Needham

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Laura Martin, CFA • lmartin@needhamco.com • 917-373-3066
Dan Medina • dmedina@needhamco.com • 212-705-0295

Entertainment, Cable & Media / Consumer

AOL Inc. (AOL) – Buy

AOL:Time to Buy

We initiate coverage of AOL with a BUY rating and a $35 12-month target price, representing 36% upside from current levels. We believe that the risk/reward for AOL is compelling at current price levels:

1. **The best question** about AOL is *not* "When will access revenue hit zero?" or "Can AOL become a successful online content company?" We think the best question for AOL is *Why aren't the employees leaving?* Tech employees are the most innovative, hard-working, risk-tolerant group on Earth. They are also mobile. The lead indicator to us that the risk/reward has become negative at AOL is employee defections. Until then, we'll bet that the insiders (employees) have a better handle on AOL's upside prospects than Wall St (outsiders). They have more to lose if they are wrong.
2. **AOL has Optionality Upside** from several sources, both existing assets and new products. We think of AOL as a $2B option on a $230B market opportunity. If AOL is successful with any of its new products, this stock could triple in 2 years.
3. **Valuation.** AOL is inexpensive we think. Nine of the ten sell-side firms that cover AOL have hold or sell ratings, which implies that AOL's investment negatives are well-chronicled quarterly and are already discounted in its share price. Such strong consensus alignment gives us solace that AOL's share price captures the risks, but probably underestimates the upside. AOL's current share price *embeds negative 13% growth* every year for the next decade, according to our calculations. In fact, at current share prices AOL is valued at around the NPV as its Access business cash flows plus the cash on its balance sheet. Investors are paying virtually nothing today for a potential upside surprise from AOL. This risk/reward assessment on AOL is too negative today, in our view.

Coverage Initiation

Market Data	
Price (12/07/10)	$25.66
12-Month Price Target	$35.00
52-Week range	$29.18-20.07
Shares Out. (MM)	107.1
Market cap (MM)	$2,748.8
Avg. daily volume (000)	827.9
Financial Data	
Total Debt/Cap.	0.0%
Price/LTM Rev.	1.1x
Tangible BVPS	$12.22
Net Cash Per Share	$5.81

	FY 12/31/09 A	FY 12/31/10 E		FY 12/31/11 E	
		Old	New	Old	New
Rev. (MM)	$3,206.8		$2,391.8		$2,092.8
Growth	*(23.0%)*	*0.0%*	*(25.4%)*	*0.0%*	*(12.5%)*
Op. Mar.	*13.7%*		(46.5%)		*10.1%*
EPS: 1Q	1.34		0.79A		0.40
EPS: 2Q	0.96		0.67A		0.39
EPS: 3Q	0.82		0.82A		0.34
EPS: 4Q	0.71		0.45		0.40
EPS: Year	3.83		2.73		1.53
Growth	*126.6%*	*0.0%*	*(28.7%)*	*0.0%*	*(43.9%)*
P/E Ratio	6.3x	nm	9.4x	nm	16.7x

Note: Pro forma earnings estimates displayed above do not include one-time items or any stock compensation expenses.

Disclosures applicable to this security: B.
Disclosure explanation on the inside back cover of this report.

INVESTMENT THESIS

We initiate coverage of AOL with a BUY rating and a $35 12-month target price, representing about 36% upside from yesterday's closing price. We believe that the risk/reward for AOL is compelling at current price levels. Several building blocks underpin our Buy rating:

THE BEST QUESTION

We think the best question for AOL is *Why aren't the employees leaving?* Tech employees are the most innovative, hard-working, risk-tolerant group on Earth. They are also mobile. Tech employees move frequently because they view their labor as a valuable non-diversifiable asset. By changing jobs they maximize their NPV (broadly defined - money, great colleagues, engaging problems, change the world opportunities, etc) over the portfolio of their career.

- Yahoo's management turnover has been continuous both before and after its new CEO took over. Google just instituted a 10% salary increase to all employees plus a $1,000 bonus per employee to try to hold onto its people. These are excellent companies with strong strategic positions. Why are their employees leaving but AOL's are not?
- Since Tim Armstrong became CEO at AOL about 21 months ago, he has shrunk AOL's employee base from 9,900 to 4,500, of which 1,500 are new hires. Usually this type of downsizing has everyone running for the door if they can escape. Why aren't they leaving?
- Tim Armstrong had employees cancel their summer vacations as part of AOL's "summer sprint initiative" where each part of the organization had important goals to hit by September. The whole place is working overtime to turn the ship around. Why aren't they leaving instead?
- AOL employees live every day with the user and engagement problems chronicled by Wall St each quarter. They live with the long list of negatives the press and Wall Street highlight. And they know that it's never been done before. Why aren't they leaving?

Bottom Line: Tech is a business where *people* drive value creation. Does Wall St know more or less than employees about the future prospects of AOL? The lead indicator to us that the risk/reward has become negative at AOL is employee defections. Until that day, we'll bet that the insiders (employees) have a better handle on AOL's upside prospects than Wall St (outsiders). They have far more to lose if they are wrong.

UPSIDE OPTIONALITY

What might AOL employees be seeing that Wall Street is missing? We think there is optionality upside from both existing assets and from new products. Certain forms of AOL's optionality are easy to identify but hard to quantify. Those include:

- Tim Armstrong, CEO
- AOL's brand name
- Strong and global platform
- Millions of monthly viewers
- Millions of paying consumer relationships

If we want to quantify AOL's option value, we think it's best to look at the new products that AOL is launching. What are they and how big could they be?

- **Devil** is the new advertiser page layout on many AOL content pages. It appeals to large branded advertisers because there is only ONE ad per AOL page. The ads include video, pictures, purchase options, and store locations info for a single branded advertiser alongside high quality AOL content. The size of the national ad market is $100B, according to eMarketer. AOL is offering a substantively premium ad experience to the largest advertisers (who represent 75% of national ad spending in the US) compared with other websites.

- **Patch**; Local content aggregation down to the town level. Don't think Manhattan news and advertisements. Think Soho news and advertisers. Patch should have 500 markets done by 12/31/10 and 1,000 by 12/31/11. There are 18,000 towns in the US. We expect AOL to compete in the most lucrative 3,000 of them. The size of the local ad market was $130B in 2009 according to BIA/Kelsey. AOL can monetize either in a single town or by aggregating towns by zip code for sale to advertisers.

