

Software & Services

YELP – NYSE

Oct 30, 2015

Closing Price 10/30/2015 22.25
 Rating: Buy
 12-Month Target Price: 29.85
 52-Week Range: 20.50 – 63.76
 Market Cap: 1,674.4 M
 Shares O/S: 75.3 M
 Float: 80.6 %
 Avg 3mo Daily Volume: 3.13 M
 Dividend Yield: 0.00 %
 Risk Profile: Medium
 Fiscal Year End: Dec 31
 5-Year Adjusted Beta 1.527

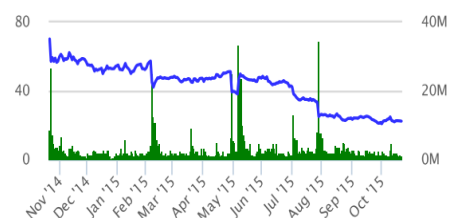
Revenue (‘000,000)

	2015E	2016E	2017E
1Q	118.5A	151.9	196.0
2Q	133.9A	165.4	213.3
3Q	143.6A	177.4	228.3
4Q	148.5	189.3	243.3
FY	544.5	684.0	880.9

GAAP EPS

	2015E	2016E	2017E
1Q	-0.02A	-0.10	-0.05
2Q	-0.02A	-0.08	-0.02
3Q	-0.11A	-0.05	0.03
4Q	-0.08	-0.02	0.07
FY	-0.23	-0.26	0.03

Historical One Year Stock Price



(Source: CapitalIQ)

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PLEASE SEE PAGE 8 FOR IMPORTANT DISCLOSURES AND DISCLAIMERS.

Yelp Inc.

Buy

YELP Is Likely to Benefit from Shifting Trends in Local Business Advertising Industry, and Has Abundant Potentials for Growth.

Summary

- We are initiating our coverage on Yelp Inc. with a rating “Buy” and a target price of \$ 29.85.
- Local advertisers are shifting from traditional advertising to online, which gives boost to YELP and its industry.
- Interviews showed that local businesses would likely continue advertising on YELP.
- Acquisition synergy with Eat24 may be realized further in the future.
- Although YELP’s international growth possibility is a big question mark, even limited success in a few countries can lead to a significantly higher valuation.

Investment Thesis

Local businesses are spending increasingly more money on online advertisement, and YELP may get a bigger market share of the local business advertisements. According to BIA Kelsey, U.S. local advertising spend is projected to be \$152 B in 2017, 12.5% of which will be spent online. This compares with 2012, when local businesses invested only 8.2% of the total advertising expense of \$132.5 B for online advertising. We believe Yelp will be able to charge more to local businesses as competition for online advertising rises.

YELP will benefit from the shifts in the U.S. consumption from traditional retailing to experiences. In 2015 Q3, Yelp’s restaurants and shopping categories together accounted about 42% of the businesses that had been reviewed. The recent September data showed that although retail sales (excluding auto) fell from August, consumers spent 0.7% more on restaurants and bar than they did in the prior month. With air travels also continuously increasing, Americans seek more information for the nearby restaurants and shopping malls in new locations, and Yelp is a platform that serves this purpose.

Local businesses are likely to continue advertising on YELP. Based on the interviews we conducted with local businesses, Yelp’s brand recognition and rich user base seem to be the primary reasons why they advertise on Yelp. We believe these Yelp’s strengths will improve further in the future because of the increasing uses of smart phones and Yelp’s TV advertisement starting this year.

Acquisition synergy with Eat24, a food delivery website, in Feb 2015 may be realized further in the future. On Earnings Calls Q2 and Q3, 2015, the management said Yelp has “dedicated” teams for Yelp local advertising and Eat24, and plans to continue this at least in the short run. In our view, hiring one talented salesperson at premium for restaurant sector can lead to more opportunity, and this may change the long term Marketing cost structure. Moreover, on October 30, Yelp has optimized the Order Delivery feature in the App by enabling the users to find the nearby restaurants that do delivery with a single button. This may attract more transactions to Eat24.

In our view, YELP has higher potentials to succeed oversee than the market is expecting. Many investors have been frustrated as Yelp generates only 2% of revenue oversee after its five years of investment. However, the management views the international revenue as a “work in progress” and is keeping the door largely open. For example, in the fourth quarter of 2014, Yelp acquired French and German review websites. Review platform will have increasingly greater international synergies as the number of foreign tourists increase. In our view, after Yelp hits its \$1 billion revenue and accumulate enough resources, the management will focus more on the international market.

