Citron RESEARCH

CITRON REPORTS ON QIHOO 360 (NASDAQ:QIHU)

The most overvalued and misunderstood

Chinese Internet Stock:

Target Price-$5

Recent Market Cap: $ 2.5 Billion USD

Last Quarter Revenue: $35.1 million

Management: Disturbing Record of Deceit

Outlook: Destined for Single Digits

On May 2, 2011, Citron reported on Sky-Mobi (NASDAQ:MOBI) when the stock was $18. Citron placed a price target of $3 on the stock, pointing out the company's outdated business model and documenting its gross representations of itself to Wall St. Well, Sky-Mobi kicked and screamed. They held a conference call to refute our critique, and multiple analysts upgraded their stock ratings and raised targets. Not more than 4 months later, despite the protests, the MOBI traded at $3 — not because of Citron, but rather the inevitable fate of their business model's value.

Citron explores today a company with many similarities, Qihoo 360 (NASDAQ:QIHU). **We estimate that it is headed to $5 per share, more than 75% below its current trading range.** Sky-Mobi and Qihoo have both intentionally misrepresented their businesses to Wall St in the hope of sustaining exaggeratedly high market capitalizations, but in both cases Citron's analysis points decisively to the conclusion that their best days are behind them, not in front of them.

Qihoo went public at the right time. In the spring of 2011, all Chinese internet stocks were entering bubble territory. SINA was approaching $150 per share and YOKU was over $50. With scant revenues, Qihoo claimed some bold benchmarks in their prospectus and their most recent quarterly statement. Once you have read our findings, you will see those claims in a different light.

Corporate History

QIHU publishes a browser that has gained considerable market share in China over the years because it is bundled with anti-virus software (In reality, this was simply a customized version of Google's Chrome, bundled with anti-virus technology mostly licensed from 3rd party providers, Qihoo's R&D has been historically minimal). In fact, 2008-2009 the company had generated the bulk of their revenues selling anti-virus protection, a revenue stream that rapidly dwindled to zero. After realizing that this was a dead-end business model, in the Q4 2009, QIHU began to give away its software, selling ads on its default home page and referring search requests to

Google for a revenue share, as do thousands of other websites.

So this is where they are today, a web 1.0 brand with a web 1.0 business model that is hoping (and claiming) to be moving into mobile, cloud computing, and search — all businesses in which they are **years behind and have zero present-day market share.**

Before going into their revenues and business model, let's address those big market share numbers that are thrown in the face of the investment community on page 1 of their prospectus. Those numbers are greatly exaggerated or misleading to say the best. According to their prospectus and recent filings they claim :

It sounds impressive, but the problem is that it is so far from the truth.

The Numbers That Really Count

The company boasts they have "over 300 million active users", "80% penetration", and are "the 3rd largest Chinese internet company by active user base". We find that, based on independent metrics, the truth shows no resemblance to that.

What does their biggest customer think?

More than 21% of QIHU's revenues are derived from Google, primarily be referring search queries. According to Doubleclick ad planner as powered by Google, 360.cn is the **21st most visited site in China with a reach of only 10%.**
[http://www.google.com/adplanner/static/top100countr](https://www.google.com/adplanner/static/top100count)

(Note: There are many companies with higher rankings and dramatically lower valuations on this list.)

For the sake of comparison in this report, we will compare Qihoo to SOHU and FENG. Two publically traded Chinese Internet Companies who have ad based models similar to Qihoo.

SOHU SOHU.com	QIHU 360.cn	**SOHU vs QIHU**	FENG.com
7th	21st		18th
74 million	28 million	**3 x more**	34 million
26.3%	10%	**2.6 x larger**	12.2%
4,800 million	710 million	**6.7 x more**	3,300 million

This 10% reach estimate would take 360.cn into only 30 to 40 million Chinese homes, not anywhere near the 300+ million they claim.