Figure 2

AOL: Calculation of Weighted Average Optionality Upside

Product Name	Market Size (2009 Rev in $mm)	AOL's Potential Mkt Share by 2013	% Chance	AOL's Weighted New Revenue Potential ($B)	Incremetal OIBDA (Margin=50%)
Devil	$100,000	0.0%	40%	$0	$0
	$100,000	0.5%	20%	$100	$50
	$100,000	1.0%	20%	$200	$100
	$100,000	2.0%	20%	$400	$200
			100%	$700	$350
	AOL's current EV/OIBDA multiple, 2013E				5.5
	Weighted Avg Option Value Upside from Devil				**$1,925**
Patch	$130,000	0.0%	40%	$0	$0
	$130,000	0.5%	20%	$130	$65
	$130,000	1.0%	20%	$260	$130
	$130,000	2.0%	20%	$520	$260
			100%	$910	$455
	AOL's current EV/OIBDA multiple, 2013E				5.5
	Weighted Avg Option Value Upside from Patch				**$2,503**
Optionality Upside from Devil Product					$1,925
Optionality Upside from Patch Product					$2,503
Total Optionality from Two New Products					**$4,428**
AOL's Current Market Cap, net of Cash					**$2,000**
		AOL's Optionality Upside from 2 Products			**221%**

Source: Needham & Company LLC estimates

We calculate that the upside potential of just these two products is about twice the size of AOL's entire current market capitalization, primarily because these markets are so large. Figure 2 uses conservative assumptions of AOL's market share to calculate the probability that AOL could garner ½%, 1%, or 2% of these markets and concludes that if either product works out, the stock is a double from current levels. In effect, AOL is a $2B option on a $230B market opportunity.

Video. In addition to these two products, AOL has recently purchased two companies, 5Mins and Studio Now. Video is the fastest growing piece of the online world. We expect AOL to work closely with YouTube as part of AOL's renegotiated deal with Google (announced on Sept 2, 2010). The size of the video ad market online will be $1.5B in 2010 according to eMarketer, growing at 35-45% annually for the next 5 years.

AOL's Strategic Position. According to eMarketer, 71% of all US online ad spending in 2009 went to the largest 10 Internet companies. By implication, ad dollars are concentrating at the top of the food chain, which is where AOL lives. We have seen this type of concentration in the head (rather than the long tail) over digital platforms in our other content businesses. AOL is a key beneficiary of this reality on digital platforms.

Cash Taxes Below Consensus. One of the most important drivers of valuation in a DCF is cash taxes. We believe that AOL's cash tax rate may be lower than investors think. When Bebo became insolvent and AOL closed it down, AOL was able to take a "worthless stock" deduction and treat their tax basis in Bebo of $700mm as though it were an NOL. AOL can offset the next $700mm of operating income or capital gains with this NOL. Going forward, AOL will not pay cash taxes until it has used up that NOL which could take years given its shrinking profits.

On the books, there is currently a deferred tax asset of $300mm on the balance sheet ($700mm times a 40% tax rate) and the P&L will continue to show a 40% book tax rate.

Less clear to us is how AOL will handle Netscape. AOL has a basis of about $2.7 billion in Netscape by our estimate. AOL could sell it and have a large capital loss but it would need a large capital gain to take tax advantage of that sale. Bottom line: We feel that tax shelter value as AOL's business shrinks is a key asset that the market is overlooking.

Mergers and Acquisitions Upside. There is a lot of press about AOL being involved in some sort of M&A activity. AOL is the ideal strategic fit for several companies in the online space, and even a few not in the Internet space. We would expect that any transaction would provide an upside surprise for AOL shareholders, well in excess of recent trading levels.

VALUATION

It's virtually impossible to analyze AOL without concluding it's cheap.

- Our preferred form of valuation for all our stocks is a "Breakeven DCF". In this form of valuation we set up an academically rigorous DCF and at the last minute plug in the current share price to calculate the requried OIBDA growth rate for the next decade that is embedded in the current share price. AOL's current share price embeds *negative 13%* OIBDA growth every year for the next decade, according to our calculations. (Please see Table 6 for the detailed calculation.)
- AOL trades at 1.1x revenue, 4.8x EV/EBITDA and at a P/E of 16.7x. (Please see Table 7.) This is well below comparable companies. (Please see Table 9.)
- At current share prices, AOL is trading at the present value of the access business cash flow streams plus the cash on its balance sheet today. In Figure 1 we calculate that the NPV of the access business cash flow streams is about

$2B. This is equal to AOL's market capitalization (excluding cash balances). Investors are paying virtually nothing today for a potential upside surprise from AOL. This risk/reward ratio is too negative, in our view.

Figure 1

AOL: Access Business NPV

$ in millions

FYE 12/31:	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	CAGR
OIBDA from Access Biz	**$520**	**$406**	**$316**	**$247**	**$192**	**$150**	**$117**	**$91**	**$71**	**$56**	**-22.0%**
PV Discounted at WACC of 10.5%	$520	$367	$259	$183	$129	$91	$64	$45	$32	$23	
Sum of PV of Free Cash Flow										$1,715	
Terminal Value of 2020E FCF										$656	
PV of Terminal Value at WACC										$268	
Total NPV of Access Business										**$1,982**	

Source: Needham & Company LLC estimates.

INVESTMENT NEGATIVES ARE ALREADY BAKED INTO THE SHARE PRICE

Nine of the ten sell-side firms that cover AOL have a Hold or Sell rating, which implies that AOL's investment negatives are well-chronicled quarterly and are already baked into AOL's share price. Really, does anyone NOT know that:

1. **User Metrics.** AOL's user engagement metrics and share of time spent across the AOL branded properties have been falling, especially since 1Q09. Social media sites like Facebook and Google on mobile devices have been growing at AOL's expense.
2. **Revenues and Margins in Decline.** AOL's operating segments have reported steady profit declines for several years, and we don't project that to change in the next 12 months. We expect the Access business will continue to decline by 20% to 25% per year for the foreseeable future. We project that AOL's revenue and OIBDA and EPS will fall in 2011, with margin pressure resulting in faster EPS declines. The good news is that the investment spending in 2010 and 2011 should begin to generate revenue in 2011 so that returns on marginal invested dollars should improve as 2011 proceeds.
3. **Execution Risk.** AOL is in turnaround mode, which entails execution risks. AOL recently successfully renewed its search deal with Google, which is a positive for its search business. Turning around the branded display business is the next task that AOL must tackle, through products like Devil, etc.
4. **Competitors, Old and New.** AOL competes against huge online and offline companies for viewers and ad dollars and there are new competitors entering all the time.

Bottom Line. The investment risks of AOL are well known. Such strong consensus alignment gives us solace that AOL's share price today captures the risks, but probably underestimates the stock's upside potential.

FINANCIAL OUTLOOK & EARNINGS ESTIMATES

Table 1 includes our estimates, and compares these to consensus estimates.

Table 1- Quarterly EPS estimates vs Consensus

FYE 12/31:	4Q10E	2010E	1Q11E	2Q11E	3Q11E	4Q11E	2011E
Rev Current ($m)	**$580**	**$2,392**	**$535**	**$514**	**$505**	**$539**	**$2,093**
Previous ($m)	-	-	-	-	-	-	-
Consensus ($mm)	$589	$2,410	$535	NA	NA	NA	$2,120
EPS Operations	$0.45	$2.73	$0.40	$0.39	$0.34	$0.40	$1.53
Previous	-	-	-	-	-	-	-
Consensus	$0.42	$2.69	$0.39	NA	NA	NA	$1.61
P/E Current		9.4					16.7
Source: Yahoo Finance, Needham & Company estimates.							

TARGET PRICE

Our $35 target price is based on a 10-year DCF model. (Please see Exhibit 5.) We use a WACC of 10.5% and a long-term nominal GDP growth rate of 2%. The standard DCF is widely used on Wall Street because it is a rigorous bottom-up valuation of the enterprise based on discounting its long-term cash flows, and it removes the impact of non-cash accounting conventions.

