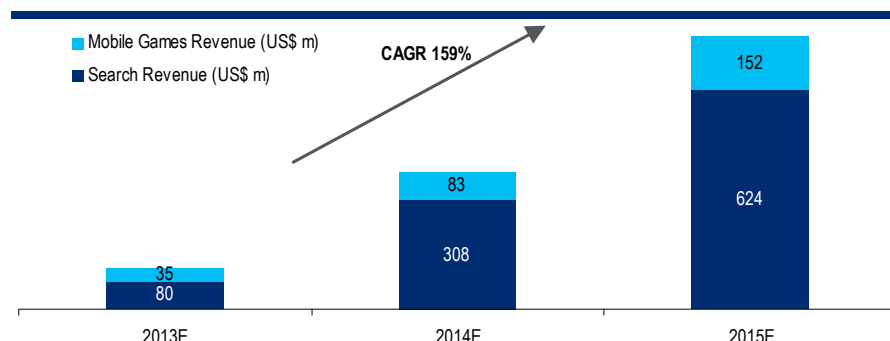


Qihoo 360 Technology (QIHU)

Emerging Winner in China's Search and Mobile Internet Market

■ **TP hiked to Street-high US\$65 on upside from mobile & search** — Qihoo, with 457m PC Web users and 275m users of its mobile security products, is poised to become a mobile market leader in China, in our view. Qihoo will seize mobile wallet-share via its market-leading mobile apps store which will emerge as a leading mobile games platform (growing gaming revenue much faster than the traditional client-based games market). Over the longer term, we expect Qihoo to play an additional role in the mobile ecosystem via mobile search, other targeted mobile display ads as well as via its strategy as an e-commerce aggregator. We believe that the Street has yet to factor in the company's mobile potential and is hence taking a narrow view of Qihoo's market potential, and that the stock will re-rate significantly as these new growth drivers emerge. We maintain a Buy (no longer at High Risk).

■ **Mobile games to be new catalyst; 13-15E revenue CAGR of 108%** — We estimate Qihoo's revenue market share in *search* will expand to 4.5% in FY14 (29% of revenue), from 1.4% in FY13 (13% of revenue). *Mobile* will contribute 10% of revenue in FY13E (mostly from mobile games and mobile ads), and we expect a 2-year revenue CAGR of 108% for mobile games to US\$152m in FY15. Our FY13E NP is 20% higher than consensus. At US\$65 (from US\$39), our DCF-based TP equates to a PEG of 0.6x.



Source: Citi Research estimates

Statistical Abstract

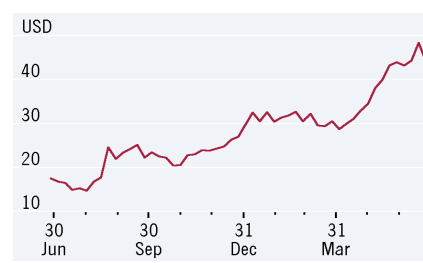
Year to 31 Dec	Net Profit (US\$M)	Diluted EPS (US\$)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2011A	64	0.55	408.2	85.0	14.6	34.1	0.0
2012A	97	0.80	44.2	59.0	12.0	22.9	0.0
2013E	123	0.97	22.3	48.2	9.9	22.8	0.0
2014E	250	1.91	96.4	24.6	7.2	34.4	0.0
2015E	413	3.05	59.8	15.4	5.0	39.0	0.0

Source: Powered by dataCentral

- Estimate Change
- Target Price Change
- Rating Change

Buy	1
<i>from Buy/High Risk</i>	
Price (01 Jul 13)	US\$46.90
Target price	US\$65.00
<i>from US\$39.00</i>	
Expected share price return	38.6%
Expected dividend yield	0.0%
Expected total return	38.6%
Market Cap	US\$5,758M

Price Performance (RIC: QIHU.N, BB: QIHU US)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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QIHU.N: Fiscal year end 31-Dec						Price: US\$46.90; TP: US\$65.00; Market Cap: US\$5,758m; Recomm: Buy					
Profit & Loss (US\$m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	167.9	329.0	598.0	1,049.4	1,594.2	PE (x)	85.0	59.0	48.2	24.6	15.4
Cost of sales	-18.9	-32.8	-78.5	-158.0	-259.3	PB (x)	14.6	12.0	9.9	7.2	5.0
Gross profit	148.9	296.2	519.5	891.4	1,334.9	EV/EBITDA (x)	79.3	46.4	29.3	14.7	8.5
Gross Margin (%)	88.7	90.0	86.9	84.9	83.7	FCF yield (%)	1.2	0.8	0.0	4.5	7.4
EBITDA (Adj)	70.4	115.9	182.4	355.1	566.9	Dividend yield (%)	0	0	0	0	0
EBITDA Margin (Adj) (%)	41.9	35.2	30.5	33.8	35.6	Payout ratio (%)	0	0	0	0	0
Depreciation	-3.4	-14.9	-40.1	-63.1	-86.8	ROE (%)	8.4	11.0	12.8	26.6	32.6
Amortisation	-0.8	-1.7	-4.2	-7.2	-10.8	Cashflow (US\$m)	2011	2012	2013E	2014E	2015E
EBIT (Adj)	66.1	99.3	138.1	284.8	469.3	EBITDA	22.4	65.3	128.4	298.3	499.0
EBIT Margin (Adj) (%)	39.4	30.2	23.1	27.1	29.4	Working capital	13.8	4.3	-90.5	64.1	87.2
Net interest	2.5	6.7	7.0	9.5	16.4	Other	44.4	48.4	39.1	22.2	11.4
Associates	0	0	0	0	0	Operating cashflow	80.6	118.0	77.0	384.6	597.6
Non-op/Except	5.2	7.3	-0.1	-0.1	-0.1	Capex	-17.8	-73.9	-78.1	-105.3	-127.4
Pre-tax profit	25.9	62.7	91.0	237.5	417.7	Net acq/disposals	-2.1	12.1	0	0	0
Tax	-10.9	-11.4	-21.7	-44.1	-72.8	Other	-15.0	-24.2	0	0	0
Extraord./Min.Int./Pref.div.	0.6	-4.6	0	0.0	0.0	Investing cashflow	-34.8	-86.1	-78.1	-105.3	-127.4
Reported net profit	15.6	46.7	69.3	193.3	344.9	Dividends paid	0	0	0	0	0
Net Margin (%)	9.3	14.2	11.6	18.4	21.6	Financing cashflow	233.3	2.1	0	0	0
Core NPAT	63.6	97.4	123.2	250.2	412.8	Net change in cash	281.5	35.1	-1.1	279.3	470.2
Per share data	2011	2012	2013E	2014E	2015E	Free cashflow to s/holders	62.8	44.1	-1.1	279.3	470.2
Reported EPS (\$)	0.14	0.38	0.55	1.48	2.55						
Core EPS (\$)	0.55	0.80	0.97	1.91	3.05						
DPS (\$)	0	0	0	0	0						
CFPS (\$)	0.70	0.96	0.61	2.94	4.42						
FCFPS (\$)	0.54	0.36	-0.01	2.13	3.48						
BVPS (\$)	3.22	3.91	4.75	6.50	9.35						
Wtd avg ord shares (m)	115	122	127	131	135						
Wtd avg diluted shares (m)	115	122	127	131	135						
Growth rates	2011	2012	2013E	2014E	2015E						
Sales revenue (%)	191.1	96.0	81.7	75.5	51.9						
EBIT (Adj) (%)	418.3	50.2	39.0	106.3	64.7						
Core NPAT (%)	408.2	53.1	26.6	103.0	65.0						
Core EPS (%)	408.2	44.2	22.3	96.4	59.8						
Balance Sheet (US\$m)	2011	2012	2013E	2014E	2015E						
Cash & cash equiv.	343.7	380.7	379.6	658.9	1,129.1						
Accounts receivables	16.7	23.6	62.4	109.5	166.3						
Inventory	0.0	0	0	0	0						
Net fixed & other tangibles	21.1	209.0	243.1	274.8	299.5						
Goodwill & intangibles	12.4	16.9	18.7	22.1	27.2						
Financial & other assets	29.7	57.2	79.1	115.9	160.3						
Total assets	423.7	687.4	782.9	1,181.1	1,782.4						
Accounts payable	5.9	7.1	17.0	34.2	56.2						
Short-term debt	0	0	0	0	0						
Long-term debt	0	0	0	0	0						
Provisions & other liab	46.6	204.2	164.4	295.2	461.7						
Total liabilities	52.5	211.3	181.4	329.5	517.9						
Shareholders' equity	370.9	478.1	601.3	851.5	1,264.3						
Minority interests	0.6	0.2	0.2	0.2	0.2						
Total equity	371.5	478.3	601.5	851.7	1,264.4						
Net debt	-343.7	-380.7	-379.6	-658.9	-1,129.1						
Net debt to equity (%)	-92.5	-79.6	-63.1	-77.4	-89.3						

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For definitions of the items in this table, please click [here](#).

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Investment Thesis

As China spearheads the irreversible shift from desktop to mobile and multi-device, we see a substantial revenue opportunity in mobile that will define the next generation of Web market leaders in China. Best placed to exploit that opportunity, in our view, are Qihoo and Tencent, especially given their capability of driving the convergence of Web games and mobile games (in which growth will far out-strip that of the traditional client-based games market). We expect mobile to be the next clear stock catalyst for Qihoo and believe that we are the first on the Street to highlight, assess and value this opportunity.

Tencent and Qihoo will seize mobile wallet-share in different ways: Tencent via WeChat emerging as a ubiquitous gateway into mobile games and other apps, Qihoo via its #1 mobile apps store (by downloads) and the convergence of this with its Web games platform. Over the longer term, we expect Qihoo also to emerge as a leader in mobile search as well as in other mobile ad and commerce formats via its Internet access gateway and e-commerce aggregation strategy. Current stock valuations for Qihoo (and Tencent) do not capture this significantly enhanced earnings profile over the coming 36 months, in our view.

Qihoo to tap big search/mobile opportunity

Creating new leaders and challenging incumbent leaders. The TMT sector is undergoing a 10-year disruption through the impacts of smartmobility, the Cloud, Local and ad budgets moving to social and video platforms. Mobile is arguably the biggest disruptor, with more desktop cannibalization from mobile in China than in developed countries. Already in China, mobile accounts for c.22% of total media consumption time versus c.12% in the US. The challenge is that mobile monetization is, in many cases, fundamentally different from the desktop. Mobile is, however, well suited to micropayment-based business models for virtual items. We expect ecommerce via mobile for real goods to inflect aggressively from next year.

Over the coming 12-18 months, we expect Web games and mobile games to converge in China.

The corollary of this is a **substantial mobile gaming opportunity in China**, with major earnings upside for first movers. The US\$8bn traditional client-based games market in China is mature – growing only in the high single digits. The Web games market (c.US\$2bn) continues to grow at c.35%-40% per year, however, while the c.US\$1bn mobile games market is expanding in the triple digits, we believe. Over the coming 12-18 months, we expect Web games and mobile games to converge in China. Best positioned to capitalize on this industry dynamic, in our view, are Qihoo and Tencent.