We reiterate our Buy rating and 12-month price target of 29.85. Our target is based on the Discounted Cash Flow model. Please refer to the “Discounted Cash Flow Model Assumptions” section on page 5 for details.

Stock Ownership Distributions

Institutional Ownership: 90.2%
Insider Ownership: 2.2%
(Source: FactSet)

Analysts Covering YELP:

of Buys: 11

of Holds: 23

of Sells: 2

Avg target Price: 29.30

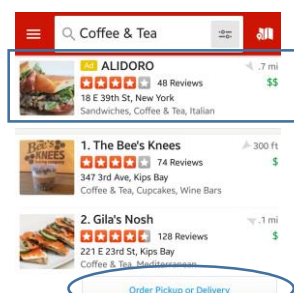
(Source: Bloomberg, excluding FinanceScript)

Company Overview

Business Overview

Since 2004, Yelp's platform has assisted people by connecting them with great local businesses. After customers visit a local store, they can rate the business and leave reviews on Yelp based on their experiences. These "words of mouth" become instantly available to anyone with an access to the Internet. Many consumers often used the information on Yelp when looking for business that serves their needs and wants. As Larry Page, a Co-Founder of Google, once said, when someone builds a useful feature at a large scale, monetization follows. Yelp's revenue can be divided as follows.

- **Local advertising:** Yelp generates revenue from local advertising programs, in both CPC (Cost per Click) and CPM (Cost per Impression) basis. CPC structure is becoming increasingly popular and now comprises about 52% of the local revenue. The management does not think this transition will materially impact revenue. Additionally, "local advertising" also includes SeatMe restaurant reservation product, a monthly subscription service.
- **Transaction revenue:** After Yelp's acquisition of Eat24, an online food delivery ordering platform, its transaction revenue skyrocketed. Yelp receives commission from the orders that went through the platform. The pricing term is subject to negotiation with restaurants. Other transaction products include Yelp Deals (vouchers or coupon sold at Yelp's platform), or Gift Certificate (a full-priced gift certificates sold directly to consumers through their business profile pages). Yelp earns a fee based on the amount of the Yelp Deals and Gift Certificate sold.
- **Brand advertising:** Yelp generates revenue from advertising solutions for national brands, particularly through its web page. Yelp plans to discontinue brand advertising products over the remainder of 2015 in order to enhance user experiences and save web page real estate.
- **Others:** Among many, Yelp monetizes partner arrangements, which include allowing third party data providers to update business listing information on behalf of businesses, and resale of Yelp's local advertising products by certain partners.



Local advertising (boxed)
Transaction revenue (circled)



Brand advertising (circled)

Finance History

Yelp Inc. was founded by the current CEO Jeremy Stoppelman and former CTO Russel Simmons in 2004. Starting with the seed capital of \$1 M from Max Levchin, who served as Chairman of Yelp until June 2015, Yelp has attracted more investments from various firms, including \$5 M from Bessemer Ventures in 2005, \$15 M from DAG Ventures in 2008, and \$100 M from Elevation Partners in 2010. In November 2011, Yelp filed Initial Public Offerings with \$15 per share, with implied Market Cap at \$898 M.

Investor Relations Contact:

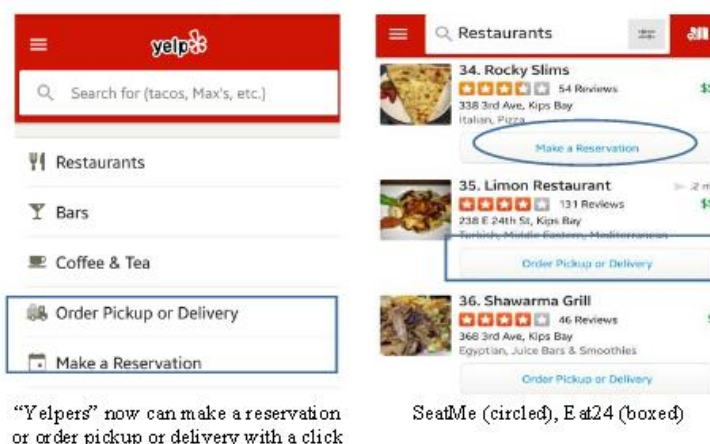
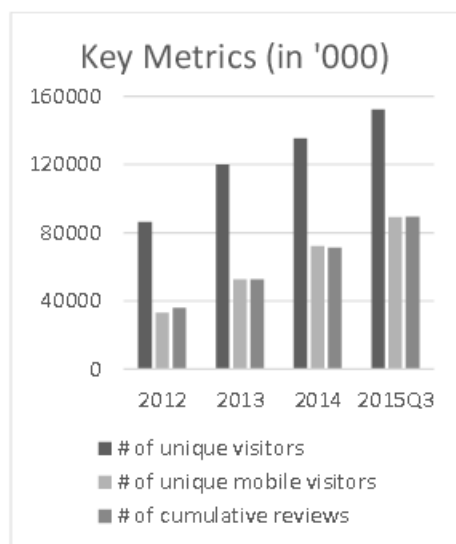
Wendy Lim
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Key Personnel

