Goldman Sachs

Shanda Interactive Entertainment (SNDA)
SINA Corporation (SINA)

Shanda acquires 19.5% of Sina; we view a swap ratio of 0.9:1.0 as fair

Note

February 20, 2005

Shanda Interactive Entertainment

In-Line/Neutral

Stock data

Price	US$30.01
Price target	US$33.00
52-week range	US$45.40 - 10.58
Dividend yield	1.1%

Capitalization

Market cap	US$2,092 mn
Enterprise value	US$1,715 mn
Net debt/equity	NM
Shares outstanding	69.7 mn

SINA Corporation

In-Line/Neutral

Stock data

Price	US$25.60
Price target	US$26.00
52-week range	US$46.21 - 18.88
Dividend yield	--

Capitalization

Market cap	US$1,287 mn
Enterprise value	US$1,111 mn
Net debt/equity	NM
Shares outstanding	50.3 mn

Summary: Shanda announced in a SEC filing after the market close on Feb 18 that it has acquired 19.5% of Sina's shares using cash on hand, the vast majority immediately following Sina's 4Q2004 results release on Feb 8. The transaction itself is earnings accretive - we raise our Shanda 2005 fully diluted (FD) EPS estimate by 8% to US$1.42 and 2006 by 7% to US$1.60 to reflect Shanda equity accounting its stake and thus booking 19.5% of Sina's earnings ($13 mn boost), offsetting foregone interest income ($4 mn reduction). A full acquisition would be earnings dilutive given Shanda is at 23X our 2005 FD EPS while Sina is at 25X; we view Sina's earnings quality (60% wireless) as lower, though Shanda might boost Sina's earnings through leveraging its prepaid card network. We assume Shanda will wait and watch Sina's share price next week, and consider a share swap acquisition at a ratio of not more than 1:1.We have an IL rating on Shanda and a 12 month target price of $33 based on 21X our 2006 forecast EPS; risks include loss of massive multiplayer game players to rival game World of Warcraft. We have an IL rating on Sina and a 12 month target price of $26 based on 20X our 2006 fully diluted EPS; risks include over-reliance on wireless and specifically SMS/MMS products.

Forecasts and valuation - Shanda Interactive Entertainment

Fiscal year ended	Net Income US$ mn	EPS US$	EPS Growth %	P/E X	EV/EBITDA X	Div. Yield
12/02A	16.8	0.33	4,533.3	89.6	84.4	--
12/03A	27.9	0.60	78.4	50.2	58.3	--
12/04E	71.2	1.02	71.2	29.3	25.1	1.1
12/05E New	118.3	1.70	66.1	17.7	15.8	--
12/05E Old	109.5	1.57	--	--	--	--
12/06E New	133.8	1.92	13.0	15.6	13.9	2.4
12/06E Old	124.7	1.79	--	--	--	--

Forecasts and valuation - SINA Corporation

Fiscal year ended	Net Income US$ mn	EPS US$	EPS Growth %	P/E	EV/EBITDA X	Div. Yield
12/02A	(4.9)	(0.11)	83.8	NM	(2,520.1)	--
12/03A	31.4	0.66	NM	39.0	25.3	--
12/04E	66.0	1.33	102.5	19.2	14.2	--
12/05E	65.6	1.29	(3.3)	19.9	14.6	--
12/06E	76.3	1.50	16.3	17.1	12.5	--

Source: Company data, Goldman Sachs Research estimates

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Global Investment Research

- Shanda has in the past traded out of some investments (e.g. the Rmb41 mn investment income it booked in 4Q2004, which may have been from a prior foray into Sina shares) and moved to full control of others (e.g. buying 29% then a further 9% in Actoz in 4Q2004).
- We believe Sina's stock price may initially trade up strongly, then fall back if Shanda does nothing and no alternate acquirers emerge. Shanda's stock price may take an initial hit on fears of it issuing stock to pay for a bigger stake in Sina and on investor concern that Shanda will now face wireless service risk, then rebound if Shanda does nothing. If Shanda's share price does not rise, we would thus be sellers of Sina above $31 (same price as Shanda's current price and 25X Sina's 2006 FD EPS). Netease, Tencent, and Sohu may trade up on hope that they too could be acquisition targets, but: (1) we do not view them as targets given they each - unlike Sina - have a controlling shareholder unlikely to sell at anywhere close to current prices; (2) a merged Shanda-Sina entity could prove a formidable competitor, especially to Sina's traditional rival Sohu.