Search and mobile will be key growth drivers for Qihoo. We estimate Qihoo will gain revenue market shares in search of 1.4% in FY13 (US\$80m, 13% of Qihoo's total revenue) and 4.5% in FY14 (US\$308m, 29% of total revenue). We expect mobile will contribute 10% (US\$60m) of Qihoo revenue in FY13 (6% from mobile games and 4% from mobile ads on its apps store). On our model, Qihoo's mobile games revenue will grow at a two-year CAGR of 108% to reach US\$152m by FY15. We believe mobile growth potential is underestimated by Street.

Our mobile estimates for Qihoo are conservative at this embryonic stage. We believe mobile ads (based on apps store) could be a significant near-term revenue contributor, and mobile search/commerce are possible longer term growth drivers. In a bull case, overall mobile revenue could be 2x our FY14 and 3x our FY15 estimates (for a mobile revenue 13-15E CAGR of 280%, vs. our projected 108%).

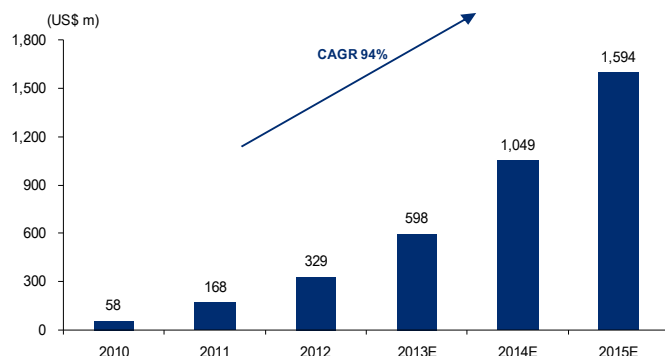
FY12-15E net profit CAGR of 62%. At this early stage of platform creation and monetization, we expect Qihoo to continue to deliver rapid growth. We forecast Qihoo revenue will grow at a (3-year) CAGR of 69% from FY12 to reach US\$1.6bn in FY15E. We forecast non-GAAP net profit to grow at a 3-year CAGR of 62% from FY12 to reach US\$413m in FY15E. Our FY13E NP is 20% higher than consensus. Key catalysts will be progress toward 20% search traffic market share by 2013 and surging mobile revenue.

Qihoo – Revenue Breakdown/Growth

USD mn	2012	2013E	2014E	2015E
Online Advertising & Marketing				
Online Mkt & Ad	203.7	285.3	357.5	423.4
Search Referral	17.8	0.0	0.0	0.0
PC Search	0.0	80.4	308.1	624.0
Sub-total	221.5	365.8	665.6	1,047.3
Internet Value-added Services (IVAS)				
Web Games	84.1	153.4	230.0	299.2
Mobile Games	0.0	35.1	83.0	152.3
Other IVAS	19.2	42.1	70.8	95.4
Sub-total	103.3	230.6	383.8	546.9
Other	4.3	1.6	0.0	0.0
Total Revenue	329.0	598.0	1,049.4	1,594.2
Growth		82%	75%	52%

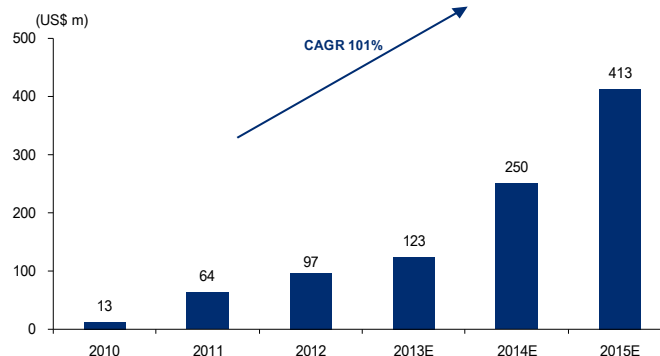
Source: Company, Citi Research Estimates

Figure 1. Qihoo: Revenue, 2010-2015E



Source: Company Reports and Citi Research Estimates

Figure 2. Qihoo: Net Profit, 2010-2015E



Source: Company Reports and Citi Research Estimates

Qihoo's core PC and mobile security products are a staple for China's Internet population with a pre-eminent brand, mind-share and stickiness.

Huge user base and pre-eminent brand built on core security products. Qihoo, with 457m PC Web users and 275m users of mobile security products, has a top-4 user base and platform traffic in the China Internet and Software space. Given that cyber crime is pervasive in China, Internet security is core for Web users. Qihoo's core PC and mobile security products, underpinned by an intellectual property (IP) competitive moat, are a staple for China's Internet population with a pre-eminent brand, mind-share and stickiness. Based on its security products, Qihoo developed services like browser, directory page and apps store to direct and monetize traffic in its platform mainly through ads, search and virtual items (games).

Key to driving Qihoo's equity value will be continued evolution of the company's business model. Qihoo develops a high-functionality open platform and redirects traffic to generate online ad and search revenue. Qihoo's Freemium (Free + Premium value-added services) business model also allows for fast growth in IVAS revenue (games, online lottery sales, etc.), comparable to Tencent's monetization based on the free QQ service. Leveraging on its substantial user base and proven product development capabilities, Qihoo is able to continue to evolve its business model to drive sustainable earnings growth using free and effective security solutions for cross-selling an increasing range of PC and mobile services.

DCF-based target price raised to US\$65, after including mobile and search forecasts. Our DCF model uses an explicit 10-year forecast period and a terminal growth rate of 3% (lower than longer term sector and GDP growth), discounted back using a cautious (high) cost of capital of 15% to create investor margin-of-safety and to fully factor the embryonic nature of China's mobile ecosystem, the embryonic nature of Qihoo's current monetization model and substantial execution risks balanced against the company's market-leading brand, mind-share and IP competitive moat contained within its core security products portfolio. Our US\$65 price target translates to a PEG of 0.6x (using 3-year forward EPS CAGR), which is broadly in line with a full universe of local and global comps, though at a significant discount to a comparable universe of potential post-disruption platform market leaders, which arguably should trade at a multiple of this benchmark.

Our DCF fair value of Qihoo would be at US\$56 without factoring in any mobile contribution, still offering attractive upside from current levels. Share price downside support could be at c.US\$30 level, in our view, the price level when Qihoo's search potential was barely priced in. Mobile service offerings and market position enhancement, and new business models to monetize platform traffic, could lead to further significant strategic upside from our target price.

Related Reports

[Global Telecoms - Monetizing the Mobile Money Opportunity](#)

[Pan-Asian Telecoms - Affordable Smartphones and the Impact on Emerging Asia Telcos](#)

[Citi's Global Handset Model - Updating Our Global Handset Model; Smart Device Explosion Trend Continues As Smart Phones Continue to Gain from Feature](#)

[Asia Pacific Technology - Device Explosion: Smartphone Shipments to Hit 1.1bn in 2013](#)

[Global Consumer Staples - Making the Most of the World-Wide Web](#)

Compelling Opportunities in Mobile and Search

In terms of market shares in China, Qihoo is No.1 in browser, No.1 in directory page and top 3 in Android apps store.

Qihoo has built a large user base (96% penetration of China PC Web users and 70% penetration of China smartphone users) by initially offering free and user-friendly PC and mobile Internet security products and services. Based on its core security products, Qihoo developed services like browser, directory page and apps store to direct and monetize traffic in its platform, mainly through ads, search and virtual items (games). Qihoo has gained no.1 market share in browser, no.1 in directory page and top 3 in Android apps store, and built a solid open platform based on its security products.

Leveraging on its substantial user base and proven product development capabilities, Qihoo is able to continue to evolve its business model to drive sustainable earnings growth, in our view. We believe Qihoo could emerge as one of China's handful of Internet giants with enhanced market positions in Internet security and browser (key for cross-selling other Qihoo products), and growth drivers from evolving monetization methods like search and mobile games.

Mobile

Mobile will have significant revenue contribution starting from 2H13; potentially a key positive catalyst for the stock

We expect mobile games revenue will grow at a two-year CAGR of 108% to reach US\$152m by FY15.

We believe the Street underestimates Qihoo's mobile growth potential. We expect mobile will contribute 10% (US\$60m) of Qihoo revenue in FY13, as we believe that, by traffic, Qihoo's apps store is already China's No. 1 Android apps store. We expect Qihoo will have US\$35m revenue from mobile games (6% of revenue) and US\$25m from mobile ads (4% of revenue) in FY13. We expect mobile games revenue will grow at a two-year CAGR of 108% to reach US\$152m by FY15, as a key mobile revenue contributor for Qihoo.

Mobile monetization can be expected through apps store/games first, then search and finally other display forms. Qihoo started mobile monetization in year-end 2012, and has gained encouraging results. Mobile game revenues were an embryonic US\$2-3m in 1Q13, accounting for 2% of total revenue. Qihoo also generated c.US\$2m ad revenue from apps store in 1Q, paid by companies that promote apps downloads through Qihoo apps store.

As smartphones and tablets proliferate and more users shift from desk computers to smartphones, we see Qihoo's mobile strategy as a key stock catalyst from 2H13 as we expect the company to further elucidate and highlight its strategy in this area. Qihoo's mobile monetization will be mobile games and ads focused in FY13. Channel checks with a variety of industry players indicate the mobile games market will boom in 2013, and apps distribution platform operators like Qihoo will be key beneficiaries. Mobile ads, a material revenue source for some leading apps stores in China, will be another major revenue driver for Qihoo.

We expect Qihoo to gradually launch mobile search related products and tap into this market in 2014.

Qihoo will continue to use its mobile security product and iTunes-like terminal software to build a mobile brand and user base, which can then be monetized via leveraging into traffic flow (apps store, browser, games, etc.). We expect Qihoo to gradually launch mobile search related products and tap into this market in 2014. Total smartphone users of Qihoo mobile security products reached 275m in Mar13 (smartphone user penetration of c.70%), vs 207m in Dec12.

Case study of NetDragon, a leading company in mobile monetization

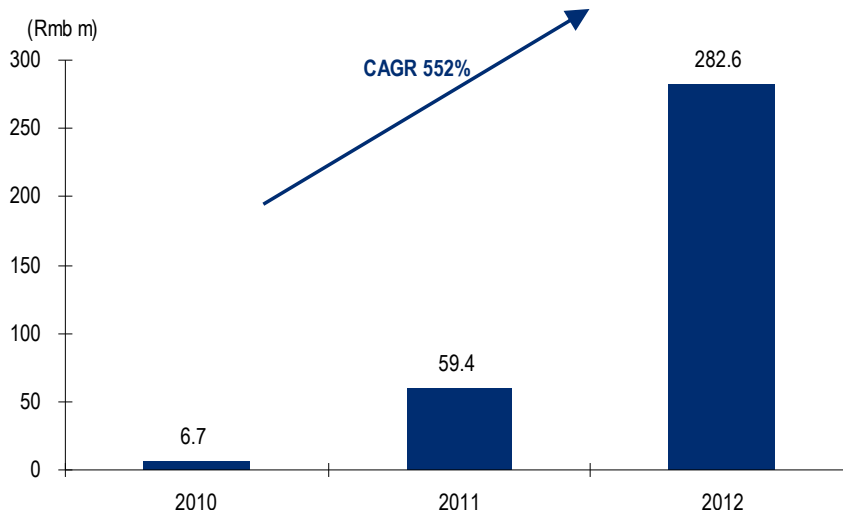
NetDragon, a pioneer and leading player to monetize apps store in China, is a benchmark for Qihoo's mobile growth potential. NetDragon's 91 platform is among the top 3 third-party mobile apps distributors in China, according to 3rd party consulting firms. NetDragon generates revenue primarily through mobile games and mobile ads distributed by its two apps stores 91 Assistant and HiMarket. NetDragon had partnered with more than 93,000 apps developers and 700 mobile games developers as of 2012.