- **Jeremy Stoppelman** founded Yelp Inc. in 2004, and has served as the CEO since then. He continues to drive the vision and product experience for the company, personally overseeing product development. Prior to Yelp, he served as VP of Engineering at Pay Pal from 2000 to 2003. Mr. Stoppelman received his Bachelor's degree in Computer Engineering from University of Illinois, and completed his first year of M.B.A. program at Harvard Business School.
- **Geoff Donaker** joined Yelp in 2005 and has been COO since 2006. Mr. Donaker oversees the company's business operations including sales, marketing and administration. Prior to joining Yelp, he held several roles at eBay, most recently as Director of International Categories. He holds Bachelor's degree in Mechanical Engineer from Stanford University.

Mergers and Acquisitions

On February 9, 2015, Yelp acquired Eat24Hours.com, Inc. ("Eat24") for \$134.2 M. Eat24 is an online food delivery platform. In July 2013, Yelp acquired SeatMe, an online restaurant reservation platform, for \$12.7 M. Other mergers and acquisitions primarily focused on international expansions. In October 2014, Yelp acquired Cityvox SAS (a French review website) and Restaurant Kritik (a German review website) for \$15.3 M.



Key Metrics

In Q3 2015, the number of cumulative reviews reached 89.6 M, 6.1 M of which were removed from the platform either by Yelp or the users. The number of unique desktop visitors started decreasing in 2015, although not significantly. The number of unique mobile visitors is continuously increasing at a fast pace. The combined number of unique desktop visitors and mobile visitors was 168.5 M.

Yelp Community

Yelp has shown its effort to increase quality reviews on its platform by promoting the community. For example, a "Yelper" may apply to become an "Elite," who will be invited to parties with free food and beverage at least once a month. They also have a badge next to their accounts, and, on average, users believe their reviews have more credibility than regular "Yelpers". To qualify as an "Elite," the "Yelper" must have his/her real photo and name and leave a lot of quality reviews on the web page, which will be reviewed by Yelp employees. A business owner cannot become an "Elite" because of possible conflicts of interest.

National TV Campaign

Yelp launched its first television and digital advertising campaign in the second quarter of 2015 and expanded in the third quarter. The TV advertisement highlights the many different uses for Yelp, such as finding a mechanic, golf instructor, or restaurant. On the third quarter's earnings calls, "More than half of non-Yelp users indicated they are now likely to use Yelp in the future."

International Influence

Yelp has expanded to 31 foreign countries: Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Malaysia, Mexico, The Netherlands, New Zealand, Norway, Philippines, Poland, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, Turkey, and UK. However, the international revenue comprised only 2% of the overall revenue in Q3, 2015.

Some Local Businesses Experiences

Clothing Shop Owner & Yelp Advertiser in New York, NY

Nick is running a women's fur clothes shop. The biggest challenge for him was to attract customers to his store, which is located on the eighth floor. He decided to advertise his store on Yelp because "many people use Yelp," and he believed advertising on Yelp would enhance its visibility. His store also offers an online coupon, but not many people have used it. He pays \$300 per month for the advertisement. Although he is disappointed that his store only appears under woman's clothing category (and not on fur clothes category), he intends to keep doing business with Yelp except "maybe July and August," when the demand for fur clothing declines sharply.

Restaurant Owners & Yelp Advertisers in New York, NY

John is running a sandwich shop around Time Square. He has decided to advertise on Yelp for two reasons: Yelp's popularity and high ratings he received from Yelpers. However, bad ratings are not necessarily the reasons for not advertising on Yelp. He was not willing to provide the exact number for the ROI, but he was "very happy with it." He said he would continue advertising on Yelp as long as the ROI remains high. An Indian restaurant owner spends \$350 a month for the advertisement even though the store received an average of two star ratings. He is likely to continue advertising on Yelp.

Restaurant Owners & Eat24 Users in New York, NY

We have observed mixed signs through the restaurants we visited for informational interviews. Zhuo opened a Chinese restaurant near Baruch College a few months ago. She uses both Grubhub and Eat24 for online food deliveries, but she is unhappy with the high commission fees they charge. Eat24 is charging about 18% of the revenues for the orders that go through the system. She would continue using the system in the short run in order to attract more customers early on, but she would likely discontinue in a year.

