technology Development

China.com develops a testable, beta version of a client’s Internet solution (based on the recommended strategy blueprint). Through the technology development process, China.com designs, codes, integrates and tests all necessary programs and components. This is accomplished through the use of a broad range of vehicles, including:

- Object-based and relational database systems.
- Electronic commerce systems.
- Custom ActiveX, Java and C++ programming and host integration.
- Implementation of third-party applications and security technologies.
- Integration of hardware, software and Internet access products.

5. Online Promotion

China.com works with clients to develop a strategy for achieving online marketing objectives by increasing Web site traffic, strengthening brand awareness and generating sales leads. Accordingly, the company focuses on ways to encourage audience development, including strategies to optimize a client’s Web site search engine presence and to increase site access through the strategic placement of hyperlinks within the site. In addition, the company develops and implements strategies to disseminate the client’s key messages to Internet newsgroups, mailing lists and other Web forums.

6. Site Management

China.com provides its clients with continuing support, which ranges from content maintenance to site administration. The company’s technical staff maintains close contact with clients to resolve technical problems and provide assistance with hosting environments, in addition to giving support on Internet software.

Recent Projects

In order to illustrate the shape of the Web consulting process and the company’s products in this area, we have detailed below five key projects completed by the company in 1998:

Hong Kong Tourist Association

In collaboration with the Hong Kong Tourist Association (HKTA), China.com designed, developed and maintained a site to reflect the HKTA’s high-profile “Hong Kong — City of Life” campaign that specifically addressed the needs of a global Internet audience of potential visitors to Hong Kong. In addition, China.com has worked with the HKTA to develop the “www.hkta.org” Web site to deliver comprehensive and up-to-date information on entertainment, cultural events and travel news relating to Hong Kong.
China.com is currently working with the HKTA to create a co-branded portal that will provide e-mail, message boards and other portal-specific functions related to tourism in Hong Kong. China.com and the HKTA are also cooperating on a number of other cross-branding and content-sharing deals where each partner promotes the other’s products.

**STAR TV**

China.com developed, launched and maintained the STAR TV Web site at “www.startv.com.” The company worked with STAR TV to design a bilingual English and Chinese-language site specifically addressing the needs of a pan-Asian, Indian and Middle Eastern audience for STAR TV of about 260 million viewers across 53 countries.

The site delivers information on STAR TV’s programming schedules and the latest information on its 22 news, music, movies, sports and general entertainment channels. The site also includes streaming videos of Asian news and trailers for channels.

**1998 World Cup**

In association with China Telecom and Agence France Presse, China.com developed a unique Chinese-language Web site (“worldcup98.china.com.”) to provide comprehensive coverage of the 1998 World Cup. This site, available in both English and Chinese, generated more than 1 million page views per day and served as the primary information and picture resource on the event for newspapers across mainland China and a Chinese reading online audience throughout the world.

**Sunday**

Sunday is one of Hong Kong’s PCS cellular operators. The company was launched in 1997 and has differentiated itself in the market through its focus on the creation of a strong consumer/mass market brand. China.com played a key role in interpreting the brand and developing a marketing presence for the brand on the Internet. Sunday’s future plans include the more extensive use of the Internet for advertising, marketing and the possibility of developing integrated mobile telephony/Internet products.

**China E-Government**

In a joint project with the Chinese authorities, China.com is planning to design and host an Internet platform for online government services. This site will serve as a one-stop gateway to all the Internet resources provided by China’s central, provincial, and municipal governments. We believe that this strategic alliance could provide a stable source of revenue for China.com through recurring hosting, editorial and servicing revenues in addition to potential advertising and sponsorship revenue. The site will be promoted in China and overseas through the China.com portal network.

**Cross-Marketing Opportunities**

The Web solutions business may be leveraged to generate incremental page views for the company’s portal network by bringing businesses and organizations onto the Internet who, in turn, create and provide more content as they begin to realize the benefits of being online.
Beyond page-view generation, the promotional and advertising opportunities between the Web solutions and 24/7 Media advertising network should provide for accelerated revenue generation. Since the acquisition of the remaining 49% of the Web solutions business, China.com has started to promote its Web solutions clients on the company’s portal sites, while simultaneously aggregating those clients onto the affiliated network of 24/7 Media Asia.

**Competition**

China.com’s competition in its Web solutions business include:

1. Advertising and media agencies such as Foote, Cone & Belding and Ogilvy & Mather.
2. Internet integrators and Web site design and development companies such as iXL, Modem Media, Poppe Tyson and Proxicom.
3. Internet advertising agencies such as WCJ, Grey and Euro RSCG.
4. Large information technology consulting service providers such as Andersen Consulting, Cambridge Technology Partners and EDS.
5. Telecommunications companies such as AT&T and C&W HKT.
New entrants in all three of China.com’s main areas of operation face relatively low barriers to entry in terms of the capital commitment required as well as regulatory/licensing barriers and technology. As a result, we believe it is critical that China.com continues to develop and innovate around its existing products and services as well as progressively introduce new products and services. We believe that China.com’s commitment to continuous innovation will enable the company to maintain and build on its market leader, branding and first-mover advantages. This should allow the China.com to offer innovative new products as well as provide a mechanism for the continuous improvement of its existing products and services for its four client bases, which are:

- Users of the company’s portal network.
- Affiliated Web sites whose advertising inventory is sold by China.com.
- Advertisers who use either China.com’s portals or affiliated Web pages.
- Web solutions clients.