NetDragon started to report mobile business segment in 2010 with revenue of Rmb6.7m (US\$1.0m), representing 1.2% of total revenue. The segment grew by 793% in 2011 and 376% in 2012 to reach Rmb282.6m (US\$44.8m, 25.5% of its revenue).

Mobile games have become the biggest mobile growth driver for NetDragon.

Mobile revenue has maintained fast growth in FY13 and mobile games have become the biggest mobile growth driver for NetDragon. NetDragon had Rmb144.7m (US\$23.6m) mobile revenue in 1Q13, up 219% yoy and 42% qoq. Mobile games revenue grew by 85% qoq to reach US\$11.1m, and mobile ads revenue grew by 24% qoq to reach US\$11.3m in 1Q13. 47% of NetDragon's mobile revenue was from mobile games and 48% from ads in 1Q13. Mobile games contributed to 35% of NetDragon's mobile revenue in 4Q12 and 29% in 4Q11.

Figure 3. Mobile Internet Revenue of NetDragon



Source: Company data, Citi Research

Implications for Qihoo: fast mobile revenue growth mainly driven by games

We believe apps store download traffic of Qihoo surpassed that of NetDragon in 2Q13, and Qihoo should have comparable mobile monetization potential to NetDragon in the next one to two years. Qihoo grows its apps store user base mainly through iTunes-like mobile assistant software, which is embedded in its PC-based security software and helps smartphone users download apps through PC connection.

Qihoo gained US\$2-3m mobile games revenue and c.US\$2m mobile ads revenue in 1Q13, and should see fast mobile growth, as indicated by NetDragon's much higher mobile revenue size and fast revenue growth.

We expect Qihoo to grow mobile games revenue at a two-year CAGR of 108% to reach US\$152m by FY15.

We expect Qihoo will grow mobile games revenue faster than mobile ads revenue, and mobile games will become a major mobile revenue source in the next two years. Mobile games market will surge to c.US\$1bn in China in 2013 according to feedback from a number of industry players, driven by fast smartphone penetration growth. Apps store will be a key distribution channel for mobile games. We expect Qihoo will generate US\$35m mobile games revenue in FY13 and mobile games revenue will grow at 108% two-year CAGR to reach US\$152m by FY15.

Search

Search is a compelling growth option for Qihoo

We took an aggressive (and non-consensus) research view that Qihoo would enter the search market some 4 months before the company announced its strategy in this area. This was borne out by the company's launch of its search service in Aug 2012.

Qihoo has the potential to claim 20% search traffic market share within the next year, and possibly 30-35% in the very long term.

Our view is Qihoo will fill the void created by Google's exit and emerge as a credible #2 in China's search market. Qihoo, we believe, has the potential to claim 20% search traffic market share within the next one year, and possibly 30-35% in the very long term. Qihoo's market share of China's online search market by page views (PV) increased to 14.1% in April 2013, following Baidu's 70.6% share, according to CNZZ. With a lack of an effective alternative in the search space, Baidu largely filled the space left by Google with its market share increasing from 70% in 1Q10 to 88% in 2Q12. This left a void in the space that both users and advertisers had pent-up demand to be filled.

Qihoo's search monetization is on track by cooperating with Google Adwords in Jan and also by developing its own search monetization system. Qihoo already generated 5% of total revenue from search in 1Q13 and gained c.14% search traffic market share (by 3rd party data and our channel checks) by April.

We expect Qihoo to gain 1.4% search revenue market share in FY13 (US\$80.4m, 13.5% of Qihoo total revenue) and 4.5% market share in FY14 (US\$308.1m, 29.4% of Qihoo revenue) as its search traffic market share keeps rising. China search market size reached Rmb 28.1bn (US\$4.5bn) in 2012, up 48.6% yoy, according to iResearch.

Search monetization driven by traffic growth...

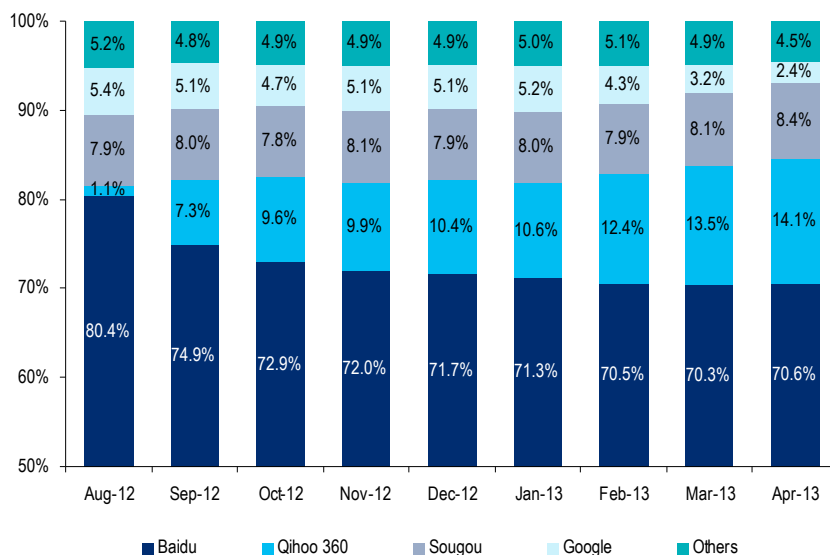
Qihoo launched its search service in Aug 2012 and its traffic market share stabilized at 10% at year-end 2012 after initial competitive escalation with Baidu and traffic volatility for a few months. Qihoo then started search monetization through its internal platform in Dec12 and through partnership with Google Adwords in Jan13. Search revenue ramped up quickly to reach US\$6m in 1Q13, accounting for 5% of Qihoo total revenue.

Qihoo management targets 20% search traffic market share by 2013.

Sustainable search traffic market share growth is key search revenue growth driver. Qihoo search is now the industry #2 after Baidu with a c.14% search query share and is gradually increasing market share. Qihoo management targets 20% search traffic market share by 2013. Qihoo's market share of China's online search market by page views (PV) increased to 14.1% in April 2013 from 10.4% in Dec 2012, according to Alibaba Group's third-party web analytics subsidiary CNZZ. Qihoo continues to grab page view market share from Baidu, whose share declined from 71.7% in Dec 2012 to 70.6% in April 2013. Google's share saw faster decline than Baidu during the first four months of 2013, down from 5.1% in Dec 2012 to 2.4% in April 2013, which we believe is also due to Qihoo's market share gains. According

to CNZZ, aggregate market share of other search companies has been largely stable since Aug 2012, indicating Qihoo gained market share mainly from Baidu and Google. These data are consistent with our channel checks.

Figure 4. China's Online Search Traffic Market Share (by Page Views)



Source: CNZZ, Citi Research

In 2013 Qihoo plans to aggressively increase search traffic market share and improve search monetization system efficiency, which can help close the price gap between Qihoo and Baidu and drive Qihoo's search revenue growth.

Qihoo plans to expand search traffic market share to 20% in 2013 via the following efforts:

- Default search reset in 360 browser and navigation page
- Change browsing behaviors: Many 360 Browsers users still type URLs to go to targeted websites. Actually, the browser allows users to directly input keywords into the address bar and return results via Qihoo's search engine. The company believes that by further directions, it could suggest users to simply type keywords only, and thus convert some traffic to its search engine.
- Deliver a differentiated and comparable search experience. Its first differentiation is to separate paid and unpaid listings, unlike Baidu with comparable search results for the popular search key words. Qihoo also launched a program called "thumbs up" which encourages users to rate/recommend good websites via Qihoo search.
- More marketing campaigns to increase search brand awareness
- Build search traffic alliance from end of 2013

...and monetization system building

We expect Qihoo's own search monetization system could contribute to over 50% of its search revenue from 2H13/1H14. Qihoo plans to focus on its own search

monetization platform in the long term, and is currently leveraging its Google partnership to fill the monetization “scale gap” in the near-to-medium term.

Qihoo plans to improve monetization system efficiency through further developing its keyword system, and building up internal sales force and agency network. We believe Qihoo has the potential to deliver positive surprise in search monetization given Qihoo's strong operational capabilities.

Most of Qihoo's key products (browser, directory page and mobile apps store) are gaining share from competitors.

Qihoo has a good track record in product and business development. Most of its key products (browser, directory page and mobile apps store) are gaining share from competitors. We believe Qihoo has “organizational DNA” that lends itself to the search business given its expertise in analytics, data warehousing, data mining and behavioral targeting which were already being expressed via a move toward “searchless search”, via tailored directory, via its performance-based ad business (CPC and CPA) in its directory page. Qihoo has a key search R&D team that has evolved from its 3721.com and Yahoo China history.

Existing Key Revenue Streams to Grow Steadily

We believe continued user and traffic growth on Qihoo platform will drive solid growth of Qihoo's online ads and games, Qihoo's existing main revenue source.

We expect Qihoo will maintain solid growth in its online ads driven by increasing contribution from performance-based ads and continued traffic growth in its directory page. Qihoo would continue to benefit from a rebound in the online ad market if China's economy recovers.

Potential to emerge as one of China's Internet giants in terms of revenues, cashflows, capital returns and equity values.

Furthermore, considerable user base, continued traffic growth and monetization methods development give the company the opportunity to emerge as one of China's handful of Internet giants alongside Baidu, Tencent and Alibaba Group (unlisted) in terms of revenues, cashflows, capital returns and equity values, over the longer term.

Forecasts by Business Segments

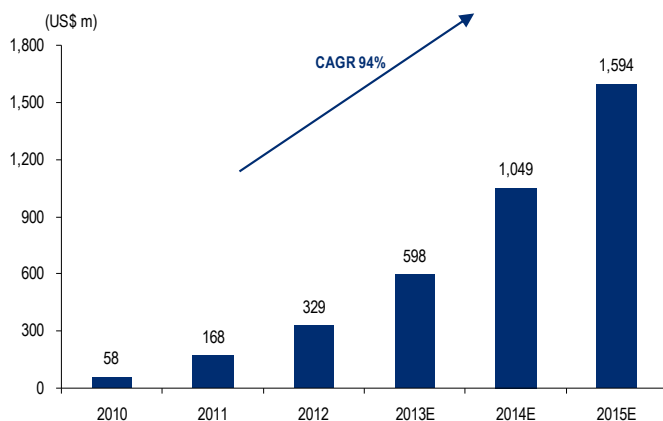
We forecast Qihoo's revenue will grow at a 3-year CAGR of 69.2% to reach US\$1,594.2m and non-GAAP net profit will grow at a 3-year CAGR of 61.9% to US\$412.8m in 2015.

Business model evolution will bring new revenue drivers and revenue mix changes. PC Search will contribute significantly to the total revenue in the future. We expect the revenue contribution from PC search will surge to 39.1% in 2015 from 13.5% in 2013.

Gross margin will decrease slightly from 86.9% in 2013 to 83.7% in 2015 due to higher revenue contribution from search and mobile which have lower margins than Qihoo's existing ads business.