Our $35 target price embeds a 10-year OIBDA ***negative 5%*** growth rate annually beginning in 2011 and represents a 7.2x multiple of forward year (2012E) OIBDA

VALUATION

Our BUY rating is based on several forms of valuation:

Table 2: AOL: Valuation Summary & Conclusions					
2011E Valuation Multiples			**Embedded Expectations Metrics**		
1	EV/Sales	1.1	9	**Breakeven DCF** (Calculated as the 10-Yr EBITDA CAGR required to justify current share price)	-13.3%
2	EV/OIBDA	4.8			
3	P/E	16.7			
4	FCF/Share	$2.98			
5	EV/FCF	7.0			
6	FCF Yield	12%			
Source: Needham & Company estimates.					

1. The "Breakeven DCF" valuation methodology uses the current share price to calculate the market's growth expectations for the enterprise, including capital efficiency trends. This valuation methodology concludes that AOL must achieve a 10-year OIBDA compound annual growth rate of ***negative 13%*** to justify its current share price. (Please see Table 6.)
2. In Table 7, we summarize several valuation multiples for Sales, OIBDA and P/E. AOL's EV/OIBDA trading multiple is approximately 4.8x 2011E.
3. In Table 8, we present Free Cash Flow valuation metrics. Our Free Cash Flow analysis shows that AOL is currently valued at about 7x 2011E Free Cash flow and has a 12% free cash flow yield.
4. In Table 9, we present our Comparative Industry valuation metrics.

MANAGEMENT TEAM

Tim Armstrong, CEO, joined AOL in March 2009 from Google, where he served as President of The Americas Operations, overseeing Google's North American and Latin

American advertising sales, marketing and operations teams. Prior to joining Google, Armstrong worked at Snowball.com and at Disney's ABC/ESPN Internet Ventures. He started his career by co-founding and running a newspaper based in Boston.

Arthur Minson, CFO, is AOL's Chief Financial Officer. Prior to joining AOL, Minson was Executive Vice President and Deputy Chief Financial Officer of Time Warner Cable. Prior to TWC, Minson was Senior Vice President of Corporate Finance and Development at AOL. Minson, a CPA, began his career in the Audit Practice of Ernst and Young. Minson graduated cum laude with a BSBA in Accounting from Georgetown University and an MBA with a concentration in Finance from Columbia Business School.

Alexander Gounares, Chief Technology Officer, leads all aspects of AOL's technology strategy, platform development and external technology partnerships. Gounares joined AOL from Microsoft. Prior to joining Microsoft in 1993, Gounares worked at Los Alamos National Laboratory. He has founded two startups and is also an inventor on more than 100 U.S. patents filed and pending. Gounares holds a bachelor's degree cum laude in Computer Science from Princeton University.

COMPANY DESCRIPTION

AOL is one of the largest online companies in the world with a wide range of brands and a global audience. AOL's business includes online content products and services for a world-wide base of consumers, publishers and advertisers. AOL provides online advertising services on both owned and operated properties and third-party websites, in addition to a display advertising network. AOL operates one of the largest Internet subscription access services in the United States. AOL separated from Time Warner Inc. (TWX-Hold) on December 9, 2009.

Table 3A

AOL: Quarterly Financial Projections, 2010E

$ and shares in thousands, except per share data

	3/31/10A	10/09	6/30/10A	10/09	9/30/10A	10/09	12/31/10E	10/09	Year	10/09
Revenue:										
Advertising	$354	-18%	$297	-27%	$293	-27%	$332	-28%	$1,276	-25%
Subscription	$283	-28%	$260	-27%	$245	-26%	$230	-25%	$1,018	-27%
Other	$27	-9%	$27	-6%	$26	-12%	$18	-40%	$98	-17%
Total Revenues	**$664**	**-22%**	**$584**	**-26%**	**$563**	**-26%**	**$580**	**-27%**	**$2,392**	**-25%**
Costs and Expenses										
Costs of Revenues	$365	-24%	$333	-28%	$343	-24%	$362	-26%	$1,403	-26%
S,G & A	$133	-2%	$126	3%	$117	-19%	$128	0%	$504	-5%
Amortization of Intangible Assets	$62	79%	$36	7%	$23	-28%	$27	-29%	$148	7%
Amounts Related to Securities Litigation and Govt. Investigations, net of recoveries	$0	-100%	$0	-100%	$0	NM	$0	NM	$0	NM
Restructuring Costs	$23	-60%	$11	-23%	($0)	NM	$0	NM	$34	NM
Goodwill Impairment Charge	$0	NA	$1,414	NM	$0	NM	$0	NM	$1,414	NM
Gain on Disposal of Assets, net	$0	NA	$0	NA	$0	NM	$0	NM	$0	NM
Total Costs and Expenses	$584	-19%	$1,921	NM	$483	-25%	$517	-33%	$3,504	27%
Operating Income	$81	-41%	($1,337)	NM	$81	-34%	$63	NM	($1,112)	NM
Other Income (Loss), net	($3)	-13%	($4)	NM	$14	NM	$15	NM	$22	NM
Income (Loss) from Cont. Ops Before Taxes	$78	-42%	($1,341)	NM	$94	-20%	$78	NM	($1,091)	NM
Income Taxes (Benefit)	$37	-31%	($269)	NM	($5)	NM	$30	NM	($208)	NM
Income from Continuing Operations	$41	-49%	($1,072)	NM	$100	42%	$48	NM	($882)	NM
Discontinued Operations, net of tax	($7)	NA	$17	NM	$72	NM	$0	NM	$82	NM
Net Income	$35	-58%	($1,055)	NM	$172	NM	$48	NM	($800)	NM
Less: Net Income Attributable to Non-Contolling Interes	$0	NA	$0	NM	$0	NM	$0	NM	$0	NM
Net Income (Loss) Attributable to AOL	$35	-58%	($1,055)	NM	$172	NM	$48	NM	($800)	NM
Items Impacting Comparability, After-Tax	$50		$1,126		($84)		$0		$1,093	595%
EPS-Operations	**$0.79**	-41%	**$0.67**	NM	**$0.82**	0%	**$0.45**	NM	**$2.73**	**-29%**
EPS-Reported	**$0.32**	-59%	**($9.89)**	NM	**$1.60**	NM	**$0.45**	NM	**($7.52)**	NM
Weighted Avg. Diluted Shares	107	1%	107	0%	107		108		107	
Calculation of OIBDA										
Operating Income	$81	-41%	($1,337)	-970%	$81	-34%	$63	150%	($1,112)	NM
Plus:										
Depreciation	$54	-20%	$52	-28%	$47	-28%	$47	-14%	$200	-24%
Amortization	$62	79%	$36	7%	$23	-28%	$24	-40%	$145	0%
Asset Impairments, Other	$1	-52%	$1,416	NM	$7	-1%	$7	-5%	$1,431	NM
OIBDA	**$198**	-18%	**$167**	-37%	**$158**	-30%	**$141**	11%	**$663**	**-23%**

Sources: Company reports, Needham & Company estimates.