**China.com’s Three-Point Strategy for R&D**

1. **Incorporate and Enhance New Technologies From Third Parties**
   
   An example of this would be China.com’s range of community products on its portal sites. China.com has historically utilized services of third parties to provide a greater selection of products and services to users of the portal network at a lower cost than if the products were developed in-house. Although these products are outsourced, it is the company’s strategy to utilize its own engineers to modify and enhance these products in order to differentiate the China.com offering whenever possible and appropriate.

2. **Expand Products and Services Internally**
   
   While the company does use third-party vendors where it is efficient to do so for cost or strategic reasons, China.com will continue to develop its own products and services. Examples of products developed in-house are the company’s suite of community products, personalization, homepage builder and instant messaging products.

   The cost of qualified labor in China is significantly lower than in the U.S. or Hong Kong. As a result of these cost benefits, the company has more flexibility in what it is able to develop in-house relative to many of its global competitors.

3. **Conduct Market Research**
   
   As the Internet portal business continues to develop into a broadly accepted mainstream media business, and as Internet usage penetrates new segments of the population, we believe the company must remain informed and aware of rapidly evolving user tastes and needs. To this end, the company has focused its R&D activities around its current user base as well as the broader potential audience for the company’s products in Greater China and the rest of Asia.

   As part of its R&D process, before a product or marketing initiative is launched, China.com often pre-launches the product/initiative to a smaller audience of users to assess user response. The company then utilizes this feedback to refine the product before implementing a full product launch.
Figure 6: China.com  
Revenue Summary (US$ Mil., Unless Otherwise Stated)

<table>
<thead>
<tr>
<th>Year to December</th>
<th>1998A</th>
<th>1999E</th>
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<th>2Q00</th>
<th>3Q00</th>
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<tr>
<td><strong>Portal Revenue Summary</strong></td>
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<td></td>
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<td></td>
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Source: Company data and Lehman Brothers estimates.
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### Research and Development

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### Figure 7: China.com

**Actual and Projected Income Statements (Continued, US$ Mil., Unless Otherwise Stated)**

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Source: Company data and Lehman Brothers estimates.
Figure 8: China.com
Actual and Projected Statements of Cash Flow

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Source: Company data and Lehman Brothers estimates.

Figure 9: China.com
Actual and Projected Mainland China Internet User Penetration Statistics

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<td>Penetration Subs</td>
<td>0.08%</td>
<td>0.11%</td>
<td>0.13%</td>
<td>0.14%</td>
<td>0.15%</td>
<td>0.17%</td>
<td>0.17%</td>
<td>0.24%</td>
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<tr>
<td>Penetration Users</td>
<td>0.17%</td>
<td>0.25%</td>
<td>0.28%</td>
<td>0.31%</td>
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<td>0.37%</td>
<td>0.37%</td>
<td>0.52%</td>
<td>0.70%</td>
</tr>
</tbody>
</table>

Source: Company data and Lehman Brothers estimates.
# Telecom & Media

## Americas

### Media, Broadcasting, Publishing & Internet Services
- Larry Petrella  (1) 212 526-2215
- Brian Oakes  (1) 212 526-3557
- Patrick Walravens  (1) 415 274-5285
- Kevin Sullivan, CFA  (1) 212 526-2341
- Gloria Radeff  (1) 212 526-5816

### Internet/Media: Latin America
- William M. Landers, CFA  (1) 212 526-4023
- Mark Ribeiro de Sá  (1) 212 526-3152

### Telecom Services: U.S.
- Blake Bath  (1) 202 452-4732
- William Garrahan  (1) 202 452-4727
- Daniel J. Fletcher, CFA  (1) 202 452-3375
- Geoffrey Stricker  (1) 202 452-4759
- Lara Warner  (1) 202 452-4705

### Telecom Services: Latin America
- Mickey Schlein, CFA  (1) 212 526-3520
- Vanessa Marquez  (1) 212 526-3782
- Sean Rourke  (1) 212 526-9069

### Wireless Services/Satellites
- John M. Bensche, CFA  (1) 212 526-1869
- Briar Mewbourne  (1) 212 526-4782
- Robert S. Peck  (1) 212 526-5085

## Europe

### Media, Broadcasting & Publishing
- Carlo Campomagnani  (44) 171 260-2714
- Julien Roch  (44) 171 260-2099
- Gareth Hunt  (44) 171 256-4271

### Telecom Services
- Paul Norris  (44) 171 260-2097
- James Barford  (44) 171 260-2561
- Karen Egan  (44) 171 260-2438
- Jo Oliver  (44) 171 260-2237
- Paul Ryb  (44) 171 260-1656
- Tarek Robbiati  (44) 171 260-3028

## Asia

### Telecom & Media, Internet Services
- Ravi Sarathy  (852) 2869-3642
- Juliette Chow  (852) 2869-3026
- Charle Peza  (852) 2869-3749
- James Chan  (852) 2869-3132

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**Key to Investment Rankings:**
- **1=Buy** (expected to outperform the market by 15 or more percentage points)
- **2=Outperform** (expected to outperform the market by 5-15 percentage points)
- **3=Neutral** (expected to perform in line with the market)
- **4=Underperform** (expected to underperform the market by 5-15 percentage points)
- **5=Sell** (expected to underperform the market by 15 or more percentage points)
- **V=Venture** (return over multiyear time frame consistent with venture capital; should only be held in a well-diversified portfolio)

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