

December 23, 2005

## Global Internet An Update from the Digital World – Pace of Global Technology Innovation Is Accelerating – December 2005

•**Broadband and mobile drive new computing cycles.** Global technology innovation is accelerating and is becoming a major driving force in the next two major, and converging, computing cycles for the evolution of the Internet — one for broadband Internet usage and the other for mobile Internet usage. Consumers around the world, not enterprises, are driving demand. For businesses, the opportunities — and potential dislocations — are significant. For China, the opportunities to help set the pace for the development of the Internet (especially in mobile) are very real.

**Desire to communicate is at core of innovation. Communication accounts for 45%, and rising, of online usage in the United States.** Internet leader are vying to become next-generation global communication hubs. Mobile network speeds continue to advance, greasing the skids for innovation on the mobile platform. Revenue models for broadband and mobile Internet are now different but will likely converge.

**Asian companies no longer just ‘fast followers’.** A rising number of Asian companies have begun to ramp up innovation with a focus on anticipating customer and consumer needs. We see a core group of next-generation customers in China, where there are more Internet and mobile phone users under the age of 30 than in any market in the world.

**A version of this report appeared in the Chinese business weekly *Caijing* on December 10, 2005.**

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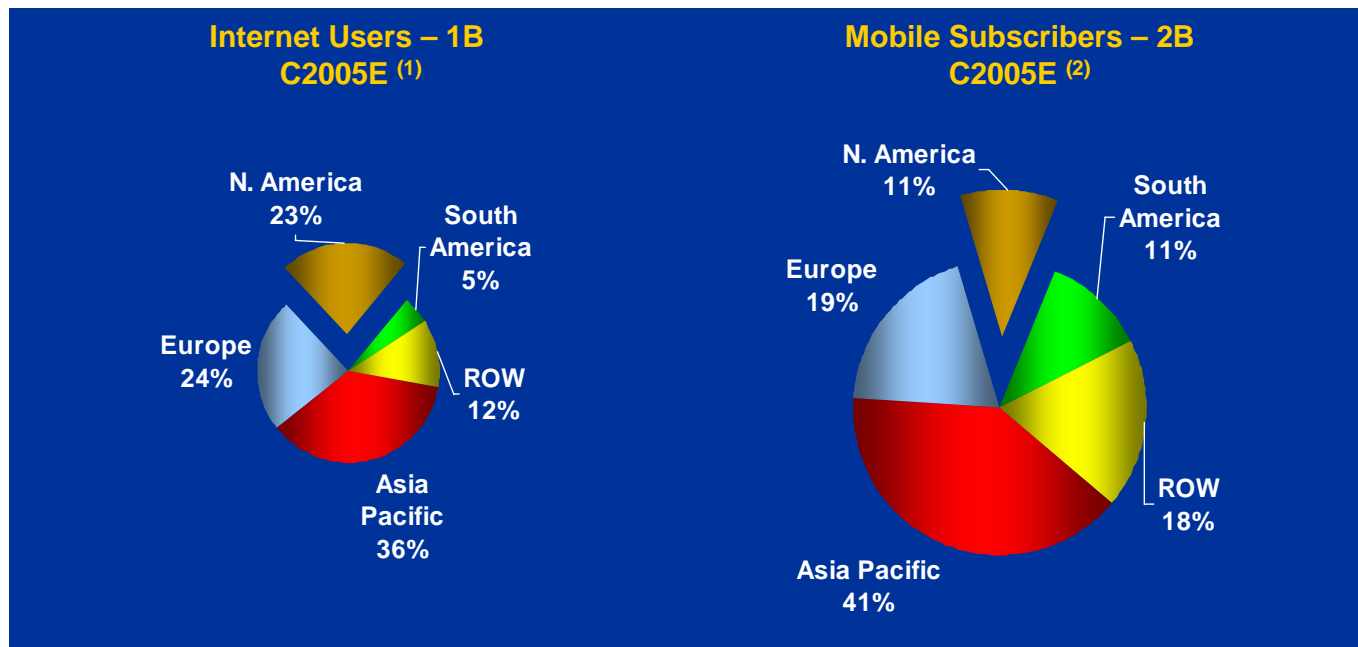
**Global technology innovation is accelerating and is becoming a major driving force in the next two major, and converging, computing cycles for the evolution of the Internet** — one for broadband Internet usage and the other for mobile Internet usage. The first ten years (1995-2005) of the commercial Internet look to us like a warm-up act for what is about to happen. For the next ten years, a lot of the innovation will likely will come from outside the United States. Core Internet innovation remains robust in the United States (note the successes of companies like Google, Yahoo!, eBay and Amazon.com). But Northern / Eastern Europe (with Linux and Skype), India (with outsourcing) and China and Asia (with mobile phone advancements) are showing unprecedented strength in innovation.