But Google's AdSense ranking for QIHU's site is actually high next to Alexa, which shows 360.cn as the as the **35th ranked site in China**.

http://www.alexa.com/topsites/countries/CN [http://www.alexa.com/topsites/countries/CN]

(FYI…for those of you who might be confused, 360buy.com is not related to QIHU, they just have similar names.)

Alexa traffic statistics	SOHU SOHU.com	QIHU 360.cn	FENG.com
Rank in China	9th	35th	12th
Average time spent	53 seconds	36 seconds	Not stated
Pct of worldwide pageviews	.12%	.012%	.2%

Further, SOHU also owns SOGOU.com (search dog), a site that also outranks QIHU's 360.cn on its own. (13th on Doubleclick ad planner, ranked 25th on Alexa).

Valuation Comparison QIHU and SOHU

Now look at the comparative valuations of SOHU and QIHU. SOHU is widely acknowledged as direct competition to QIHU. The below chart shows how ridiculous their comparative valuations are.   We'll also look at FENG, which outranks QIHU on every metric, but in the same ballpark.

	QIHU	FENG	SOHU *
Shares Outstanding (m)	117	65.4	38.4
Stock Price (USD)	20.5	5.14	61
Market Capitalization	2,398.5	336.2	2,342.
Cash Balance	309	178	811
Enterprise Value	2089.5	158.2	1531.
Value of Spun off Holdings	0	0	**607.9**
Enterprise Value ex Subs	2089.5	158.2	923.5
2011E Revenue ex Subs	146	141	408
2012E Revenue ex Subs	257	217	521
2011E Revenue Multiple	**14.3x**	1.1x	2.3x
2012E Revenue Multiple	**8.1x**	**0.7x**	1.8x
Revenue per $1000 invested	**69.87**	891.52	441.8

* When comparing to SOHU, we have to credit SOHU's 67.1% ownership of CYOU, worth $600 to $885 million (enterprise value / market value times SOHU's percentage owned) in addition to SOHU's enterprise value for the balance of its business.

CYOU's value to SOHU

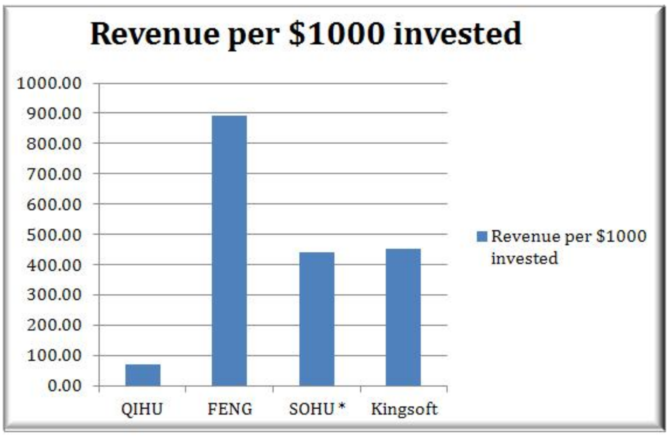
Recent Stock Price	25
Market Valuation (m)	1,320
Cash (m)	414
Sohu's Stake	67.10%
Enterprise Value (m)	906
Market % Ownership (m)	**885.72**
Enterprise % Ownership (m)	**607.93**

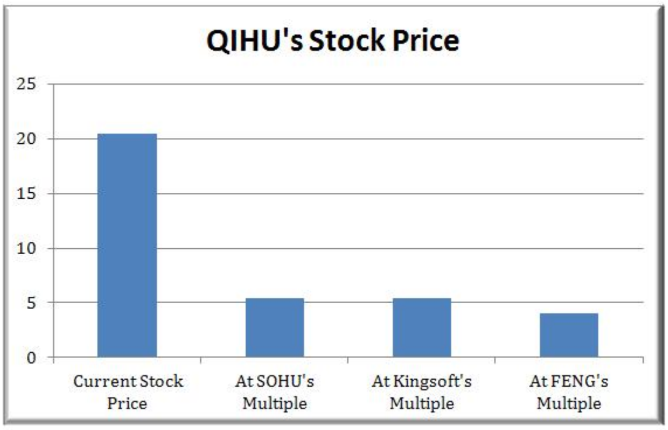
* What makes comparing these 2 companies even more ridiculous is the mindshare perspective. SOHU is number 7 on the Google Doubleclick ranking and number 9 on Alexa respectively. From point of few of internet ranking, the gap from #7 to #21 is massive – about 3 to 7-fold in terms of overall web presence. And in addition, SOHU owns 65% of SOGOU.com, a search site which on its own outranks QIHU in both Alexa and Doubleclick.