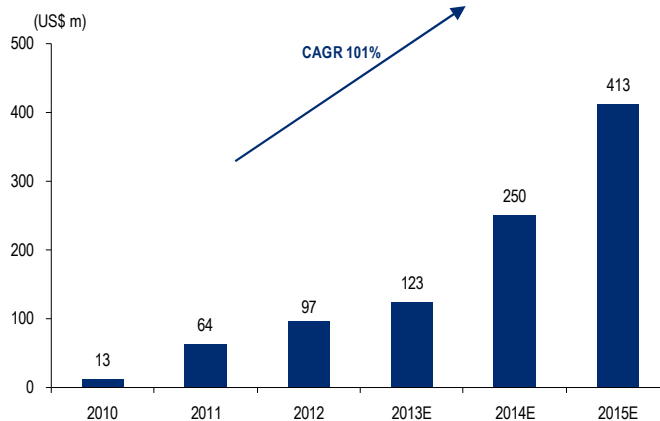
Non-GAAP EBIT margin will drop to 23.1% in 2013 but rise to 29.4% in 2015 as operating leverage emerges with rising search and mobile revenue. Qihoo added lots of opex related to search before early 2013 with limited search revenue, pressuring margins. Search and mobile revenues will become significant after 2Q13 and drive margin recovery. We are more optimistic on FY13E margins than consensus and we expect Qihoo to deliver positive surprise in margin recovery.

Figure 5. Revenue



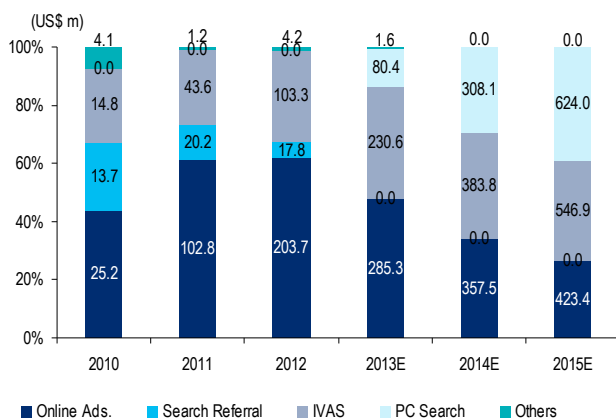
Source: Company Reports and Citi Research Estimates

Figure 6. Non-GAAP Net Profit



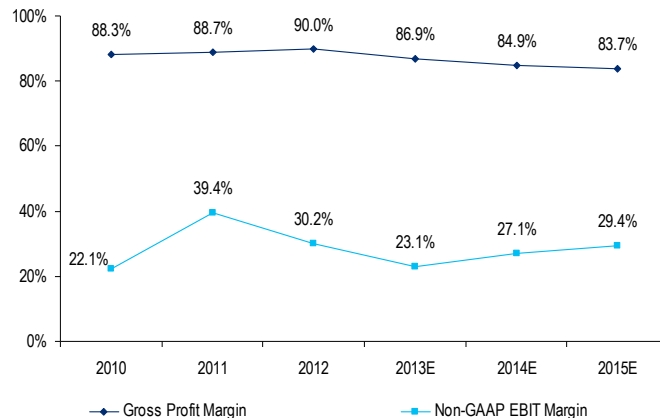
Source: Company Reports and Citi Research Estimates

Figure 7. Revenue Breakdown



Source: Company Reports and Citi Research Estimates

Figure 8. Margins (%)



Source: Company Reports and Citi Research Estimates

Mobile

We expect Qihoo will generate US\$60m from mobile in FY13 (10% of total revenue). We expect Qihoo will have US\$35m revenue from mobile games (6% of revenue) and US\$25m from mobile ads (4% of revenue) in FY13. We forecast mobile games revenue to reach US\$152m in FY15, at a two-year CAGR of 108%.

We expect Qihoo will grow mobile games revenue much faster than mobile ads revenue in the long term.

We expect Qihoo will grow mobile games revenue much faster than mobile ads revenue in the long term. At the embryonic stage of mobile growth, we take a conservative approach and only include mobile games revenue in our mobile forecasts. We believe mobile ads (based on apps store) could be significant near term revenue contributor, and mobile search/commerce are possible longer term growth drivers. We expect in a bull case, Qihoo's total mobile revenue could be 2x our FY14E and 3x our FY15E mobile games revenue, which would lead to mobile revenue CAGR of 280% in FY13-15E, compared with our current CAGR projection of 108%.

We expect Qihoo will report mobile revenue in either IVAS revenue (includes mobile games revenue) or online ads revenue (includes mobile ads revenue, which is from 3rd party apps promotion fees through the apps store) in FY13.

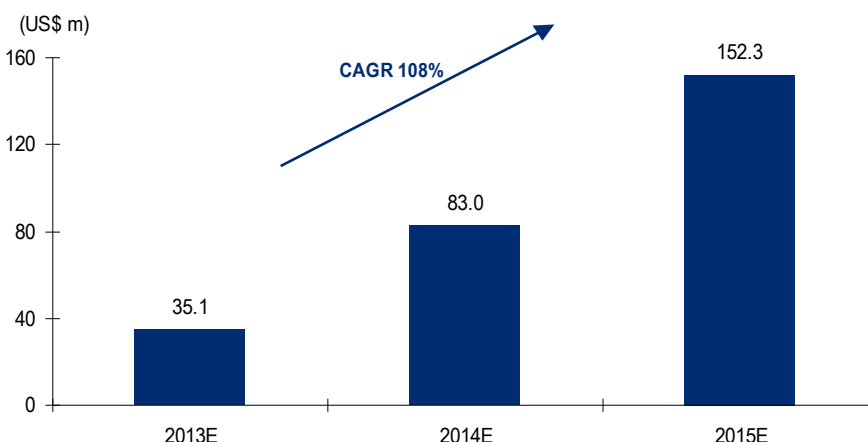
Drivers to mobile growth are mainly from continued user growth of mobile security and apps store (which help cross-sell other mobile apps of Qihoo), and also from fast smartphone penetration growth in China.

We believe Qihoo will have an entrenched position in mobile security, as it does in PC Internet security.

We expect smartphone penetration will continue to soar in China, driven by 3G service promotion from telecom operators and US\$100 device with over 4.5" screen from Chinese smartphone vendors like Huawei, ZTE and Lenovo. Mobile Internet security issues will be more severe than for fixed devices with an embryonic software ecosystem as mobile devices inherently contain more private information. According to iResearch, Qihoo already has a 70% market shares in smartphone-based mobile security. We believe Qihoo will have entrenched market position in mobile security, as it does in PC Internet security.

We believe Qihoo's apps store is already China's No. 1 Android apps store by traffic, and there is big potential for ecosystem revenue sharing through mobile games and other apps.

Figure 9. Forecast of Mobile Games Revenue



Source: Citi Research Estimates

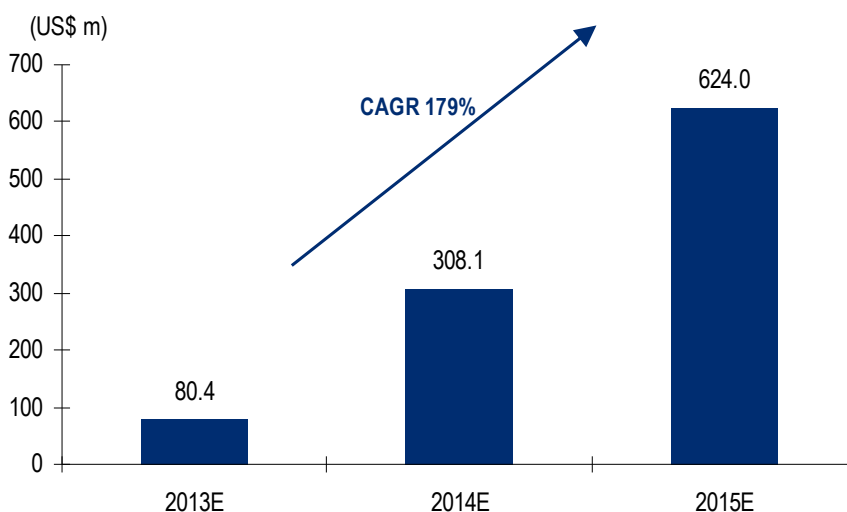
Search

We estimate search revenue of US\$80.4m in FY13 (13.5% of total revenue) and US\$624.0m in FY15 (39.1% of total revenue), at a 2-year CAGR of 178.5%.

We have introduced search revenue in our forecasts, with more visibility of its search growth trends after Qihoo partnered with Google and keep growing its search traffic market share. We estimate Qihoo will generate US\$80.4m search revenue in FY13 (13.5% of total revenue), and US\$624.0m search revenue in FY15 (39.1% of total revenue) at a 2-year CAGR of 178.5%. We forecast Qihoo will gain 8% search revenue market share by FY15. Qihoo's search market share growth was mainly at the expense of Baidu and Google.

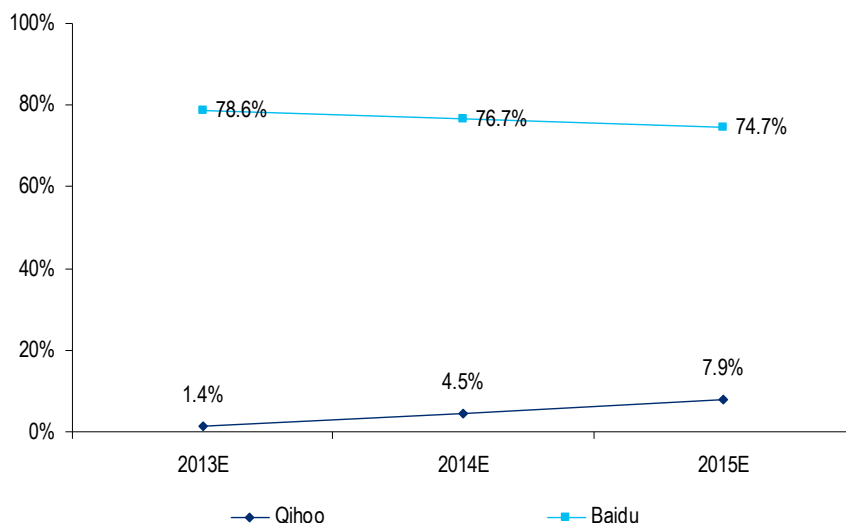
The search traffic market share of Qihoo has reached 14%, not far from Google's peak market share of 17-18%, which provided a good foundation for monetization. We expect Qihoo will generate 20% search traffic market share by 2013 and 28% traffic share by 2014. In the long term we expect Qihoo could gain 30-40% search traffic market share and 15-20% search revenue share. Any speeding up in Qihoo's search traffic share or monetization system development could lead to upside risks to our search revenue estimates.