**Consumers around the world, not enterprises, are driving demand. For businesses, the opportunities** — and potential dislocations — are significant. For China, the opportunities to help set the pace for the on-going development of the Internet (especially in mobile) are very real. Just as Asian consumers have adopted many of the types of broadband services developed in the United States, so we believe, increasingly, consumers in the United States will adopt mobile services developed in Asia.

**Just a few years ago, few could have predicted that Internet technology would be adopted so quickly and so broadly around the globe:**

1. 1 billion Internet users, with fewer than 25% in North America and China as the No. 2 market behind the US.
2. 2 billion mobile phone users, with fewer than 15% in North America and China as the No. 1 market.
3. South Korea leads world in broadband penetration, at 70% of households.
4. China leads world in number of Internet users under the age of 30, at 70 million.
5. 180 million consumers subscribe to broadband Internet access, with 45% growth in mid-2005.
6. Skype has 61 million registered users of its free voice-over-Internet-Protocol (VoIP) telecom service, with 340 percent growth in late 2005.
7. Owing to rapid acceptance of VoIP, 'free' voice communication exceeds landline communication usage in Denmark.
8. Tencent supports 16 million simultaneous Instant Messaging (IM) users in China, with 75 percent growth.
9. Google served up 8 billion searches in mid-2005, with 75% growth.
10. eBay's PayPal online payment system has 90 million registered users, with 50% growth.

Exhibit 1

**Global Internet & Mobile Phone Users by Region**

(1) Source: Morgan Stanley Research. (2) Source: Morgan Stanley Communications Equipment Research: Scott Coleman, John Marchetti.

**We have entered two of the most important computing cycles of the last fifty years, defined by broadband and mobile Internet technologies.** Every few decades over the past half-century, we have undergone a major computing cycle (including the cycles for mainframe computing, mini-computing, and personal computing). Today, we are in the early stages of two computing cycles, for broadband Internet and for mobile Internet usage. Broadband has already entered the 'sweet spot' of its adoption cycle, at a level of penetration representing 25% of global users in 2004; 2.5G mobile services (which allow for basic Internet connectivity) should enter their own 'sweet spot' of adoption within two years.

**Consumers, not enterprises, are driving demand.** This is evident to us in Microsoft's third-quarter financial results: the company indicated consumer demand for lower-price PCs drove 15-17% PC unit growth, but only 7% revenue growth for the Windows operating system business.

**Public market financings, for non-United States based companies, as a percentage of total technology financings, are at an all time high, and rising.** In 2005 year-to-date, as of 11/11/05, non-US technology company financings accounted for 65% of technology financings, versus 58% in 2004, 51% in 2003 and 39% in 1998. Non-Japan Asia has supported the highest and most consistent growth and, 2005 year-to-date, accounted for 37% of total public technology financings in dollar terms. These trends are evidence that global investors have been willing to commit rising amounts of capital to Asian technology companies. The onus is on the Asian companies to prove that they are built for the long-term.