Table 3B

AOL: Footnotes to Consolidated Revenue Detail

$ in thousands, except per subscriber data

	2010E									
	3/31/10A	10/09	6/30/10A	10/09	9/30/10A	10/09	12/31/10E	10/09	Year	10/09
Advertising Summary										
AOL Properties										
Display	$126	-10%	$120	-13%	$121		$145		$512	
Search & Contextual	$121	-25%	$106	-28%	$99	-28%	$93	-34%	$419	29%
Total AOL Properties	$246	-18%	$226	-21%	$220	-21%	$238	-23%	$931	-21%
Third Party Network	$108	-17%	$71	-42%	$73	-41%	$94	-37%	$346	-34%
Total Ad Rev($mm)	**$354**	**-18%**	**$297**	**-27%**	**$293**	**-27%**	**$332**	**-28%**	**$1,276**	**-25%**
US Subscriber Summary										
Beginning Subs (000)	4,999	-27%	4,656	-26%	4,362	-25%	4,083	-24%	4,999	-27%
Internal Growth %	-6.9%		-6.3%		-6.4%		-6.0%		-23.2%	
Internal Growth in Subs.	(343)	-40%	(294)	-42%	(279)	-36%	(245)	-32%	(1,161)	-38%
Ending Subs. (000)	4,656	-26%	4,362	-25%	4,083	-24%	3,838	-23%	3,838	-23%
Avg. Subs.	4,828	-27%	4,509	-26%	4,223	-24%	3,961	-24%	4,419	-26%
Monthly Revs/Sub	$19.52	-2%	$19.24	-2%	$19.33	-3%	$19.35	-2%	$19.36	-1%
Total Subscriber Rev($mm)	**$283**	**-28%**	**$260**	**-27%**	**$245**	**-26%**	**$230**	**-25%**	**$1,018**	**-27%**
Other	**$27**	**-9%**	**$27**	**-6%**	**$26**	**-12%**	**$18**	**-40%**	**$98**	**-17%**

Sources: Company reports, Needham & Company estimates.

Table 3C

AOL: Quarterly Financial Projections, 2011E

$ and shares in millions, except per share data

	3/31/11E	11/10	6/30/11E	11/10	9/30/11E	11/10	12/31/11E	11/10	Year	11/10
Revenue:										
Advertising	$296	-16%	$286	-4%	$290	-1%	$336	1%	$1,208	-5%
Subscription	$215	-24%	$202	-22%	$189	-23%	$176	-23%	$782	-23%
Other	$24	-12%	$26	-4%	$26	0%	$27	47%	$103	4%
Total Revenues	**$535**	-19%	**$514**	-12%	**$505**	-10%	**$539**	-7%	**$2,093**	**-12%**
Costs and Expenses										
Costs of Revenues	$332	-9%	$317	-5%	$318	-7%	$329	-9%	$1,296	-8%
S,G & A	$120	-10%	$121	-4%	$118	1%	$129	1%	$489	-3%
Amortization of Intangible Assets	$24	-61%	$24	-33%	$24	5%	$24	-11%	$96	-35%
Amounts Related to Securities Litigation and Govt. Investigations, net of recoveries	$0		$0		$0		$0		$0	
Restructuring Costs	$0		$0		$0		$0		$0	
Goodwill Impairment Charge	$0		$0		$0		$0		$0	
Gain on Disposal of Assets, net	$0		$0		$0		$0		$0	
Total Costs and Expenses	$477	-18%	$462		$460	-5%	$482	-7%	$1,881	-46%
Operating Income	$58	-28%	$52		$45	-45%	$57	-10%	$212	-119%
Other Income (Loss), net	$4	-248%	$2	-147%	$2	-85%	$2	-87%	$10	-53%
Income (Loss) from Cont. Ops Before Taxes	$62	-20%	$54	-104%	$47	-51%	$59	-25%	$222	-120%
Income Taxes (Benefit)	$25	-32%	$22	-108%	$19	-446%	$24	-21%	$89	-143%
Income from Continuing Operations	$37	-9%	$32	-103%	$28	-72%	$35	-27%	$133	-115%
Discontinued Operations, net of tax	$0		$0		$0		$0		$0	
Net Income	$37	8%	$32	-103%	$28	-84%	$35	-27%	$133	-117%
Less: Net Income Attributable to Non-Contolling Interest	$0		$0		$0		$0		$0	
Net Income (Loss) Attributable to AOL	$37	8%	$32		$28	-84%	$35	-27%	$133	-117%
Items Impacting Comparability, After-Tax	$6		$10		$10		$10		$36	
EPS-Operations	**$0.40**	-50%	**$0.39**	-42%	**$0.34**	-58%	**$0.40**	-10%	**$1.53**	**-44%**
EPS-Reported	**$0.35**	7%	**$0.29**	-103%	**$0.25**	-84%	**$0.31**	-30%	**$1.21**	NM
Weighted Avg. Diluted Shares	109	1%	110	3%	111	3%	112	4%	110	3%
Calculation of OIBDA										
Operating Income	$58	-28%	$52	-104%	$45	-45%	$57	-10%	$212	-119%
Plus:										
Depreciation	$45	-17%	$45	-13%	$45	-4%	$45	-4%	$180	-10%
Amortization	$23	-63%	$23	-36%	$22	-4%	$20	-17%	$88	-39%
Asset Impairments, Other	$0		$0		$0		$0		$0	
OIBDA	**$126**	-36%	**$120**	-28%	**$112**	-29%	**$122**	-14%	**$480**	**-28%**

Sources: Company reports, Needham & Company estimates.

Table 3D

AOL: Footnotes to Consolidated Revenue Detail

$ in thousands, except per subscriber data

	2011E									
	3/31/11E	11/10	6/30/11E	11/10	9/30/11E	11/10	12/31/11E	11/10	Year	11/10
Advertising Summary										
AOL Properties										
Display	$115	-8%	$126	5%	$130	8%	$161	11%	$532	4%
Search & Contextual	$87	-28%	$86	-19%	$82	-17%	$80	-14%	$335	-20%
Total AOL Properties	$202	-18%	$212	-6%	$212	-4%	$241	1%	$867	-7%
Third Party Network	$94	-13%	$74	5%	$78	7%	$95	1%	$341	-1%
Total Ad Rev($mm)	**$296**	**-16%**	**$286**	**-4%**	**$290**	**-1%**	**$336**	**1%**	**$1,208**	**-5%**
US Subscriber Summary										
Beginning Subs (000)	3,838	-23%	3,603	-23%	3,373	-23%	3,153	-23%	3,838	-23%
Internal Growth %	-6.1%		-6.4%		-6.5%		-7.1%		-23.7%	
Internal Growth in Subs.	(235)	-31%	(230)	-22%	(220)	-21%	(225)	-8%	(910)	-22%
Ending Subs. (000)	3,603	-23%	3,373	-23%	3,153	-23%	2,928	-24%	2,928	-24%
Avg. Subs.	3,721	-23%	3,488	-23%	3,263	-23%	3,041	-23%	3,383	-23%
Monthly Revs/Sub	$19.30	-1%	$19.30	0%	$19.30	0%	$19.30	0%	$19.30	0%
Total Subscriber Rev($mm)	**$215**	**-24%**	**$202**	**-22%**	**$189**	**-23%**	**$176**	**-23%**	**$782**	**-23%**
Other	**$24**	**-12%**	**$26**	**-4%**	**$26**	**0%**	**$27**	**47%**	**$103**	**4%**

Sources: Company reports, Needham & Company estimates.