On the other hand, Andy, a sandwich shop owner, has switched from Grubhub to Eat24 because "Grubhub does not negotiate anymore." Although he was not able to answer how much Eat24 takes away because of the business terms, he said the commission is substantially lower than 18%. Another restaurant owner said she uses Eat24 and Grubhub for marketing reasons. "If we only deliver through the online platforms, we would go out of businesses," she added. She said she plans to continue using the services.

Risk Factors

Yelp's management may decide not to invest more overseas even after it has enough resources to do so, or rising competitions can lower the chances of its international successes. We built our model based on the assumption that the management would focus on the international market with a 10% chance from 2020 to 2024. However, the future is largely unknown, and increases in competition may discourage the management to invest, or worse, the investment might fail to generate returns. Under the assumption that Yelp continues to incur \$3 M quarterly loss in the international market indefinitely, we value Yelp at \$23.42 per share at the end of 2016.

Increasing competition in review websites continue to serve a threat to long-term successes of Yelp. Although currently Yelp has unmatched reputation as review sites in the U.S. and has most advanced review selection algorithms, profitability of the business may continue attracting additional competitors. For details, refer to the "Competition" section below.

Competition

Yelp faces competition for both local business directory traffic and advertiser spending, and we expect competition to increase in the future. In a broad term, the competitors include traditional advertisement media, such as newspapers and direct mail. Competition for online advertising is becoming especially severe both in the domestic and international market as local business moves toward online. For example, GrubHub Inc. in the U.S. is a leading online delivery platform that incorporates some restaurant reviews. Google also has its own business review features. In the U.K., Zomato is a leading restaurant review platform.

Opportunities

Yelp has a potential to better leverage its user base for local business advertising. Yelp may be able to further explore the interaction between local businesses and customers by adding features. For example, Yelp can enhance its online coupon functionality by sending a notification to the “fans” of the store when the store issues a new coupon. We believe other unexplored monetization opportunities certainly exist.

More restaurants may start Eat24 services. Interviews showed that the primary reasons why local businesses use online delivery platforms were marketing. As the nearby restaurants that do online delivery is shown just by pressing one button on Yelp App starting today, Eat24 may become more popular among restaurants

Discounted Cash Flow Model Assumptions

- **Discount rate:** We assume that YELP keeps its 0% debt financing ratio in the future. The cost of equity is calculated based on the CAPM. The rate will change over time from 13% in 2015 to 9.61% in 2024 as beta converges to 1 and risk-free rate increases. The terminal WACC is assumed to be 9.27%.
- **Revenue:** The local advertising is expected to grow at 33% year over year in 2016 as the U.S. market is maturing. The rate will decrease further to 28% in 2017, 20% in 2018, 18% in 2019, and 15% in 2020. The transaction revenue is expected to grow 7% per quarter until 2018, and grow 5% per quarter until 2020. We assume the management implement its plan to discontinue the branding advertising by Q4, 2015. We also project “other services” revenues will increase 3% quarter over quarter until 2020.
- **Expenses:** The proportion of cost of revenue will decrease from 10% (the expected proportion in Q4, 2015) of revenue to 7% (the management long-term target) of revenue through 2015 to 2020. We project the sales and marketing cost will increase about 5% per quarter until 2017, and 2% per quarter thereafter, which will make the cost become 44% of revenue in 2019, the same target ratio by the management. Product Development cost will be increased by 35%, 30%, 20%, and 15% year over year in 2016, 2017, 2018, and 2019, respectively. We assumed the General and Administrative cost would increase 3% each quarter, and Depreciation and Amortization cost would be about 5% of revenue through 2017, and about 4.8% of revenue thereafter.
- **Fixed Capital Investment:** We project the fixed capital will increase 6.8% each quarter until 2020.
- **Working Capital Investment:** We project non-cash working capital will increase 4.4% each quarter until 2020.
- **Terminal Value:** We assumed the FCFE growth rate will linearly decline from 30% in 2021 to 3% in 2036. The 3% is the expected terminal growth rate.
- **International Adjustment:** Due to high uncertainties, we made conservative approaches when driving the international portion of the valuation. In each year from 2020 to 2024, YELP has a 10% chance of investing heavily internationally, with a 60% probability of success in France, Germany, and the U.K, and a 75% probability of success in Canada. For simplicity, we assumed Yelp does not attempt to invest heavily in other countries because smaller chances of successes. We used the 2020 U.S. revenues and 2015 population levels for the revenue estimations, and assumed 15% less revenue would be generated than the population size implies. We also assumed 30% of tax rate, and that upon failure, 50% of costs would be generated as revenues, as Yelp does now. We used the Gordon Growth Model at 3% growth level to drive the terminal value. If Yelp does not invest heavily until 2024, we assumed Yelp would pull back current \$ 12 M/ year investment as the increases in competition make it less likely to succeed in the future.