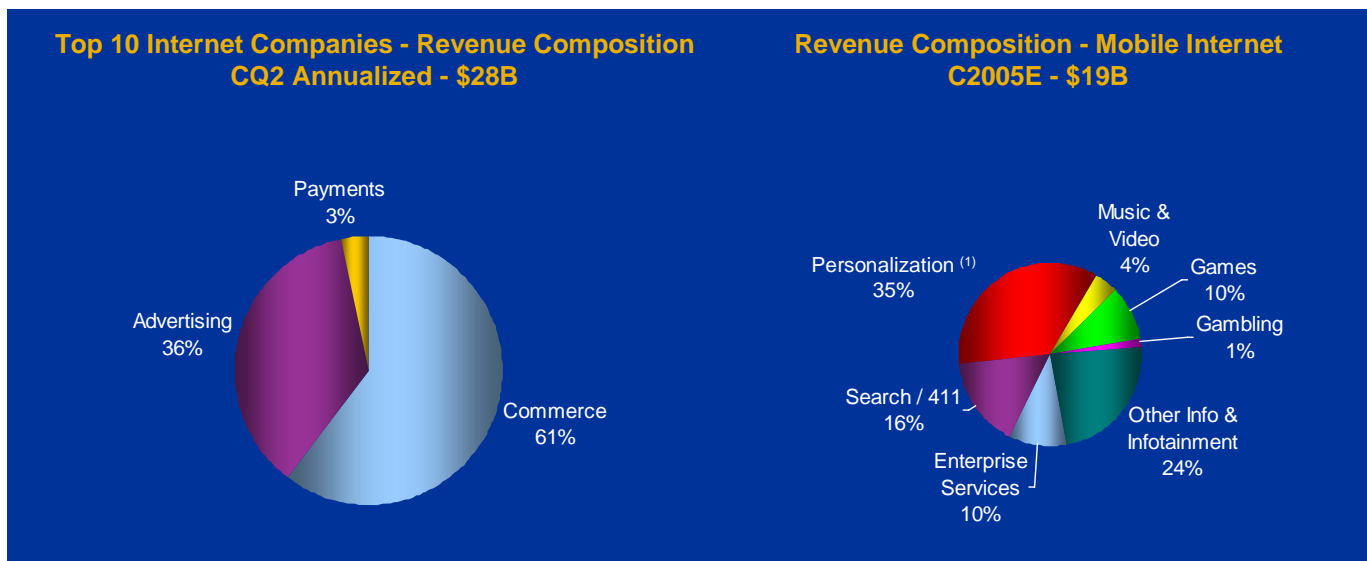
**The desire to communicate and connect, combined with the acceptance and convergence of usage of broadband and mobile Internet is at the core of the innovation.** Communication accounts for 45%, and rising, of online usage in the United States. For many users, instant messaging has already surpassed e-mail as a primary way of communicating online; VoIP, blogging, and user-generated content are quickly gaining momentum.

**Internet leaders like Google, Yahoo!, eBay and Microsoft are not the only ones vying to become global next-generation communications hubs.** They aim to leverage their relative strengths in online search, community, content, messaging, commerce and payments to be the 'go-to' places for consumers to connect. It is worth noting, however, that these companies are not the only ones that support tens of millions — and often, hundreds of millions of users — of their core products. The leading mobile service providers — China Mobile (with 225 million subscribers); Vodafone (165 million); China Unicom (120 million) and China Netcom (120 million) — also desire to be next-generation market leaders. They have hefty user bases and active development environments for mobile value added services (MVAS) to support their efforts.

**Mobile network speeds continue to advance, greasing the skids for innovation on the mobile platform.** 2.5G should enter a 'sweet spot' of sorts over the next two years, as 25% of users use the service. 2.5G allows for basic downloads, like ringtones and screensavers, and limited Web browsing. However, we believe the adoption of 3G, with speeds of 200-700 Kbps, will be key to monitor for more advanced development of the mobile Internet. In addition, it will be important to observe the rollout of WiFi / WiMax services, and their potential roles as mobile networks. As we saw with the conversion of the dial-up Internet to the broadband Internet, faster access speeds make for more compelling user experiences, and create a more feasible environment for developing applications and services. Increasingly, as mobile phone features and access speeds improve, users will expect, in effect, to use their phones as remote control devices to search and pay for products, services and information.

Exhibit 2

## Broadband vs. Mobile Internet Revenue Composition



Source: Left Chart - Morgan Stanley Research estimates: includes revenue from Google, eBay, Yahoo!, Yahoo! Japan, Amazon.com, T-Online, InterActive, Time Warner (AOL only, ex-access), Microsoft (MSN only, ex-access), and Rakuten. Right Chart - Morgan Stanley Research estimates, Global Data. Informa (5/05), Ovum (5/05). (1) Personalization includes ringtones, wallpapers, and screensavers. If SMS / MMS were added to Mobile Internet—it would add \$55B to total revenue and would account for 74% of total revenue.