Table 4

AOL: Annual Income Statement Summary Projections, 2008A-2011E

$ in thousands, except per share data

	2008A	2009A	09/08	2010E	10/09	2011E	11/10
Revenue:							
Advertising	$2,096	$1,700	-18.9%	$1,276	-24.9%	$1,208	-5.3%
Subscription	$1,929	$1,389	-28.0%	$1,018	-26.7%	$782	-23.1%
Other	$140	$118	-15.6%	$98	-17.0%	$103	4.4%
Total Revenues	**$4,166**	**$3,207**	**-23.0%**	**$2,392**	**-25.4%**	**$2,093**	**-12.5%**
Costs and Expenses							
Costs of Revenues	$2,278	$1,884	-17.3%	$1,403	-25.5%	$1,296	-7.6%
S,G & A	$645	$530	-17.9%	$504	-4.8%	$489	-3.1%
Amortization of Intangible Assets	$166	$138	NM	$148	7.1%	$96	-35.0%
Amounts Related to Securities Litigation and Govt. Investigations, net of recoveries	$21	$28	34.1%	$0		$0	NM
Restructuring Costs	$17	$189	NM	$34	-82.0%	$0	-100.0%
Goodwill Impairment Charge	$2,207	$0	-100.0%	$1,414	NM	$0	-100.0%
Gain on Disposal of Assets, net	$0	$0	NM	$0	NM	$0	NM
Total Costs and Expenses	$5,334	$2,769	-48.1%	$3,504	26.5%	$1,881	-46.3%
							NM
Operating Income	($1,168)	$438	NM	($1,112)	NM	$212	-119.1%
							NM
Other Income (Loss), net	($4)	($2)	NM	$22	NM	$10	-53.5%
Income (Loss) from Cont. Ops Before Taxes	($1,172)	$436	NM	($1,091)	NM	$222	-120.4%
Income Taxes	$355	$198	NM	($208)	NM	$89	-142.6%
Income from Continuing Operations	**($1,527)**	$237	NM	**($882)**	NM	**$133**	-115.1%
Discontinued Operations, net of tax	$0	$11		$82	NM	$0	-100.0%
Net Income	($1,527)	$248		($800)	NM	$133	-116.6%
Less: Net Loss Attrib. to Non Controlled Int.	$0.8	$0		$0	NM	$0	NM
Net Income (Loss) Attributable to AOL	**($1,526)**	**$249**	**-116.3%**	**($800)**		**$133**	-116.6%
EPS Operations	**$105.80**	**$3.83**	**NM**	**$2.73**	**NM**	**$1.53**	-43.9%
EPS Reported	**($14.42)**	**$2.35**	**-116.3%**	**($7.52)**	**NM**	**$1.21**	**-116.1%**
Weighted Avg. Diluted Shares	106	106	0.0%	107	1.3%	110	3.0%
Calculation of OIBDA:							
Operating Income	($1,168)	$438	NM	($1,112)	NM	$212	-119.1%
Plus:							
Depreciation	$311	$262	-15.9%	$200	-23.6%	$180	-9.9%
Amortization	$166	$145	-12.9%	$145		$88	
Asset Impairments, Other	$2,240	$21	-99.1%	$1,431	NM	$0	-100.0%
OIBDA	**$1,547**	**$865**	**-44.1%**	**$663**	**NM**	**$480**	**-27.6%**

Sources: Company reports, Needham & Company estimates.

Table 5

AOL: Target Price Calculation

$ and shares in millions, except per share data

Valuation Conclusions		% of Total
Sum of PV of Free Cash Flow [1]	$2,018	47%
PV of Terminal Value Discounted at WACC [1]	$1,217	28%
Value of Operations (WACC Method)	**$3,235**	**75%**
Plus: Excess Cash at 12/31/11E	$1,000	
Plus: NPV of Tax Step Up	$100	
Enterprise Value	**$4,335**	**100%**
Less: Debt at 12/31/11E	$0	
Less: Lease Obligations	($430)	
Less: Preferred Stock Outstanding	$0	
Less: Value of Options & Restricted Sk, After-tax	($25)	
Common Equity Value	**$3,880**	**90%**
Fully Diluted Shares Out, 2011E	110	
DCF Value/Share	**$35.15**	
Current Share Price @ 12/7/10	$25.66	
Upside Potential (DCF-Current Price/Current Price)	**37%**	

Standard Discounted Cash Flow (DCF) Valuation

Why We Calculate: DCF is a rigorous bottoms-up valuation of the enterprise focusing on cash flows (not accounting)

Strengths

1 Focuses on operations. Removes financing
2 Focuses on FCF. Removes non-cash accounting
3 Explicitly forecasts capital needs (WC & CapX)
3 Uses a levered beta (widely available)
4 Ent value focus captures entire business model

Weaknesses

1 Many assumptions. Valuation can be manipulated
2 Terminal value big & based on low visiblity projections
3 Model assumes constant debt/equity ratio
4 Complex to calculate
5 Calculates the enterprise value first, then equity value

[1] **Calculation of the Value of Operations (WACC Method)**

FYE 12/31:	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	CAGR '12-21E
OIBDA (after sk comp exp & corp):	**$480**	**$456**	**$433**	**$412**	**$391**	**$371**	**$353**	**$335**	**$318**	**$303**	**$287**	**-5.0%**
- Depreciation	($180)	($181)	($162)	($154)	($133)	($120)	($114)	($103)	($97)	($93)	($88)	
+ Option Exercise Procee	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	
+ Int & Inv Income only	$1	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	
EBIT	$311	$290	$286	$273	$273	$266	$254	$248	$236	$225	$214	
Cash Taxes (at 20%)	($62)	($58)	($57)	($55)	($55)	($53)	($51)	($50)	($47)	($45)	($43)	
Plus: Depreciation	$180	$181	$162	$154	$133	$120	$114	$103	$97	$93	$88	
Plus: Sk Based Comp Exp	$40	$40	$40	$40	$40	$50	$50	$50	$50	$50	$50	
Working Capital Change	($10)	($10)	($10)	($9)	($8)	($7)	($7)	($6)	($6)	($5)	($5)	
Less: Capital Spending	($100)	($100)	($95)	($91)	($78)	($71)	($67)	($60)	($57)	($54)	($52)	
FCF from Operations	**$359**	**$343**	**$326**	**$312**	**$305**	**$305**	**$293**	**$284**	**$273**	**$263**	**$253**	**-3.3%**
PV Discounted at WACC [2]		$343	$295	$256	$226	$205	$178	$156	$136	$118	$103	
Sum of PV of Free Cash Flow											$2,018	
Terminal Value of 2021E FCF [3]											$2,982	
PV of Terminal Value at WACC [2]											$1,217	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] Calculation of WACC:	
10-Year Risk Free Rate ("RFR")	2.0%
Equity Risk Premium (Ibbotson-Arithmetic)	6.5%
Levered Beta (Bloomberg)	1.40
Target Equity/(Debt + Equity)	90%
Debt Rating	BBB
Debt Spread	6.0%
Marginal Tax Rate ("T")	40.0%
WACC	**10.5%**

(RFR+(Equity Risk Premium x Beta)) x Equity/Total Capital + ((RFR + Debt Spread) x (1-T) x Debt/Total Capital).