Earnings Estimate 2015 - 2017

Yelp Inc.	2017				2016				2015			
Pro Forma Income Statement	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3A	Q2A	Q1A
Revenue	239,975	225,259	210,383	193,409	189,261	177,398	165,446	151,889	148,544	143,559	133,913	118,508
Local Advertising	210,853	197,363	183,658	167,806	164,729	154,190	143,483	131,098	123,856	115,932	107,882	98,570
Brand Advertising	0	0	0	0	0	0	0	0	5,000	8,978	8,303	6,627
Transaction Revenue	20,412	19,440	18,514	17,632	16,793	15,694	14,667	13,708	12,811	11,973	11,304	6,606
Other Services	8,711	8,457	8,211	7,971	7,739	7,514	7,295	7,083	6,876	6,676	6,424	6,705
Costs and Expenses	232,771	222,388	210,340	197,927	191,754	183,148	174,108	164,076	157,616	154,271	133,863	122,757
Cost of Revenue	19,198	18,021	16,831	15,473	17,033	15,966	14,890	15,189	14,854	14,259	13,057	8,699
Sales and Marketing	122,775	116,929	111,361	106,058	101,008	96,198	91,617	85,919	83,405	82,949	68,014	63,266
Product Development	51,891	50,037	46,235	42,050	39,917	38,490	35,566	32,346	29,568	28,511	26,345	23,960
General & Administrative	27,387	26,590	25,815	25,063	24,333	23,624	22,936	22,268	21,620	20,990	19,280	19,937
Depreciation and Amortization	11,519	10,812	10,098	9,284	9,463	8,870	9,100	8,354	8,170	7,562	7,167	6,895
Restructuring and Integration	0	0	0	0	0	0	0	0	0	0	0	0
Income from Operations	7,204	2,871	43	-4,518	-2,493	-5,750	-8,663	-12,188	-9,073	-10,712	50	-4,249
Other Income	0	0	0	0	0	0	0	0	0	-545	329	562
Income before Income Taxes	7,204	2,871	43	-4,518	-2,493	-5,750	-8,663	-12,188	-9,073	-11,257	379	-3,687
Benefit (Provision) for Income Taxes	2,161	861	1,513	-1,000	-748	-1,725	-2,599	-4,600	-2,722	-3,175	-1,684	2,403
Net Income	5,043	2,010	-1,470	-3,518	-1,745	-4,025	-6,064	-7,588	-6,351	-8,082	-1,305	-1,284
Diluted EPS	0.07	0.03	(0.02)	(0.05)	(0.02)	(0.05)	(0.08)	(0.10)	(0.08)	(0.11)	(0.02)	(0.02)

Free Cash Flow to Firms 2017 - 2020

Annualized DCF		2020	2019	2018	2017
Net Income		144,850	93,654	14,829	2,065
Non Cash Charges		68,212	59,051	49,993	41,713
FCInv	Terminal	71661.54	55465.22	42382.01	32568.06
WCInv	+ Intl Adj	81,323	68,456	57,625	48,507
FCFF	3730419.969	60,079	28,784	-35,184	-37,297
Divided by	1.658950309	1.506017	1.365318	1.236012	1.117309
Present Value of CF	2248662.873	39892.32	21082.45	-28465.6	-33381.2

Estimated Intrinsic Value of YELP in 2016	29.85
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The spreadsheet is available upon request.

Important Disclosures and Disclaimers

Recommendation Rating:

- Buy: The analyst believes the stock will outperform its relevant index over the next 12 months.
- Hold: The analyst believes the stock will neither significantly outperform nor underperform its relevant index over the next 12 months.
- Sell: The analyst believes the stock will underperform its relevant index over the next 12 months.

Risk Rating:

- Speculative: the company is at early stage with minimal to no revenues and short operating history. The stock can certainly become worthless, and may not be suitable for individual investors.
- High: the company has below-average revenues and negative earnings or cash flows. This stock may not be suitable for individual investors.
- Medium: the company has about the average revenues and earnings visibility.
- Low: the company has above-average revenues and earnings visibility.

Disclaimers:

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