**Revenue models for broadband and mobile Internet are now different but will likely grow to resemble each other.** Most of the billions of dollars in annual non-access broadband Internet revenue is generated through commerce and advertising; mobile Internet revenue is generated by content and services including ringtones, wallpaper, screensavers, music, entertainment and music. In effect, broadband revenue is generated when vendors pay for advertising to consumers on web sites like Google or Yahoo! or when vendors or consumers pay commissions for products on sites like eBay or Amazon.com. Mobile revenue is generated, for the most part, when consumers pay mobile providers for specific content and services.

The success of Apple iTunes for iPod (with 7 million players and 565 million tunes sold) suggests that consumers will pay for online music one song at a time (for \$0.99). We believe the next exciting market will be for online video. Some estimates indicate that 40% of Internet traffic is used for peer-to-peer (P2P) file sharing of video, implying that video providers are missing a large potential market opportunity by not fostering an environment where online video is easy-to-search and easy-to-buy. We think this is in the early stages of changing — we are encouraged by the recent rapid market acceptance of Disney / ABC's video sales for the Apple iPod.

Owing to efforts of leading Internet companies, online users have become accustomed to finding what they are searching for and, in our view, users have grown weary of not being able to find video content they are searching for. We believe market forces are about to change -- while mobile users have been actively willing to pay for a-la-carte content like ringtones, we believe broadband users will increasingly prove they will do the same. Simply, increasingly, users will be able to find what they are looking for anytime, anywhere.

Conversely, while advertising and commission-based revenue is underdeveloped in the mobile market, we believe that improving access speeds and rising acceptance of payment systems and enhanced search-related features for mobile phones will help drive these revenue streams. The rapid ramp of Google's revenue and profit growth is proof that vendors find Google's on-demand online customer acquisition tools to be quite effective — and Google is just beginning to tap this opportunity in the mobile market.

**Historically, many Asian technology companies have been criticized for being 'fast followers' rather than fast innovators.** We believe this trend has begun to change, and a rising number of companies have begun to ramp up focus on anticipating customer and consumer needs. We cite Japan's NTT DoCoMo (mobile data services), KDDI (mobile data services), Toshiba (flash memory), Sharp (TFT LCDs and solar cells) and Canon (imaging); Korea's Samsung (memory) and SK Telecom (mobile data services); Taiwan's TSMC (flexible semiconductor manufacturing); India's iFlex (banking application software) and Infosys (outsourcing), Tencent (instant messaging), NetEase (online gaming), Ctrip (online and offline travel) and Tom Online (mobile value added services) as good examples.

**We see a core group of next-generation customers in China, where there are more Internet and mobile phone users under the age of 30 than in any market in the world.** Combined with the highest outpouring of engineering graduates in the world plus financial incentives and rising levels of courage, this may help drive a surprising amount of innovation. Already, Asia leads the world in mobile-based services such as gaming and video-blogging and mobile phones -- in addition to becoming fashion statements, mobile phones have become 'must own' products.

History has proven that when a country combines government commitment, strong leadership, national pride, academic focus on engineering and innovation with consumer interest in the usage of technology products, ecosystems develop that can lead to impressive technology innovation. While 'Rome was not built in a day,' we are optimistic about the five-to-ten year outlook for technology innovation in Asia, and in China in particular. The opportunity exists, now it is a question of execution...

## Updates from the Digital World – An Overview

Since our first “Digital World” report, published in 2002, we have used this series to discuss some major events and inflection points related to the Internet that we thought were underappreciated. Below, you will find a list of our “Digital World” reports to date. In this report, we update our Internet Ecosystem Framework and review current trends for key Internet usage and user metrics.

- **Update to our Internet Ecosystem Framework**

*December 2005:* We compile what we believe are the most relevant publicly available metrics that represent key market trends in various parts of the Internet usage/user spectrum.