[3] Calculation of Terminal Multiple (WACC Method)	
WACC	10.5%
Long-term Nominal GDP Growth	2.0%
WACC-GDP Growth	8.5%
FCF Terminal Multiple [1/(WACC-Growth Rate)]	**11.8**
EBITDA Terminal Mutiple	**10.4**

Sources: Company Reports, Needham & Company estimates.

Table 6

AOL: Breakeven Discounted Cash Flow (DCF) Valuation Calculation, 2012E - 2021E

$ and shares in millions, except per share data

Valuation Conclusions		2011E
Sum of PV of Free Cash Flow [1]		$1,513
PV of Terminal Value Discounted at WACC [1]		$667
Value of Operations (WACC Method)		**$2,180**
Plus: Excess Cash at 12/31/11E		$1,000
Plus: NPV of Tax Step Up		$100
Enterprise Value		**$3,280**
Less: Debt at 12/31/11E		$0
Less: Lease Obligations		($430)
Less: Preferred Stock Outstanding		$0
Less: Value of Options & Restricted Sk, After-tax		($25)
Common Equity Value		**$2,825**
Fully Diluted Shares Out, 2011E		110
Breakeven DCF Value/Share		**$25.59**
Current Share Price @	12/7/10	$25.66
Discount to DCF Value (DCF-Current Price/DCF)		0%

Breakeven Discounted Cash Flow Valuation

Why We Calculate: BE DCF uses the current share price to calculate the market's growth expectations for the enterprise.

Strengths

1 Makes no assumption about growth for first 10 years
2 Prevents over-optimism by working backwards
3 Data widely available and model well understood
4 Explicitly forecasts capital needs (WC & CapX)
5 Uses a levered beta (widely available)

Weaknesses

1 Terminal value big & based on low visiblity projections
2 Model assumes constant debt/equity ratio
3 Complex to calculate
4 Calculates the enterprise value first, then equity value

[1] **Calculation of the Value of Operations (WACC Method)**

FYE 12/31:	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	Required LT Growth Rate
OIBDA (after sk comp exp & corp):	**$480**	**$416**	**$361**	**$313**	**$271**	**$235**	**$204**	**$177**	**$153**	**$133**	**$115**	**-13.3%**
- Depreciation	($180)	($165)	($135)	($117)	($92)	($76)	($66)	($54)	($47)	($41)	($35)	
+ Option Exercise Procee	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	
+ Int & Inv Income only	$1	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	
EBIT	$311	$266	$241	$211	$194	$174	$153	$138	$121	$107	$95	
Cash Taxes (at 20%)	($62)	($53)	($48)	($42)	($39)	($35)	($31)	($28)	($24)	($21)	($19)	
Plus: Depreciation	$180	$165	$135	$117	$92	$76	$66	$54	$47	$41	$35	
Plus: Sk Based Comp Exp	$40	$40	$40	$40	$40	$50	$50	$50	$50	$50	$50	
Working Capital Change	($10)	($9)	($8)	($7)	($5)	($4)	($4)	($3)	($3)	($2)	($2)	
Less: Capital Spending	($100)	($92)	($79)	($69)	($54)	($45)	($39)	($32)	($28)	($24)	($21)	
FCF from Operations	**$359**	**$317**	**$280**	**$250**	**$228**	**$216**	**$196**	**$179**	**$164**	**$150**	**$138**	
PV Discounted at WACC [2]		$317	$254	$205	$169	$145	$119	$99	$81	$68	$56	
Sum of PV of Free Cash Flow											$1,513	
Terminal Value of 2021E FCF [3]											$1,634	
PV of Terminal Value at WACC [2]											$667	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] **Calculation of WACC:**

10-Year Risk Free Rate ("RFR")	2.0%
Equity Risk Premium (Ibbotson-Arithmetic)	6.5%
Levered Beta (Bloomberg)	1.40
Target Equity/(Debt + Equity)	90%
Debt Rating	BBB
Debt Spread	6.0%
Marginal Tax Rate ("T")	40.0%
WACC	**10.5%**

(RFR+(Equity Risk Premium x Beta)) x Equity/Total Capital + ((RFR + Debt Spread) x (1-T) x Debt/Total Capital).

[3] **Calculation of Terminal Multiple (WACC Method)**

WACC	10.5%
Long-term Nominal GDP Growth	2.0%
WACC-GDP Growth	8.5%
FCF Terminal Multiple [1/(WACC-Growth Rate)]	**11.8**
EBITDA Terminal Mutiple	**14.2**

Sources: Company Reports, Needham & Company estimates.

Table 7

AOL: Valuation Multiples (Sales, OIBDA, P/E)

$ and shares in millions, except per share data

Valuation Conclusions		**2011E**
Market-Based Enterprise Value [1]		$2,287
2011E Sales (From Annual Projections)		$2,093
EV/Sales		**1.1**
Market-Based Enterprise Value [1]		$2,287
2011E OIBDA (From Annual Projections)		$480
EV/EBITDA		**4.8**
Target Price		$35.00
Target Price EV/2012 OIBDA		**7.5**
Current Price	12/7/10	$25.66
2011E EPS (From Annual Projections)		$1.53
P/E Ratio		**16.7**

[1] Calculation of Market-Based Enterprise Value		
Year End 12/31:		2011E
Current Share Price	12/07/10	$25.66
Fully Diluted Shares Out		110
Market Capitalization		**$2,832**
Less: Excess Cash		($1,000)
Plus: Tax Step Up - Minority Interest (See PMV)		$0
Plus: Unfunded Retirement Liabilities		$0
Plus: Debt at 12/31/11		$0
Plus: Lease Obligations		$430
Plus: Preferred Stock Outstanding		$0
Plus: Options & Restricted Sk Outstanding		$25
Market-Based Enterprise Value		**$2,287**

Sources: Company Reports, Needham & Company estimates.

Table 8

AOL: Free Cash Flow Valuation Metrics

$ and shares in millions, except per share data

Valuation Conclusions		**2011E**
FCF/Share [2]		$2.98
Current Price	12/7/10	$25.66
FCF Yield		**12%**
FCF [2]		$329
2011E OIBDA (From Annual Projections)		$480
FCF Conversion Rate (FCF/OIBDA)		**68%**
Market-Based Enterprise Value [1]		$2,287
FCF [2]		$329
EV/FCF		**7.0**
Net Debt/OIBDA		(2.1)
Net Debt		($1,000)
Net Debt/Market Cap		**-35.3%**

[2] Calculation of Free Cash Flow	
Year End 12/31:	2011E
OIBDA	$480
Plus: Option Exercise Proceeds	$10
Less: Cash Interest Expense	($7)
Cash Portion of Minority Interest	$0
Less: Dividends	$0
Less: Operating Cash Taxes	($53)
Less: Change in Working Capital	($9)
Less: Capital Spending	($92)
Free Cash Flow	**$329**
Less: Dividends	$0
Free Cash Flow After Dividends	$329
Shares Outstanding	110
FCF/Share	**$2.98**
FCF/Share After Dividends	$2.98

Sources: Company Reports, Needham & Company estimates.