Figure 10. Search Revenue Forecast



Source: Citi Research Estimates

Figure 11. PC Search Revenue Market Share



Source: Citi Research Estimates

Online Advertising (other than Search)

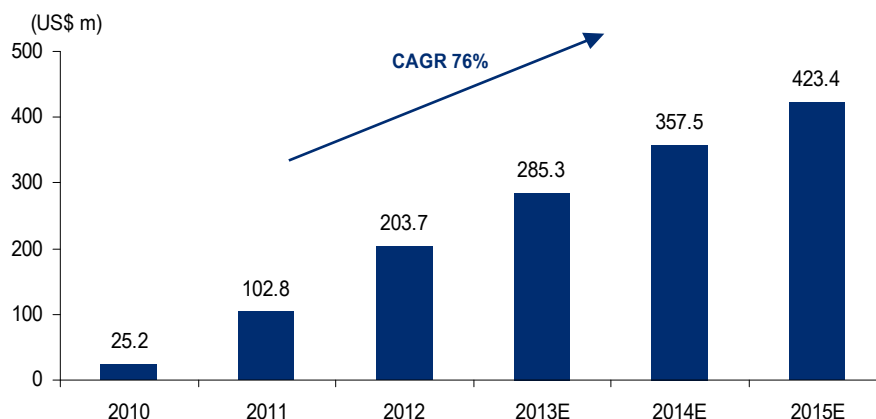
Qihoo offers advertising services by providing links to advertisers' websites or platform products such as online applications on 360 Personal Start-up Page/Sub-pages, a directory website of Qihoo. Qihoo charges fees to customers on a cost over a time period (time-based ads) or cost for performance basis (performance-based ads).

We forecast revenue from online advertising to reach US\$423.4m in 2015E (26.6% of total), a 3-year CAGR of 27.6%.

In 2012, this segment reported revenue of US\$203.7m, accounting for 61.9% of total revenue. We forecast revenue of Qihoo's online advertising to reach US\$423.4m in 2015E (26.6% of Qihoo revenue) at a 3-year CAGR of 27.6%.

Growth drivers in this business would mainly be traffic growth and performance-based ads in vertical channels/sub-pages of Qihoo Start-up Page.

Figure 12. Online Ads Revenue Forecast



Source: Company data, Citi Research Estimates

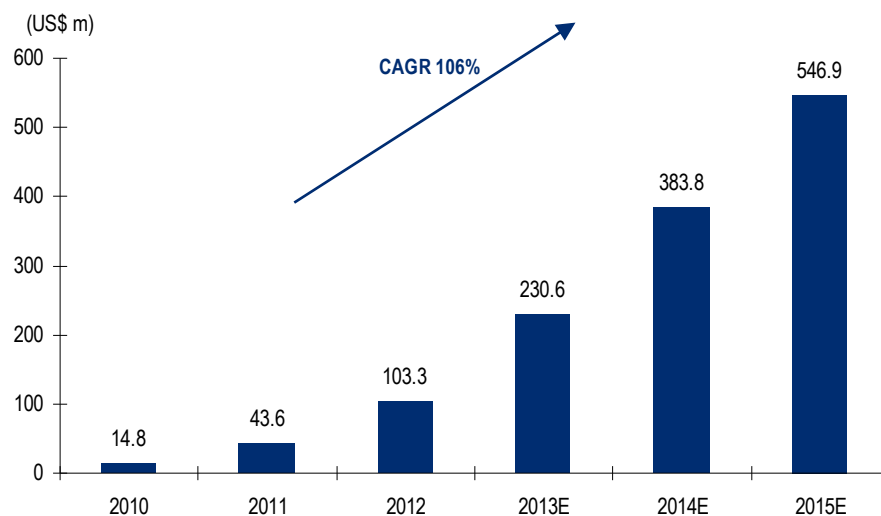
IVAS

Internet value-added services are mainly composed of online games. Qihoo provides games, including web games, client-based games and mobile games, by third parties and generates revenue through sharing of in-game item sales. Users can play those games directly on Qihoo's game platform without downloading separate software and hence minimize exposure to malware intrusion. Qihoo offered more than 110 Web games (by 80+ developers) to over 60m active users by 2012.

We forecast 3-year CAGR of 74.3% for IVAS revenue to reach US\$546.9m in 2015 (34.3% of revenues).

IVAS revenue was US\$103.3m in 2012. We forecast Qihoo's IVAS revenue will grow at a 3-year CAGR of 74.3% to reach US\$546.9m, contributing 34.3% of revenues in 2015, and IVAS gross profit will grow to US\$456.8m in 2015. As a major revenue growth driver, games are scalable VAS that can leverage on Qihoo's growing user base for its browser and other services.

Figure 13. IVAS Revenue Forecast



Source: Company data, Citi Research Estimates

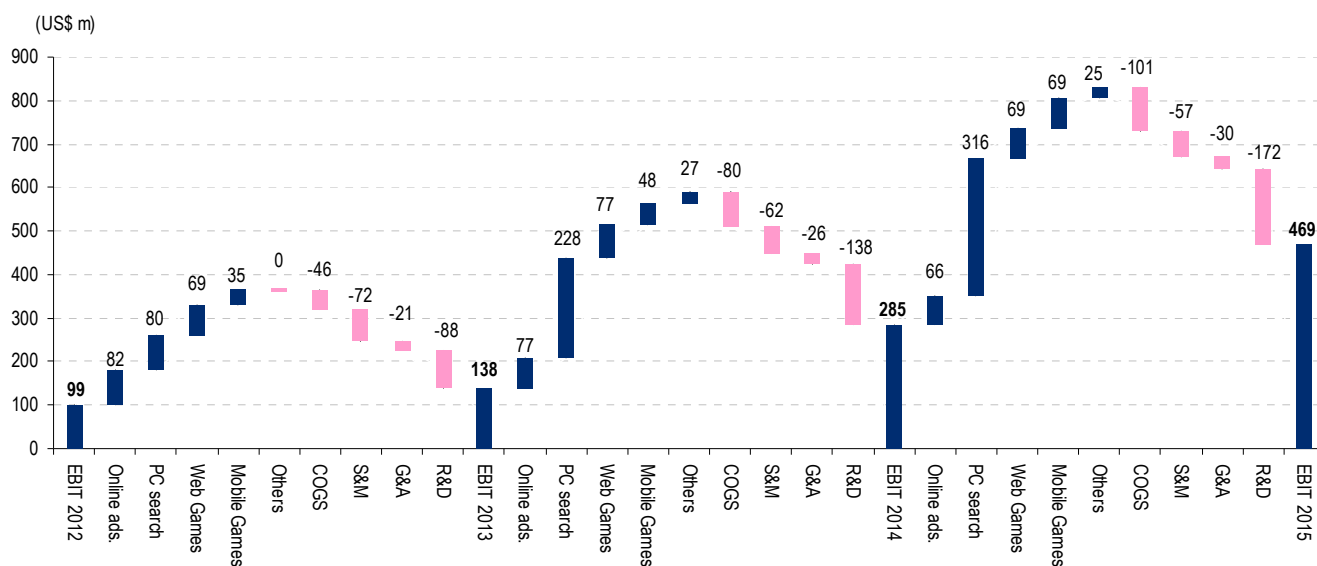
Profit Analysis

Qihoo's profit margins are affected by change in revenue mix. Revenue from online ads based on directory page has the highest margins, but revenue contribution from this segment is declining. Revenue contribution from IVAS (mainly from games) is expected to increase from 31% in 2012 to 34% in 2015E. PC search revenue will contribute significantly to revenue after monetization in 2013, accounting for 39% of total revenue by 2015E. This will moderately drive down Qihoo's gross margin between 2013-2015E.

We expect search and mobile revenue growth will outpace costs after 2Q13, driving margin recovery and earnings.

We expect Qihoo's operating margins will recover after 2Q13 with scalable growth of search revenues and operating leverage kicking in. In order to attract and retain users, Qihoo will invest heavily in developing and promoting security products, cloud-based services, search engine-related products, and mobile Internet products, which will cause rising opex in FY12-13 and pressure on margins. Selling and marketing costs (to promote Qihoo's brand and new services like mobile and search) are especially a drag on the operating margin in FY13. We expect search and mobile revenue growth will outpace costs after 2Q13, driving a margin recovery and earnings growth.

Figure 14. Qihoo Non-GAAP EBIT Variance Analysis



Note: All data are Non-GAAP

Source: Citi Research Estimates

Estimate Revisions

We reduce our FY13E EPADS by 3% after factoring in more search-related operating costs, and raise our FY14E EPADS by 26% after including search and mobile games forecasts. We forecast earnings growth of 27% in FY13E and non-GAAP EBIT margin of 23% in FY13E (30% in FY12). Developing search and mobile business will drag on near-term earnings due to costs from service development and promotion, but is long-term earnings accretive. Our FY13E net profit is 20% higher than consensus. We expect Qihoo to deliver a positive surprise in margin recovery.

Figure 15. Qihoo – Estimate Changes

	2013E			2014E			2015E	
	Old	New	Chg	Old	New	Chg	New	Chg
Revenue	486	598	23.2%	727	1,049	44.4%	1,594	-
Gross Profit	412	520	26.0%	612	891	45.5%	1,335	-
Non-GAAP EBIT	139	138	-0.5%	218	285	30.7%	469	-
Non-GAAP NP	121	123	1.5%	190	250	31.8%	413	-
Non-GAAP EPADS	1.00	0.97	-2.7%	1.51	1.91	26.2%	3.05	-

Source: Citi Research Estimates

Valuation

We increase our DCF-driven target price for Qihoo to US\$65 (was US\$39). Our DCF model uses an explicit 10-year forecast period and a terminal growth rate of 3% (lower than longer term sector and GDP growth), discounted back using a cautious (high) cost of capital of 15% to create investor margin-of-safety and to fully factor the embryonic nature of China's mobile ecosystem, the embryonic nature of Qihoo's current monetization model and substantial execution risks balanced against the company's market-leading brand, mind-share and IP competitive moat contained within its core security products portfolio. Our US\$65 target price translates to a PEG (using 3 year forward EPS CAGR) of 0.6x, which is broadly in line with a full universe of local and global comps, though at a significant discount to a comparable universe of potential post-disruption platform market leaders which arguably should trade at a multiple of this benchmark.

Our DCF fair value of Qihoo would be at US\$56 without factoring in any mobile contribution, still offering compelling upside. Share price downside support could be at c.US\$30 level in our view, the price level when Qihoo's search potential was barely priced in.

Mobile service offerings and market position enhancement, and new business models to monetize platform traffic could lead to further significant strategic upside from our TP.