- **Syndication, Blogs and RSS**

*October 2004:* Getting news/information when you want it is getting easier and easier. We focus on three factors that are combining to help drive online momentum: 1) rising usage of RSS (Really Simple Syndication) by content providers as a standard distribution platform for online content; 2) ramp in creation of blogs and other user-generated content and 3) Yahoo!’s easy-to-use integration of RSS feeds with My Yahoo!. Google may have set the pace for *searching* information, but Yahoo! may be *setting* the pace for new ways of serving information...“next-generation content” should gain usage / revenue traction in C2005E.

- **Update to our Internet Ecosystem Framework**

*February 2004:* We compile what we believe are the most relevant publicly available metrics that represent key market trends in various parts of the Internet usage/user spectrum.

- **Who Has the Momentum?**

*November 2003:* To determine which Web sites are supporting the greatest growth momentum, we reviewed multi-factor rankings aggregating absolute and sequential trends for visitors, page views, and usage minutes at 1,217 leading properties/sites (using US Media Metrix data). Growth trends for advertising, commerce, content, and community continue to look encouraging.

- **Microsoft, it’s the Sound of Online Music?**

*June 2003:* In our view, the day (May 29, 2003) that Microsoft agreed to pay AOL Time Warner \$750MM to settle the lawsuit related to Microsoft’s Netscape-targeted business practices marked an end, and a beginning, for the evolution of the Internet. To put this event in a historical context in our report, we told a short story of the evolution of the commercial Internet to date. Recent data related to online music — a natural SFO business — gave us the sense that music could, finally, become a catalyst that changes the rules of the game in the evolution of the Internet. We also focused on Microsoft’s front- and back-end Internet-related initiatives with forthcoming releases of Internet Explorer, MSN, and Windows (Longhorn), and ongoing developments to the company’s Web services (.NET) efforts.

- **What’s New at Yahoo!?**

*April 2003:* We focused on the positive core secular trends in Internet advertising and drilled down on Yahoo! as a proxy and driver of these trends. In addition, we touched on what we saw as an impressive list of improvements by Yahoo! to provide a better experience for users and more effective marketing for advertisers.

## Updates from the Digital World – An Overview *(continued)*

- **Who's Keeping the Customer Satisfied — and How?**

*Late-March 2003:* Internet leaders such as Amazon.com, eBay, and Expedia had just scored strong relative results in customer satisfaction in the highly regarded American Customer Satisfaction Survey. Convenience, low (and transparent) prices/pricing, uniquely strong 24x7 customer service, and extensive selection had long been key factors behind the growth for leading online commerce (and information) sites. These attributes were becoming increasingly apparent to us (and measurable). Owing in part to the power of their technology platforms, Internet leaders were raising the bar on customer satisfaction and loyalty.

- **What Brought on the Strong Momentum of CQ4:02?**

*March 2003:* In addition to improvements in the SFO experiences of the Internet, a key part of the answer may have been the scale and ramp of residential broadband usage, which made possible the emergence of what we saw as a group of Internet-enabled “power consumers.”

- **The Great Online Migration — Is eBay a Replay of New York City's 18th Century?**

*February 2003:* We focused on the relevance and magnitude of sellers and buyers migrating online, as illustrated by eBay's momentum, and we drew some historical analogies to the dynamics of the settlement and growth of New York City.

- **Is Search/Find/Obtain (SFO) Becoming the Internet's Third Killer Application?**

*December 2002:* Our first “Digital World” report examined online vs. offline momentum related to expanded global distribution, lower relative pricing related to transparency and the ramp in the sale of used goods, and the rising impact of replacement products.

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CNET (CNET.O)	E-V (03/18/2002)	\$15.09
drugstore.com (DSCM.O)	E (03/18/2002)	\$2.68
eBay (EBAY.O)	O-V (07/10/2002)	\$44.28
Google (GOOG.O)	O-V (09/28/2004)	\$432.04
Intuit (INTU.O)	O-V (03/18/2002)	\$53.73
Microsoft (MSFT.O)	O-V (03/18/2002)	\$26.59
priceline.com (PCLN.O)	E (03/18/2002)	\$23.14
Yahoo! (YHOO.O)	O-V (03/18/2002)	\$40.83

Stock Ratings are subject to change. Please see latest research for each company.