Table 9

Summary Comparative Financial & Valuation Information

$ and shares in millions, except per share data

Laura Martin's Coverage				2011E Multiples					12/7/10			
Sorted by Industry	Ticker	Market Cap ($B)	Rating	EV/ EBITDA	P/E	EV/ FCF	FCF Yield	Break-even DCF	Target Price	Current Price	Target/ Current	Conflicts Disclosure
Content Companies												
1 AOL, Inc.	**AOL**	**$3**	**BUY**	**4.8**	**16.7**	**7.0**	**11.6%**	**-13.3%**	**$35.00**	**$25.66**	**36%**	**B**
2 CBS	CBS	$12	BUY	8.0	14.0	15.5	10.4%	1.3%	$19.00	$17.94	6%	B
3 Disney	DIS	$71	HOLD	8.7	15.6	27.1	4.2%	5.4%	NA	$37.33		B
4 News Corp	NWS	$42	BUY	7.5	14.1	18.0	6.2%	0.4%	$20.00	$16.25	23%	B, G
5 Time Warner Inc	TWX	$35	HOLD	7.4	12.3	19.9	7.0%	0.9%	NA	$31.20		B
6 Viacom	VIAB	$23	BUY	7.7	12.3	17.4	7.3%	1.1%	$43.00	$39.40	9%	B
7 Warner Music	WMG	$0.8	BUY	6.8	(6.0)	14.8	20.3%	-8.2%	$8.50	$5.03	69%	B
Industry Total/Average		$188		7.3	11.3	17.1	9.6%	-1.8%	NA	$24.69	NA	
Cable Companies												
8 Mediacom	MCCC	$0.6	HOLD	7.6	NMF	NMF	NMF	0.6%	NA	$8.48		B, G
9 Time Warner Cable	TWC	$23	BUY	6.1	15.2	41.7	4.5%	1.3%	$65.00	$64.98	0%	B
Industry Total/Average		$23		6.8	15.2	41.7	4.5%	0.9%	$65.00	$36.73	0.0%	
Total/Average from Above		**$211**		**7.0**	**13.3**	**29.4**	**7.0%**	**-0.4%**			**NM**	

Sorted by Industry	WACC	Revenue 2011E	OIBDA 2011E	EPS 2011E	EV	Net Debt	Debt/ OIBDA	Debt Rating	FCF	FCF/ Share	Dividend/ Share	Div. Yield
$ in millions, except per share data												
Content Companies												
1 AOL, Inc.	**0.0%**	**$2,093**	**$480**	**$36.00**	**$2,287**	**($1,000)**	**-2.0835**	**0.06**	**$329**	**$2.98**	**$0.00**	**NA**
2 CBS	9.0%	$14,250	$2,398	$1.28	$19,204	$6,500	2.7	BBB-	$1,241	$1.87	$0.20	1.1%
3 Disney	8.7%	$40,511	$9,314	$2.39	$81,420	$10,250	1.1	A	$3,006	$1.58	$0.35	0.9%
4 News Corp	8.8%	$0	$6,260	$1.16	$46,725	$3,300	0.5	BBB+	$2,602	$1.00	$0.15	0.9%
5 Time Warner Inc	9.1%	$28,050	$6,705	$2.54	$49,512	$11,600	1.7	BBB	$2,482	$2.19	$0.85	2.7%
6 Viacom	9.0%	$14,241	$3,890	$3.22	$29,845	$5,400	1.4	BBB	$1,711	$2.89	$0.60	1.5%
7 Warner Music	9.1%	$2,782	$336	($0.84)	$2,280	$1,420	4.2	BB-	$154	$1.02	$0.00	NA
Cable Companies												
8 Mediacom	9.2%	$1,515	$570	$0.63	$4,307	$3,680	6.5	B+	$124	$1.75	$0.00	NA
9 Time Warner Cable	9.1%	$19,491	$7,051	$4.27	$42,662	$20,500	2.9	BBB	$1,023	$2.92	$1.60	2.5%

Sources: Needham & Co, LLC estimates, Company documents, FirstCall, Yahoo Finance.

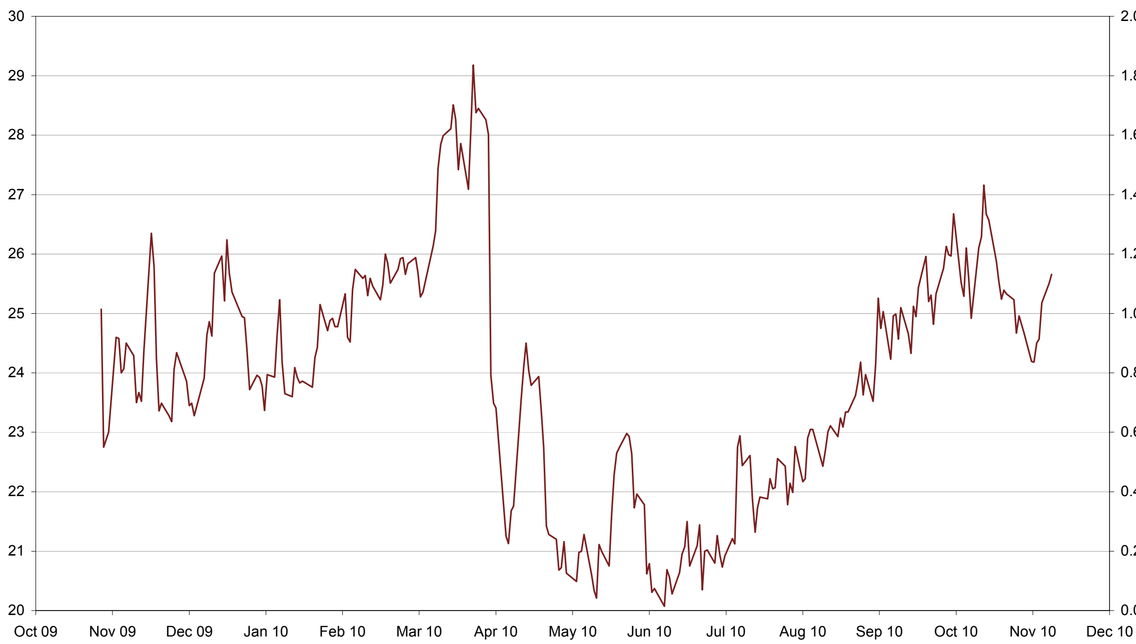
Analyst: Laura Martin, CFA (917) 373-3066. LMartin@Needhamco.com

ANALYST CERTIFICATION

I, Laura Martin, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

I, Dan Medina, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Price, Rating, and Price Target History: AOL Inc. (AOL/NYSE) as of 12-7-10



Source: Factset (Prices) / Needham (ratings)

Disclosures applicable to this security: B.