Figure 16. China Internet Comps

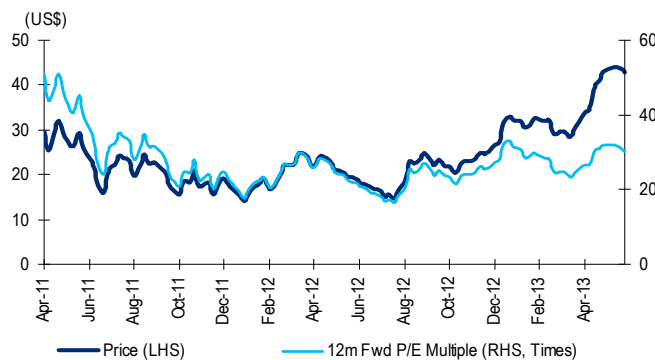
Date: 27 Jun 2013

Company Name	Reuters Ticker	Price LCY	Mkt Cap USD (M)	EPS Growth			EPS CAGR 2013-15E	P/E			PEG 2013-15E
				2013E	2014E	2015E		2013E	2014E	2015E	
China High Growth Market Leader											
Company Name	Reuters Ticker	Price LCY	Mkt Cap USD (M)	EPS Growth			EPS CAGR 2013-15E	P/E			PEG 2013-15E
				2013E	2014E	2015E		2013E	2014E	2015E	
Tencent Holdings	0700.HK	298.20	71,164	24%	33%	24%	28%	25.3	19.1	15.4	0.7
Baidu.com	BIDU.O	93.72	32,770	-1%	-3%	1%	-1%	19.0	19.6	19.3	na
Sina	SINA.O	56.21	3,752	93%	140%	na	na	188.0	78.2	na	na
Netdragon Websoft Inc	0777.HK	18.72	1,227	187%	24%	29%	26%	19.6	15.9	12.3	0.6
Perfect World	PWRD.O	16.20	784	-35%	12%	4%	8%	12.3	11.0	10.6	1.4
Kingsoft Corp	3888.HK	12.56	1,906	24%	25%	27%	26%	21.6	17.3	13.6	0.7
AutoNavi Holdings	AMAP.O	12.07	835	-48%	26%	41%	33%	23.9	19.0	13.5	0.6
Ctrip.com International	CTRP.O	31.85	4,133	6%	34%	23%	28%	23.2	17.3	14.1	0.6
Weighted Average			112,438	19%	26%	17%	20%	28.5	20.9	16.4	0.7

Company Name	Reuters Ticker	Price LCY	Mkt Cap USD (M)	EPS Growth			EPS CAGR 2013-15E	P/E			PEG 2013-15E
				2013E	2014E	2015E		2013E	2014E	2015E	
At Current Price											
Qihoo 360	QIHU.N	44.97	5,521	22.3%	96.4%	59.8%	56.6%	44.8	22.1	13.4	0.4
At Target Price											
Qihoo 360	QIHU.N	65.00	7,980	22.3%	96.4%	59.8%	56.6%	64.8	31.9	19.3	0.6

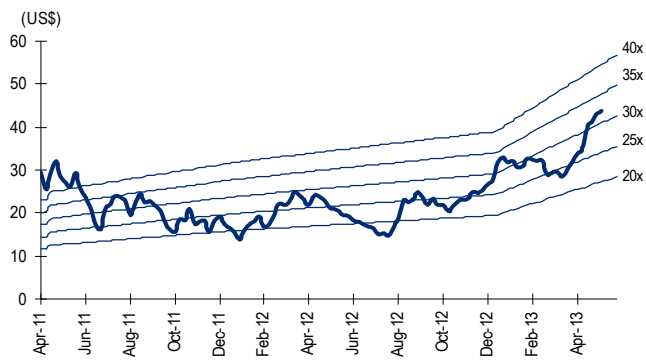
Source: Citi Research Estimates, IBES estimates (for Netdragon and Kingsoft)

Figure 17. 12M Forward P/E vs Price



Source: Company Reports and Citi Research Estimates

Figure 18. 12M Forward PE Band



Source: Company Reports and Citi Research Estimates

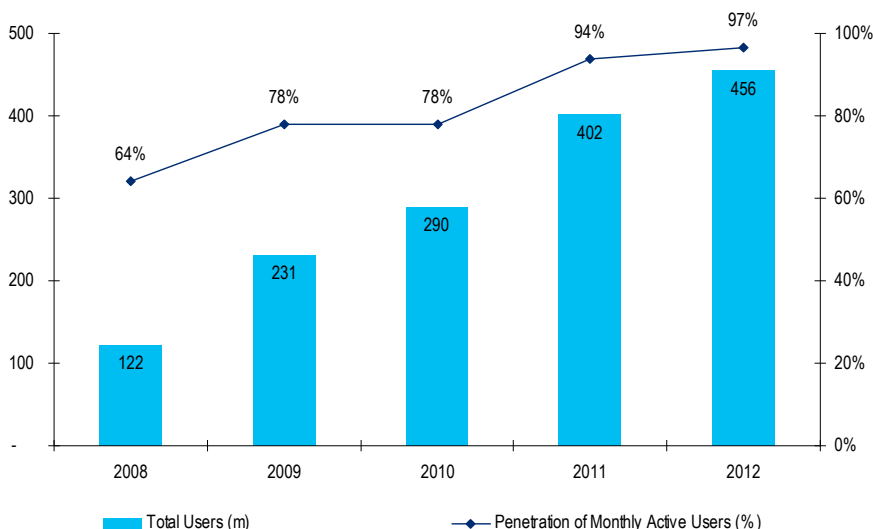
Company Overview and Business Model

Company Overview

Leading Internet company with mass user base.

Incorporated on June 9, 2005, Qihoo is a leading Internet company in China. Qihoo has built a large user base by offering comprehensive Internet and mobile security products and services against malware and malicious websites. By March 2013, Qihoo had 457m monthly active users of PC-based products and services, representing a user penetration of 95.8% among overall China PC Web users, and had 275m users of mobile security products, c.70% penetration of China smartphone users.

Figure 19. Total PC Web Users of Qihoo and Penetration



Source: Company Data, Citi Research

Figure 20. Qihoo Core Products and Monthly Active Users (March 2013)

Core Products	Monthly Active Users (m)
PC-based Products	457
PC Internet security products	445*
360 Browsers	332
360 Personal Start-up Page	94**
Smartphone-based Products	275

Note: * Data by Dec 2012; **Average daily unique visitors of 360 Personal Start-up Page in 1Q13

Source: iResearch, Company Data, Citi Research

Unique Business Model...

Three-layer products and “Freemium” business model.

Qihoo’s Freemium (Free + Premium value-added services) business model is not a vanilla “port” of a US business model. Instead, it has evolved from the unique nature of the China TMT landscape and is hence a unique business model designed explicitly for the China market.

A comparable company is Tencent, which uses free client software, QQ, as the foundation for its platform building and monetization. Tencent uses QQ to meet the social demand of China Internet users, while Qihoo uses free security software to effectively address the security concerns of China Internet users. The security need is no less than the social need, in our view, and we can see PC penetration of Qihoo’s security software is even bigger than that of Tencent’s QQ, which indicates

big potential for Qihoo's open platform development and revenue growth (Qihoo has partly proved such potential in the past two years).

Figure 21. Qihoo's Products and Services Layers



Source: Qihoo, Citi Research

Qihoo's products and services can be understood as a three-layer platform. The three layers can help explain how Qihoo grows and monetizes users/traffic, and how Qihoo bridges between end users and Qihoo's core competencies. Qihoo's monetization is mainly through products in its Service Layer, while it offers free products with the Core Security Layer and Access Layer to gain brand influence, user base and platform traffic. The Core Security Layer contains Qihoo's original IP and competitive moat as the security function can be embedded with products in other layers (ie, Qihoo's safe browser and secure online shopping environment) as a compelling selling point.

Qihoo developed its top-layer products mainly through cross-selling from low-layer products, which will continue to be a cost-effective and powerful marketing channel for its new services like search. For example, Qihoo's security software can pop-up reminder to Web users to promote Qihoo's safe browser after users remove malware. Qihoo will then develop its directory page and search users through cross-selling with browser, as default page of Qihoo's browser is its directory page which also has a search box.

Core Security Layer with market leading security products

The bottom layer, Qihoo's Core Security Layer, focuses on Internet and mobile security solutions. In Dec 2012, Qihoo had 445m monthly active PC Internet security products users, representing a user penetration rate of 94.2% in China. Qihoo's Internet security products took 80% market share by monthly time usage by year end 2012, according to iResearch. Qihoo's Internet and mobile security products include:

- 360 Safe Guard: a one-stop solution for Internet security and system optimization, the No.1 PC Internet security products in China with 418m monthly active users by 2012 (Source: iResearch)

- 360 Anti Virus: comprise multiple integrated security products, the No. 2 PC Internet security products in China with 379m monthly active users by 2012 (Source: iResearch)
- 360 Mobile Safe: cloud-based security products for mobile device, the No. 1 mobile security products with 207m smartphone users and 70% market share of mobile security products by 2012 (Source: iResearch)

On the top of Core Security Layer, Qihoo's products can be categorized as Access Layer (Internet access products) and Service Layer (open platform solutions for direct monetization), which both help Qihoo redirect traffic and influence the behavior of PC and smartphone users.

Access Layer has Internet access products like browser

Access Layer products provide users with two major secure access points to Internet: web browsers and apps store.

- 360 Browsers: can automatically block malicious websites and offer a "private browsing" option, secondary only to Microsoft IE with 310m monthly active users and a user penetration of 65.6% in China by 2012 (Source: iResearch)
- 360 Mobile Assistant: Android-based apps store, a key access point for smartphone users to browse, search, download and install apps; the apps store has iTunes-like interface to bridge between PC and smartphone Internet access. We believe 360 Mobile Assistant is currently China's #1 Android apps store in terms of apps downloads, according to feedback from 3rd party developers.

Service Layer has open platform products like directory page

Service Layer has open platform products to introduce 3rd party services (ie. video and games) and achieve monetization.

- 360 Personal Start-up Page: a directory page and the default home page of 360 Browsers, aggregates popular and preferred web sites and apps, had 91m average daily unique visitors and 450m average daily clicks in 4Q12 (Source: Qihoo)
- 360 Search: a self-developed and default search engine of 360 Browsers with about 10% market share by search traffic in Dec 2012 (Sources: iResearch)

Monetize through online ads, search and games

Qihoo monetizes its big user base and traffic primarily through online advertising, search and Internet value-added services primarily based on directory page and apps store, which are based on its free security software. The roadmap of Qihoo's platform and monetization development is similar to Tencent's. Tencent also has free client software, QQ, as the foundation for its platform. We believe Qihoo could develop more mobile monetization models in near future.

- Online advertising and search: offer advertising services by providing links to advertisers' website on 360 Personal Start-up Page and search referral. 360 Personal Start-up Page is a directory page that aggregates dynamic and personalized web links and content. Qihoo launched its own search service in Aug 2012 mainly on its browsers and Start-up Page to further monetize platform traffic. Search has become significant revenue contributor and a key growth driver for Qihoo.
- Internet value-added services: mainly composed of online web games and mobile games. Qihoo provides games by third parties and generate revenue through sharing of in-game item sales. Qihoo offered more than 110 online games (by 80+ developers) to over 60m active users by 2012 (150 web games by March 2013).

- Compelling mobile monetization potential in future. Qihoo has already generated meaningful mobile games revenue (reported in IVAS) and revenue from mobile ads based on apps store (reported in online ads). We expect Qihoo could develop further mobile monetization models from its mobile apps ecosystem driven by surging smartphone penetration in China.