RECENT EVENTS SUMMARY

Shanda disclosed in its 4Q2004 results that it had made an investment profit of Rmb41 mn trading shares in another listed company, which may have been Sina - Sina's share price varied between $21 and $40 during that quarter. Shanda has now disclosed that its unlisted parent entities bought 0.7 mn Sina shares for $19 mn (or $25-$30 per share) in January, and that Shanda itself bought 9.1 mn Sina shares for $211 mn (or around $23 per share) on February 8-9. Shanda expects to purchase the shares belonging to its parent entities at cost. The 13D filing states that 'The Securities have been acquired for strategic investment purposes... Depending upon various factors... [Shanda may consider] increasing its stake... seeking to acquire or influence control of the Issuer... seeking a merger, consolidation, or other business combination... [Shanda] may engage in discussions with the Issuer to explore the possibility of a business combination transaction.' Although Shanda's parent entities paid as much as $30 per Sina share in January, we do not think that Shanda would necessarily pay much more than $30 in the future, given:

1. We believe Shanda is more likely to use shares than cash for acquisitions henceforward (see below).
2. Shanda's share price has recently declined.
3. Sina's 4Q2004 results caused analysts to cut their 2005 earnings estimates by 20%-40%.

COMBINED ENTITY ("MERGECO") WOULD DOMINATE CHINA INTERNET LANDSCAPE...

Combining our stand-alone models, we estimate a merged Shanda-Sina entity (what we call "mergeco") would generate about $470 mn of revenues in 2005 (53% Shanda, 47% Sina), $185 mn of EBITDA (59% Shanda, 41% Sina), and $176 mn of net income (62% Shanda, 38% Sina). Mergeco would thus not only dwarf any one of the other Chinese Internet stocks - e.g. Tencent (2005E $160 mn revenue, $65 mn EBITDA, $58 mn net income), Netease (2005E $156 mn revenue, $74 mn EBITDA, $67 mn net income), Sohu (2005E $111 mn revenue, $40 mn EBITDA, $35 mn net income) - but also any two of them put together. The aggregated market capitalization of Shanda and Sina together is currently $4.2 bn.

...BUT FACE SOME EARNINGS HEAD-WINDS

Neither company discloses EBIT by product line. Looking at the revenue mix, we estimate massive multiplayer games would contribute 37% of the group total; wireless services 26%; online advertising 19%; casual games 11%; other diversified 8%. We believe most observers would agree that mergeco's wireless services would face a difficult 2005 given mergeco's 4Q2004 wireless service revenue would have relied 80% on SMS (hit in the short term by bans on TV advertising, and in the medium term by consumers shifting to newer products) and 12% on MMS (hit in the short term by policy changes). We estimate mergeco's advertising business could grow at a decent (c.30%) rather than a spectacular pace in 2005 given industry fragmentation and the Sina management team's readiness to invest in content in order to open up a traffic lead over Sohu. We would like mergeco's massive multiplayer online game business structurally but fear that both Shanda's 2D games (Mir 2, World of Legends) and Sina's 3D game (Lineage 2) could show slowing growth from 2Q2005 due to people instead playing rival game World of Warcraft. Earnings growth in 2005-2006 would thus rely to some extent on business lines that are not currently major revenue drivers.

MERGECO WOULD ENJOY SUBSTANTIAL FINANCIAL, CROSS-MARKETING, MANAGERIAL FIREPOWER

What we see as perhaps the most appealing feature of mergeco is that it could use Shanda's prepaid card distribution system to better monetize Sina's various Internet applications (portal, e-commerce, Instant Messaging, etc.). Shanda has already demonstrated this ability to leverage its payment network - which matters in China due to lack of credit cards - through its casual games. We believe this process would take 12-24 months to ramp up.