Even the Mirae analyst admits when it comes to 360.cn growth:

> The share is still growing but it is not growing a

So when these numbers are reduced to a bottom line, here's what you get when you invest $1000 in each of these companies' stock:





[http://citronresearch.com/wp-content/uploads/2011/10/QIHU-valuation-graphs.jpg]
For those of you who want to bang the table and say that QIHU should be given premium because it is not just an ad seller but rather they have security products, we included their arch nemesis Kingsoft.

http://investing.businessweek.com/research/stocks/snap ticker=9274438
[http://investing.businessweek.com/research/stocks/sna ticker=9274438]

When comparing these companies, QIHU should be trading at $5 a share, if we are being generous .. very generous.

In Management’s Own Words!

I am sure many of you are saying, "OK, Citron, that is the bear case, but what does management have to say about this?"

Here is a link to an interview given by Zuoli Xu, CFO of QIHU along with Yu Yao, their VP, in which management admits their lack of a current compelling business model and describes their **hopes** for the future. When Citron reads this interview, it seems more like the banter of an internet startup company knocking on doors to raise money — not that of an established $2.5 billion dollar internet standard bearer.

http://news.ichinastock.com/2011/08/interview-with-qihoo-cfo-and-vp-big-potential-for-360-browser-homepage/ [http://news.ichinastock.com/2011/08/interview-with-qihoo-cfo-and-vp-big-potential-for-360-browser-homepage/]

Can you Trust Top Leadership ? MUST READ

QIHU's CEO is a gentleman named Zhou Hongyi.

Before he founded Qihoo, he founded a company called 3721 which became one of China's first search engines that he sold to Yahoo in 2003 for $120 million. " But 3721’s software had become popular by lodging itself in computers as spyware. It introducing pop-windows, bedeviling its users — and some would say it introduced spyware into China."

http://venturebeat.com/2006/11/03/yahoo-china-hits-back-at-qihoo-nemesis/ [http://venturebeat.com/2006/11/03/yahoo-china-hits-back-at-qihoo-nemesis/]

Because of his "arrogance" and inability to hire English speaking workers and be trusted Zhou was forced out of Yahoo, which as you can imagined ended in a series of lawsuits. Zhou Hongy's reputation to be trusted got so bad that in late 2010, before China internet mania struck, it was though that Qihoo would never be able to go public because of their CEO, and the possibility that they have not left their spyware roots behind them. In something that we have never seen, Zhou's reputation got so soiled that Yahoo CEO encouraged western investors as recent as December 2010 "not to trust his old acquaintance from China".

If Qihoo was a US internet company, it could never have gone public because of its litigation history and questions surrounding its business model. Citron's $5 is generous. Qihoo should actually be trading at a considerable discount to any comparable valuation strictly on the questionable nature of management's judgment, as described by Citron, but rather by many internet business leaders in China as well as the courts.

http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20101222000107&cid=1102 [http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20101222000107&cid=1102]

As QIHU was preparing for its IPO, there corporate actions resembled those of a company fighting for its survival. The browser was losing market share and they were becoming insignificant in the rapidly changing face of the Chinese internet market. QIHU's choice of action was to try to muscle competitors off the desktop. Its installations forced users to uninstall competitor's products, sometimes with misleading prompts. This led to a very ugly public squabble, with accusations of spying and leaking users private information, as well as deliberately releasing malware. As the attached link shows, QIHU went to war with leading instant message platform QQ (Tencent), a major anti-virus competitor Kingsoft, and search leader BIDU.