	% of companies under coverage with this rating	% for which investment banking services have been provided for in the past 12 months
Strong Buy	9	15
Buy	62	15
Hold	27	3
Under Perform	<1	0
Rating Suspended	1	25
Restricted	0	0
Under Review	0	0

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Hold: A security, which at the time the rating is instituted, indicates an expectation of a total return of +/- 10% over the next 12 months.
Underperform: A security, which at the time the rating is instituted, indicates an expectation that the price will depreciate by more than 10% over the next 12 months.
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I, Laura Martin, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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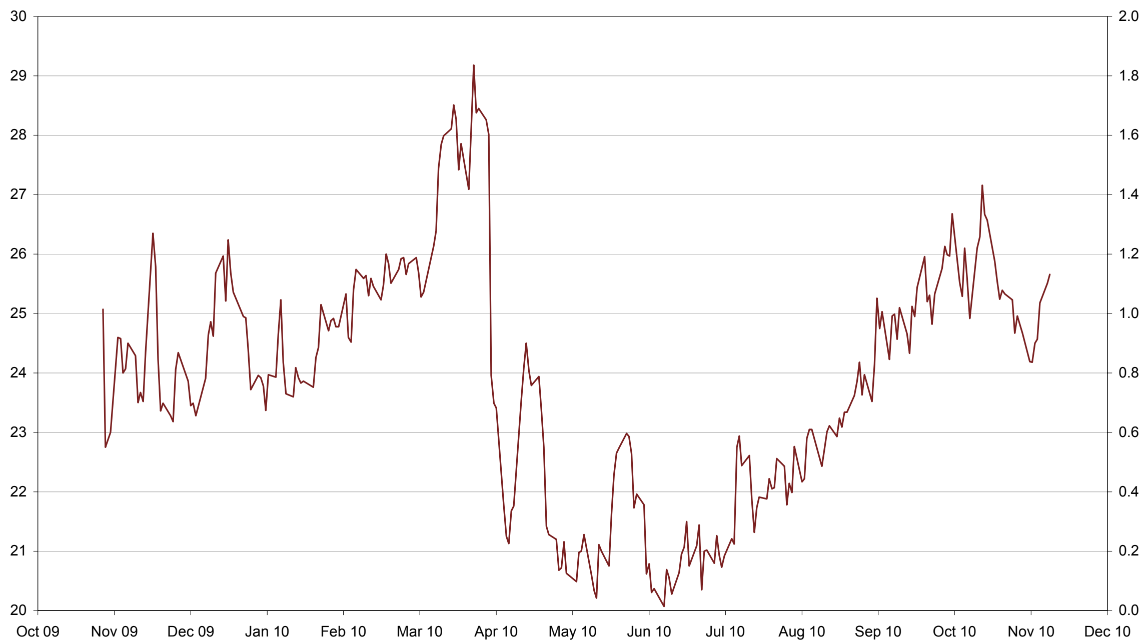
Price, Rating, and Price Target History: AOL Inc. (AOL/NYSE) as of 12-7-10



Source: Factset (Prices) / Needham (ratings)

Disclosures applicable to this security: B.

Price, Rating, and Price Target History: Time Warner Inc. (TWX/NYSE) as of 12-7-10

Source: Factset (Prices) / Needham (ratings)

Disclosures applicable to this security: B.

Price, Rating, and Price Target History: Google, Inc. (GOOG/NASDAQ) as of 12-7-10

Source: Factset (Prices) / Needham (ratings and target price)

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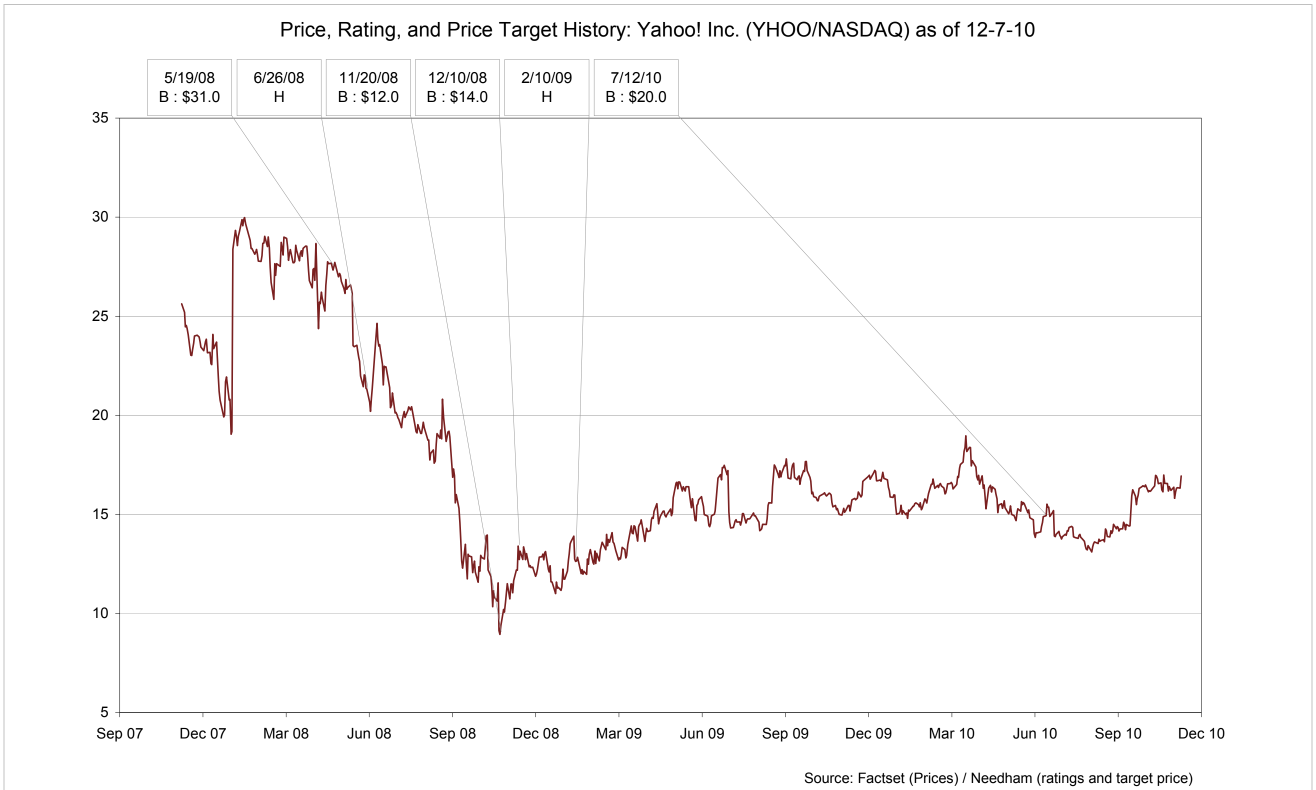

Disclosures applicable to this security: B, G.

	% of companies under coverage with this rating	% for which investment banking services have been provided for in the past 12 months
Strong Buy	9	15
Buy	62	15
Hold	27	3
Under Perform	<1	0
Rating Suspended	1	25
Restricted	0	0
Under Review	0	0

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