SYNERGY BENEFITS FROM REVENUES RATHER THAN COSTS

There are few business overlaps between Shanda and Sina. We assume mergeco would consolidate:

1. Its stake in the NCsina game company into its massive multiplayer game division.
2. Advertising sales on the poptang game portal with advertising sales on the Sina general portal.

Mergeco would likely maintain a two city (Shanghai and Beijing) headquarters strategy, since the Beijing office is useful for interacting with China Mobile and China Unicom.

DIFFICULT TO ARGUE MERGECO WOULD TRANSFORM SINA'S WIRELESS BUSINESS
We believe Sina's wireless difficulties stemmed from industry-wide challenges more than Sina-specific mistakes. Shanda offers some wireless games but these are generally single player only due to bandwidth and screen constraints.

LINEAGE 2 MIGHT SUPPORT SHANDA'S GAME BUSINESS
Sina has around 65,000 average users for its 3D game Lineage 2, which would help update Shanda's largely 2D game portfolio. However NCsoft collects 30% of the revenue and 50% of the earnings from Lineage 2, and World of Warcraft appears to be decisively overshadowing Lineage 2 in other markets ex-Korea.

FITS SHANDA'S SELF-DESCRIPTION AS ENTERTAINMENT COMPANY
Shanda has always taken pains to describe itself as a broad entertainment rather than a narrow computer game business, so we believe acquiring Sina would be in-step with its self image.

BID LIKELY UNINVITED, PROBABLY NOT HOSTILE
There is no evidence that Sina solicited the transaction. However we assume that Shanda management had informed Sina management of its investment.

MANAGEMENT SHOULD MESH
We believe the management fit between Shanda and Sina could be straightforward given Shanda's CEO, as the largest shareholder in a combined entity, would presumably receive a group-wide leadership position, while the bulk of Sina's management could receive divisional leadership roles in the wireless and portal businesses.

COUNTER-BID POSSIBLE, NO OBVIOUS CANDIDATES
At this stage we do not see an obvious alternate bidder for Sina. Part of Sina's portal popularity flows from its priority access to local news, and we believe that China's news agencies might adopt a less preferential attitude if a foreign company were to acquire Sina. The other listed local Internet stocks are typically of a size where they would likely be targets rather than acquirers of Sina.

SHANDA COULD WALK AWAY FROM ANY BIDDING WAR WITH A PROFIT
Shanda would not be a weaker company than it is today if someone else acquired Sina, unless that bidder were a game rival such as Netease or The9 - which appears unlikely, in our view. We therefore believe that if a bidding war broke out, Shanda could sell its 19.5% stake and collect a substantial profit.

TRANSACTION DOES NOT MEAN THAT SHANDA NEEDS TO BUY GROWTH
Acquisitions often represent a means for the acquirer company to "buy" earnings growth at a time when its own business is slowing down. This may not be a fair characterization of Shanda's situation since Sina arguably faces more growth constraints (especially in 2Q2005) than Shanda, and since Shanda could have bought a smaller but "growth-ier" target to achieve the same result more efficiently.

TAKING A CONTROLLING STAKE WOULD REQUIRE SHANDA ISSUES EQUITY / DEBT
Shanda ended 2004 with cash and investments of $440 mn. Its debts were limited to a convertible bond issue of $275 mn. The acquisition of 2.6 mn shares in Actoz for $92 mn closed in January. Its cash on hand prior to the Sina investment was thus $348 mn. Shanda itself spent $211 mn on Sina shares and has stated it will soon acquire the shares which its unlisted parent entities hold for $19 mn. We estimate Shanda has around $120 mn cash on hand left, sufficient for a further 7% stake in Sina.