Despite all of their public complaints, they wound up on the losing side of all three battles.

http://english.caixin.cn/2011-04-20/100250564.html [http://english.caixin.cn/2011-04-20/100250564.html]

The one lawsuit that foretells the desperation of management is one in which the QIHU CEO was sanctioned by China's courts for defaming Kingsoft's CEO on his personal blog in over 45 entries. The court ruling required him to pay damages and publish a letter apologizing and recanting his libelous claims.

http://www.yiliaobk.com/first-case-of-microblogging-zhou-jinshan-public-apology-to-the-court-of-final-appeal-judgment-claims.htm [http://www.yiliaobk.com/first-case-of-microblogging-zhou-jinshan-public-apology-to-the-court-of-final-appeal-judgment-claims.htm]

If these had been the actions of a US company, it would NEVER have been allowed to IPO!

RE Management — The bottom line is this: Given the utter lack of reach for US regulatory agency protection of shareholders interests against malicious and deceptive corporate actions in China, can this person be trusted as the basis of an investment at all ?

Qihoo's "mobile" business

The only thing more disturbing than skewed numbers are boldfaced lies. In both the prospectus and quarterly filing from the company refers to themselves as "the leading mobile security provider in China".

Does anyone believe this?. Qihoo is not even a current participant in the mobile security space, aside from a claim last month to have launched mobile internet browsers. The fact is to date it has **generated 0 revenue from mobile services. This fact is indisputable from the company's most recent 10-Q.**

http://gs.statcounter.com/#mobile_browser-CN-monthly-201006-201106 [http://gs.statcounter.com/#mobile_browser-CN-monthly-201006-201106]

We see no less than nine marketshare combatants in June 2011, with Qihoo nowhere to be seen. Is this a picture of "leading China's nascent mobile device security market?

So what is left here?

Once you get past all the rhetoric and "netspeak", you are left with a web 1.0 company that publishes a browser that at one time was getting a lot of installs, but is now hustling to try and find its place in a brutally competitive and fast changing internet landscape, out-invested and out-gunned by larger competitors.

With no disruptive technology and no fast growing properties (such as Weibo, Yoku, or Q+) Qihoo has …. a browser….that is it… plain and simple.

For those of you who need a history lesson, a browser is not a business, it is a tool. The grandfather of all browsers Netscape is now shut down, and a non-profit company now owns its browser.

A browser is not a business in the US and it is not a business in China. Dong Xu, a researcher with Analysys International, states:

> "With the move from the wide-open web to semi-closed platforms in the digital world, web browsers, which don't tend to make money, are regarded by vendors largely as a means of making their main products available."

http://www.china.org.cn/business/2011-08/08/content_23164056.htm [http://www.china.org.cn/business/2011-08/08/content_23164056.htm]

Qihoo's problem is that it doesn't have "main products". It simply tries to hustle sales of games and other links from its web traffic. And 3rd party statistics cast substantial doubt on Qihoo's claims of anywhere near as much browser penetration as they claim.

And even for their one standing business being the browser, the bad news is that competition has come to town. Baidu, a company with over 75% of the search market has recently launched their own browser that has a focus on internet security.

http://www.pcworld.com/businesscenter/article/223453/
[http://www.pcworld.com/businesscenter/article/22345

BIDU's new browser is being released to cement its position as the unquestioned leader in search, much as Google developed Chrome to make sure it had a foothold with web surfers, not to generate a revenue stream, but to assure Google's hold on the search business.

Conclusion

Citron plans to follow up this QIHU story with a part 2 that will focus on the plethora of misinformation presented to the pubic from the many investment banking firms covering QIHU. Much like MOBI, we were amazed to read the many analysts reports that have simply repeated management's hopes for the future as though it were independent analysis.

We look forward to their strident defense of this name, and hope they present some data more substantive than management's hopeful narrative.   We suggest independent investors seek out and give more weight to independent data points especially those that would verify the range of Qihu's real revenues, and less to company stated "future plans", expecially where those plans have generated no revenues.

Cautious investing to all.

NOVEMBER 1, 2011 /

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