Figure 22. Cases of Monetization on Qihoo 360 Start-up Page (Search, Online Ads and Online Game)



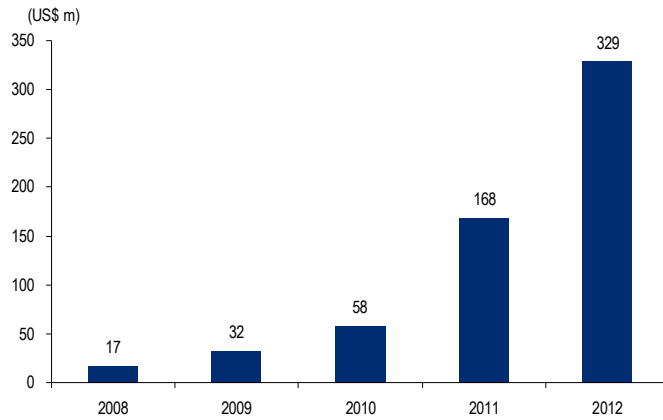
Source: Company, Citi Research

...Drives Company Financials and Equity Value

Solid financials

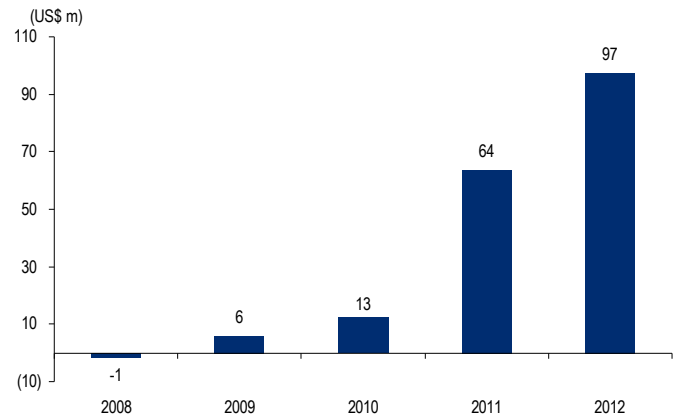
Well positioned in China's Internet security market and benefiting from the unique business model, Qihoo saw rapid growth in both top line and bottom line. The company's revenue composition keeps evolving with the economy and margins remain largely stable. In the future, key to driving equity value will be continued evolution of Qihoo's business model: to take its huge user base and evolve it into a high-functionality open platform providing a compelling online experience where users can explore content, play games, transact and share via multiple devices. This platform would then become a thriving microeconomy with Qihoo positioned as the "virtual taxation authority".

Figure 23. Revenue



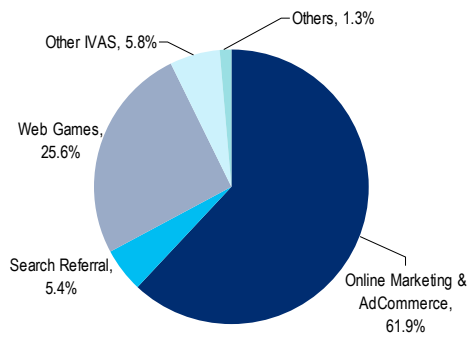
Source: Company Reports and Citi Research Estimates

Figure 24. Net Profit



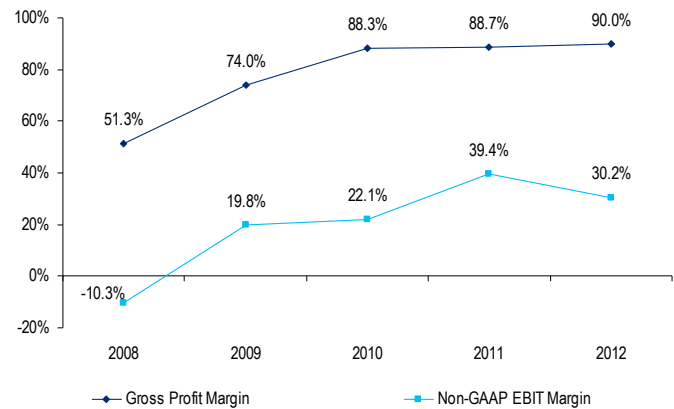
Source: Company Reports and Citi Research Estimates

Figure 25. Revenue Breakdown (2012)



Source: Company Reports and Citi Research

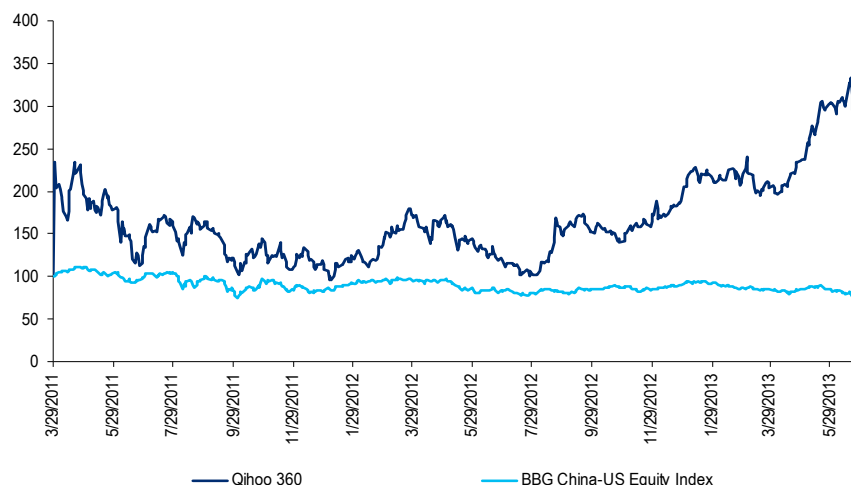
Figure 26. Margins (%)



Source: Company Reports and Citi Research Estimates

Outperformed BBG Asia Pacific Internet Index

Figure 27. Qihoo Share Price vs BBG China-US Equity Index since Its IPO



Source: Bloomberg, Citi Research

Risks

Execution - Qihoo's success depends on its management's ability to accommodate user demand, maintain and enhance brand and reputation. As prime inventory becomes more crowded on the company's directory page, management must continue to develop new services to increase traffic in vertical channels.

For search service, the challenge for Qihoo is now to use its springboard of traffic share to build its search experience and monetization, and continue to develop IP, data warehousing and analytics platform, brand and mind share. Qihoo needs to invest in its search technologies and brand promotions, and could face execution risks. Also Qihoo may have challenge in effectively developing its search monetization platform integrating its own sales forces, agencies and web alliances.

Competition - The rise of Qihoo threatens, and has seen friction with, established Internet giants. In the Internet security market, Qihoo faces significant competition from Kingsoft, Rising and other Internet security companies, although Qihoo has so far gained a clear dominant position in China's Internet security market. In the domain of building Internet platform to offer VAS, online ads and search services, some leading Internet companies, threatened by the growing user base and reputation of Qihoo, responded aggressively to Qihoo's strategy and its evolution. These companies have significant financial and brand resources to back their competitive responses.

For example, after Qihoo launched its search in Aug 2012, Baidu initiated a number of search wars including putting a notice on any of its content/search result pages that came from Qihoo search referral encouraging users to reset their search page to Baidu from Qihoo's navigation page. Competitors also tried to block Qihoo's traffic growth by undermining Qihoo's reputation through media press campaigns.

Some Internet companies like Tencent, in response to threats from Qihoo, sued Qihoo for alleged unfair competition. We expect Qihoo will likely continue to see competitive threats from, and friction with, China's Internet giants and security software companies. We are not ruling out the possibility of ongoing lawsuit in the future. We see this as an incremental share price/news flow risk as well as a significant operating and financial risk.

Financial Statements

Figure 28. Qihoo – Consolidated Income Statement (USD'M)

Income Statement (USD'M)	2010	2011	2012	2013E	2014E	2015E
Revenues						
1) Online advertising & marketing	38.8	123.0	221.5	365.8	665.6	1,047.3
1a) Online Marketing & AdCommerce	25.2	102.8	203.7	285.3	357.5	423.4
1b) Search Referral	13.7	20.2	17.8	0.0	0.0	0.0
1c) PC search revenue	0.0	0.0	0.0	80.4	308.1	624.0
2) Internet value-added service	14.8	43.6	103.3	230.6	383.8	546.9
2a) Web Games	12.6	34.9	84.1	153.4	230.0	299.2
2b) Mobile Games	0.0	0.0	0.0	35.1	83.0	152.3
2c) Other IVAS	2.1	8.7	19.2	42.1	70.8	95.4
Total Cost of Revenues	0.2	0.3	4.1	1.6	0.0	0.0
Sales of 3rd party anti-virus software	3.9	0.9	0.2	0.0	0.0	0.0
Total Revenues	57.7	167.9	329.0	598.0	1,049.4	1,594.2
Growth YoY (%)	79%	191%	96%	82%	75%	52%
Gross Profit						
1) Online advertising & marketing	36.0	112.8	202.3	259.7	324.2	382.7
1a) Online Marketing & AdCommerce	23.0	93.6	185.3	259.7	324.2	382.7
1b) Search Referral	13.0	19.2	16.9	0.0	0.0	0.0
1c) PC online search	0.0	0.0	0.0	64.4	245.6	495.4
2) Internet value-added service	11.7	35.2	85.9	193.9	321.6	456.8
2a) Web Games	11.0	30.0	71.5	130.4	194.8	252.5
2b) Mobile Games	0.0	0.0	0.0	29.8	70.1	127.9
2c) Other IVAS	0.7	5.2	14.4	33.7	56.6	76.3
3) Other services	3.2	0.0	0.0	0.0	0.0	0.0
Sale of third-party anti-virus software	0.0	0.7	0.1	0.0	0.0	0.0
Total Gross Profit	50.9	148.9	296.2	519.5	891.4	1,334.9
Growth YoY (%)	113%	193%	99%	75%	72%	50%
Margin (%)	88%	89%	90%	87%	85%	84%
Subsidy income	0.0	0.2	2.6	0.0	0.0	0.0
Non-GAAP EBITDA	14.1	70.4	115.9	182.4	355.1	566.9
Growth YoY (%)	34%	399%	65%	57%	95%	60%
Margin (%)	24%	42%	35%	30%	34%	36%
Non-GAAP Operating Expenses						
Non-GAAP Selling and Marketing	(12.1)	(15.4)	(37.2)	(109.4)	(171.0)	(228.0)
Non-GAAP General and Administrative	(4.7)	(14.5)	(26.3)	(47.8)	(73.5)	(103.6)
Non-GAAP Research and Development	(21.4)	(53.1)	(136.0)	(224.2)	(362.0)	(534.1)
Non-GAAP Total Operating Expenses	(38.2)	(83.0)	(199.5)	(381.5)	(606.6)	(865.6)
Non-GAAP EBIT	12.8	66.1	99.3	138.1	284.8	469.3
Growth YoY (%)	100%	418%	50%	39%	106%	65%
Margin (%)	22%	39%	30%	23%	27%	29%
Interest Income	0.4	2.6	6.7	7.0	9.5	16.4
Interest Expense	(0.1)	(0.1)	0.0	0.0	0.0	0.0
Other Income/Expense	0.2	(1.1)	7.2	(0.0)	(0.0)	(0.0)
Net Exchange Gain (Loss)	(0.3)	6.3	0.049	(0.0)	(0.0)	(0.0)
Non-GAAP EBT	13.0	73.8	113.3	145.0	294.3	485.6
Income Tax Benefit (Expense)	(0.5)	(10.9)	(11.4)	(21.7)	(44.1)	(72.8)
Loss from equity method investment	(0.1)	(0.4)	(4.8)	0.0	0.0	0.0
Non-GAAP Effective Tax Rate (%)	-4%	-15%	-10%	-15%	-15%	-15%
Minority Interest	(0.0)	(1.1)	(0.3)	0.0	0.0	0.0
GAAP Net Profit (Loss)	8.5	15.6	46.7	69.3	193.3	344.9
Growth YoY (%)	103%	83%	200%	48%	179%	78%
Margin (%)	15%	9%	14%	12%	18%	22%
Non-GAAP Net Profit (Loss)	12.5	63.6	97.4	123.2	250.2	412.8
Growth YoY (%)	105%	408%	53%	27%	103%	65%
Margin (%)	22%	38%	30%	21%	24%	26%