SHARE SWAP IN OUR VIEW MORE LIKELY THAN DEBT FINANCED ACQUISITION
We estimate for Shanda to acquire the residual 80% of Sina at (for example) $30 per share would require incremental debt financing of around $1.1 bn. Shanda and Sina already have a combined $374 mn of convertible debt outstanding that we believe could be put back to mergeco in 2007. A total debt burden of $1.3 bn (net of convertibles and Sina's existing cash balance) would represent 7X mergeco cash flow and EBITDA.

WE ESTIMATE SHANDA DESERVES A 2 POINT (10%) P/E PREMIUM OVER SINA
We usually view a mid-teens P/E multiple as fair for wireless services; 22X for online games; and mid-20s for online advertising. Our target 2006 P/Es are thus 22X for Shanda (ex Sina stake) and 20X for Sina. Shanda's purchase of 9.13 mn shares at $23.1 appears rational to us, since Sina's P/E was then 18X while Shanda's was 22X.

ECONOMICS FAVOR SINA SHAREHOLDERS IF SWAP RATIO IS 0.9 SHANDA : 1.0 SINA OR MORE
If Shanda believes it can grow Sina's earnings 20% above where they would otherwise have been through use of its prepaid card network and through combined marketing muscle, then we believe Shanda could theoretically be willing to pay a 2 multiple point premium to buy Sina, even though our stand-alone fair values indicate a 2 point discount. We forecast Sina's 2006 FD EPS at $1.31 on a stand-alone basis,

and Shanda's at $1.49 prior to the 19.5% associate contribution from Sina. We provisionally assess that a fair share swap ratio could be about between 0.9 (if synergy benefits flow to Shanda investors) and 1.0 (if benefits to Sina investors) Shanda shares per Sina share.

AT 0.9 SHANDA : 1.0 SINA, SHANDA'S 2006 EPS COULD BE $1.66-$1.83

There are 51 mn Sina shares outstanding (59 mn fully diluted), and Shanda already owns 9.8 mn. If Shanda purchased the remaining Sina shares at a 0.9:1.0 ratio then Shanda's FD ADR count (including dilution for Shanda and Sina convertible bonds, and for share options) would increase by 47 mn to 130 mn. Adding our Shanda and Sina stand-alone net income forecasts and assuming no synergies, we estimate mergeco would earn $202 mn net income in 2006 and its EPS would be $1.55 (3% dilution). Assuming $20 mn (after tax) of synergies (10% earnings enhancement), we estimate mergeco's EPS would be $1.71 (6% accretion).

If Shanda purchased the remaining Sina shares at a 1.0:1.0 ratio then Shanda's FD ADR count would increase to 135 mn, for an estimated mergeco EPS of $1.49 (7% dilution) to $1.64 (3% accretion).

Shanda buying 20% of Sina was around 8% earnings accretive; however Shanda buying 100% of Sina may or may not be earnings accretive because:

1. Sina's share price has risen since Shanda's investment.
2. Shanda could finance the 20% acquisition using cash on hand which generated a minimal level of interest income, whereas the residual 80% would require debt or equity financing.

SHAREHOLDINGS IN MERGECO

Tianqiao Chen (the CEO of Shanda) and his family own 57% of Shanda, so a 0.9:1.0 swap ratio would result in their FD stake in mergeco being 32%.

IN SHANDA'S INTERESTS TO WAIT IF WORLD OF WARCRAFT IS NOT DISRUPTIVE

Shanda's recent share price performance suggests some investors are concerned about its 1Q and 2Q2005 results, whereas the sell-side consensus view is that casual games will propel Shanda's earnings momentum through the year. If the consensus view is correct then we believe it may be in Shanda's interests to wait before any share swap proposal, since we believe Sina's 2Q2005 guidance will be uninspiring (we estimate that Sina will collect around $5 mn revenue from fortune telling SMS in 1Q2005 because the ban on TV advertising only took effect in February, whereas in 2Q2005 it should feel the full impact).