Source: Company Data, Citi Research Estimates

Figure 29. Qihoo – Consolidated Balance Sheet (USD'M)

Balance Sheet (USD'M)	2010	2011	2012	2013E	2014E	2015E
Current Assets						
Cash and cash equivalents	60.5	343.7	380.7	379.6	658.9	1,129.1
Accounts receivable	8.2	16.7	23.6	62.4	109.5	166.3
Prepaid expenses and other current assets	3.1	12.8	26.8	48.7	85.5	129.9
Inventory	0.0	0.0	0.0	0.0	0.0	0.0
Deferred tax assets-current	0.8	0.9	2.1	2.1	2.1	2.1
Total Current Assets	72.6	374.4	435.3	492.8	856.0	1,427.4
Non-Current Assets						
Property and equipment, net	3.3	16.7	126.0	158.1	189.7	214.4
Intangible assets, net	5.5	7.9	12.3	14.1	17.4	22.6
Goodwill	3.9	4.6	4.6	4.6	4.6	4.6
Long-term investment	2.0	15.6	27.6	27.6	27.6	27.6
Deferred tax assets- non current	0.3	0.5	0.7	0.7	0.7	0.7
Other long-term assets	0.0	0.0	73.6	75.7	75.7	75.7
Other non-current assets	0.2	4.4	9.3	9.3	9.3	9.3
Total Non-Current Assets	15.2	49.6	254.3	290.2	325.2	355.0
Total Assets	87.8	424.0	689.5	782.9	1,181.1	1,782.4
Current Liabilities						
Accounts payable	1.4	5.9	7.1	17.0	34.2	56.2
Accrued expenses	10.9	21.3	168.7	129.0	259.7	426.3
Due to related parties	0.0	0.0	0.0	0.0	0.0	0.0
Income tax payable	0.1	7.3	6.9	6.9	6.9	6.9
Current portion of long-term payable	1.5	12.1	21.0	21.0	21.0	21.0
Total Current Liabilities	13.9	46.6	203.7	173.9	321.9	510.4
Non-Current Liabilities						
Deferred tax liabilities - non current	0.5	0.5	0.8	0.8	0.8	0.8
Long term payable	0.5	5.4	6.8	6.8	6.8	6.8
Total Non-Current Liabilities	1.0	5.9	7.6	7.6	7.6	7.6
Total Liabilities	14.9	52.5	211.3	181.4	329.5	517.9
Series A convertible preferred shares	20.1	0.0	0.0	0.0	0.0	0.0
Series B convertible preferred shares	29.2	0.0	0.0	0.0	0.0	0.0
Series C convertible preferred shares	20.9	0.0	0.0	0.0	0.0	0.0
Equity						
Ordinary shares	0.1	370.9	478.1	478.1	478.1	478.1
Shares to be issued	0.0	0.0	0.0	0.0	0.0	0.0
Additional paid-in capital	12.6	0.0	0.0	0.0	0.0	0.0
Statutory reserves	0.2	0.0	0.0	0.0	0.0	0.0
Accumulated other comprehensive (loss) income	3.0	0.0	0.0	0.0	0.0	0.0
Accumulated deficit	(13.6)	0.0	0.0	123.2	373.4	786.2
Minority Interests	0.5	0.6	0.2	0.2	0.2	0.2
Total Equity (Deficit)	2.7	371.5	478.3	601.5	851.7	1,264.4
Total Liab. and Shareholders' Equity	87.8	424.0	689.5	782.9	1,181.1	1,782.4

Source: Company Data, Citi Research Estimates

Figure 30. Qihoo – Consolidated Cash Flow Statement (USD'M)

Cash Flow Statement (USD'M)	2010	2011	2012	2013E	2014E	2015E
Cash flows from operating activities						
Net (loss) income	8.5	14.5	46.5	69.3	193.3	344.9
Adjustments:						
SBC	4.0	48.0	50.6	54.0	56.9	67.9
Depreciation and amortization	1.3	4.2	16.6	44.3	70.3	97.6
Provision of allowance for doubtful accounts	(0.0)	0.1	0.5	0.0	0.0	0.0
Loss from impairment of intangible assets	0.0	0.1	1.3	0.0	0.0	0.0
Loss/gain on investment	0.1	1.6	(2.0)	0.0	0.0	0.0
Changes in operating assets and liabilities:						
Accounts receivable	1.1	(8.1)	(6.8)	(38.8)	(47.1)	(56.8)
Prepaid expenses and other current assets	(1.2)	(8.7)	(8.4)	(21.9)	(36.8)	(44.4)
Inventory	0.0	0.0	0.0	0.0	0.0	0.0
Deferred taxes	0.1	(0.3)	(1.2)	0.0	0.0	0.0
Accounts payable	0.7	4.6	1.2	9.9	17.2	22.0
Accrued expenses and other current liabilities	5.7	11.6	23.3	(39.7)	130.8	166.5
Income tax payable	0.1	7.1	(0.5)	0.0	0.0	0.0
Amount due to related parties	0.0	1.0	0.1	0.0	0.0	0.0
Other noncurrent asset	(0.2)	6.7	(3.4)	0.0	0.0	0.0
Net cash flow from operating activities	20.1	82.3	117.8	77.0	384.6	597.6
Cash flows from investing activities						
Purchase of property and equipment	(2.8)	(16.3)	(68.8)	(72.2)	(94.8)	(111.5)
Purchase of intangible assets	(1.2)	(1.5)	(5.1)	(6.0)	(10.5)	(15.9)
Consideration paid in connection with business acquisitions	(2.6)	(0.5)	0.3	0.0	0.0	0.0
Capital contribution	(1.4)	(15.0)	(24.2)	0.0	0.0	0.0
Proceeds from disposal of a VIE (YZT)	0.0	0.0	13.8	0.0	0.0	0.0
Payment for the purchase of other assets	(1.0)	(1.6)	(2.0)	0.0	0.0	0.0
Net cash flow from investing activities	(9.1)	(34.8)	(83.9)	(78.1)	(105.3)	(127.4)
Cash flows from financing activities						
Proceeds from Series C convertible participating redeemable preferred shares	20.0	0.0	0.0	0.0	0.0	0.0
Net Proceeds from ordinary shares issuance/repurchase	0.3	1.6	2.1	0.0	0.0	0.0
Proceeds from IPO	0.0	231.7	0.0	0.0	0.0	0.0
Net cash from financing activities	20.3	233.3	2.0	0.0	0.0	0.0
Effect of exchange rate on cash and cash equivalents	1.0	2.5	1.1	0.0	0.0	0.0
Net increase in cash	32.4	283.2	36.9	(1.1)	279.3	470.2
Cash and cash equivalents at YB	28.1	60.5	343.7	380.7	379.6	658.9
Cash and cash equivalents at YE	60.5	343.7	380.7	379.6	658.9	1,129.1

Source: Company Data, Citi Research Estimates

Qihoo 360 Technology

Company description

Founded in 2005, Qihoo 360 Technology Co. (Qihoo) is the top provider of Internet and mobile security products, and has a top-4 user base and platform traffic, in the China Internet and Software space. It has 457m monthly active users (iResearch data for March 2013), representing overall China Web user penetration of 96%. Based on its core security products, Qihoo has gained no.1 market share in browser, no.1 in directory page and top 3 in Android apps store, to direct and monetize traffic in its platform mainly through ads, search and virtual items (games).

Investment strategy

We rate Qihoo shares as Buy. Qihoo has effectively leveraged "the power of free" to create a substantial user base (457m as of March 2013), at 96% of China's Internet users, and a pre-eminent brand for its Internet and mobile security products in the China market. Leveraging on its user base and proven capabilities, we see Qihoo as poised to become a mobile market leader in China, with its mobile apps store emerging as a leading mobile games platform. Over the longer term, we expect Qihoo to play an additional role in the mobile ecosystem via mobile search, other targeted mobile display ads as well as via its strategy as an ecommerce aggregator. We believe that the Street is taking too narrow a view of Qihoo's market potential, and that the stock will re-rate significantly as the new growth drivers emerge.

Valuation

Our target price for Qihoo of US\$65 is based on DCF. Our DCF model uses an explicit 10-year forecast period and a terminal growth rate of 3% (lower than longer term sector and GDP growth), discounted back using a cautious (high) cost of capital of 15% to create investor margin-of-safety and to fully factor the embryonic nature of China's mobile ecosystem, the embryonic nature of Qihoo's current monetization model and substantial execution risks balanced against the company's market-leading brand, mind-share and IP competitive moat contained within its core security products portfolio. Our US\$65 TP translates to a PEG (using 3-year forward EPS CAGR) of 0.6x, which is broadly in line with a full universe of local and global comps, though at a significant discount to a comparable universe of potential post-disruption platform market leaders which arguably should trade at a multiple of this benchmark.

Risks

The main downside risks that could prevent the shares from reaching our target price are business model evolution and execution risks, the necessity to continue to deliver high-impact innovation in multiple areas and substantial competitive threats within a hostile competitive environment as follows: (1) Operating execution risks are not uncommon for companies, like Qihoo, that have high levels of growth. The current monetization model of Qihoo is (necessarily given that scaling of the user-base has been the priority to date) still at an embryonic stage. (2) The leading Internet companies in China will likely respond aggressively to Qihoo's strategy and its evolution. These companies have significant financial and brand resources to back their competitive responses.

Appendix A-1

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The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Qihoo 360 Technology (QIHU.N)

Ratings and Target Price History Fundamental Research

Analyst: Bin Liu

Covered since May 10 2011



	Date	Rating	Target Price	Closing Price
1	10-May-11	*1H	*37.00	25.75

* Indicates change

	Date	Rating	Target Price	Closing Price
2	18-Aug-11	1H	*39.00	24.72

	Date	Rating	Target Price	Closing Price
3	7-Oct-11	Stock rating system changed		

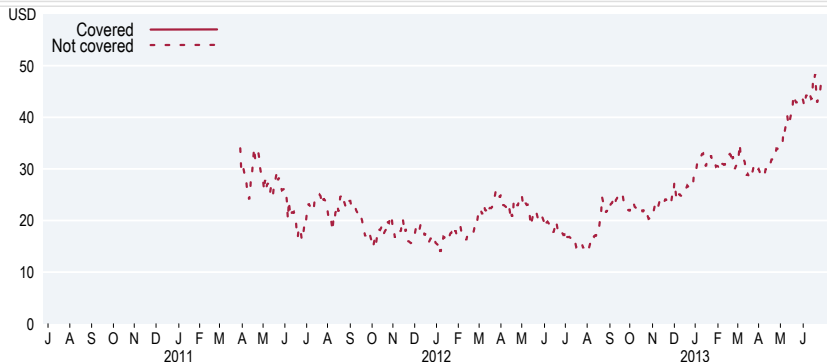
Rating/target price changes above reflect Eastern Standard Time

Qihoo 360 Technology (QIHU.N)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Bin Liu

Covered since May 10 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2013	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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