WE BELIEVE SINA TRADING RANGE SHOULD BE $25-$31

We believe the probability of Shanda paying more than $31 per share for Sina if Shanda's share price is below $31 is low, since Shanda in our view is both capable of generating a higher absolute EPS in 2005 and 2006 and deserving of a higher P/E multiple. Conversely the fact that Shanda purchased Sina shares at $23 suggests to us that Shanda is comfortable with Sina valuations at that level, so investors who buy Sina shares at $25 may face a modest 10% downside risk.

EXECUTION RATHER THAN TRANSACTION PER SE CATALYST TO MORE MERGERS

We believe an acquisition per se would not prompt the controlling shareholders of other large Chinese Internet companies to merge, since they all believe that their shares are worth more than where they are currently trading. If a mergeco were to start muscling aside its smaller rivals in the future, then consolidation might follow. We believe the most feasible challenger on paper would be a Tencent-Netease combination, which would produce a potent Instant Messaging-online games-portal entity anchored in Guangdong province. For the immediate future, however, the dominant story is that a company that did not exist during the 1999-2000 China Internet boom appears ready to take control of a company that was the pace-setter during that boom.

I, James Mitchell, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to specific recommendations or views expressed in this report.

Exhibit 1: MERGECO pro forma profit statement (US$ mn)

	2005E	2006E
MMOG	173	193
WVAS	121	139
Advertising	89	112
Casual games	54	74
Others	35	41
Total revenues	**471**	**558**
Cost of revenues	**(165)**	**(190)**
Gross profit	**306**	**369**
Total other expenses	**(141)**	**(171)**
Operating profit	**166**	**197**
Total others	28	32
Pretax profit	**194**	**230**
Income taxes	(18)	(27)
Net profit	**176**	**202**

Source: Company data, Goldman Sachs Research estimates.

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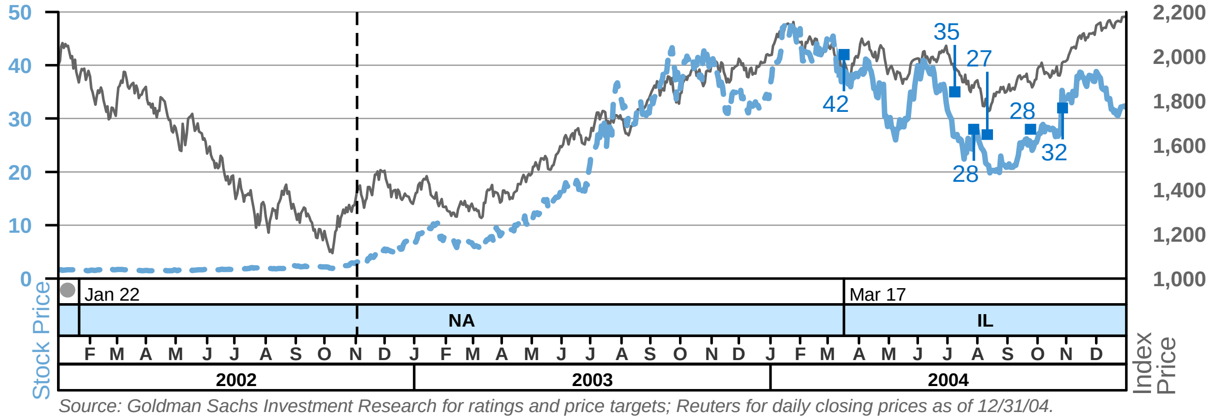
SINA Corporation (SINA)

Currency: U.S. Dollar

Goldman Sachs rating and stock price target history



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- Jan 22, 2002 to NA from MP
- Rating
- Price target
- Price target at removal
- NASDAQ Composite; pricing by FactSet
- Covered by James Mitchell, CFA, as of Mar 9, 2004
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Shanda Interactive Entertainment (SNDA)

Currency: U.S. Dollar

Goldman Sachs rating and stock price target history

Source: Goldman Sachs Investment Research for ratings and price targets; Reuters for daily closing prices as of 12/31/04.

- Rating
- Price target
- Price target at removal
- NASDAQ Composite; pricing by FactSet
- Covered by James Mitchell, CFA, as of Jun 15, 2004
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