

THE EYESHADE REPORT

May 28, 2004

<u>Company:</u> ASK JEEVES, INC.		<u>Address and Phone:</u> 5858 Horton St., Suite 350 Emeryville, CA 94608 (510) 985-7400
Ticker: ASKJ		Shares Out (basic): 47.8 M
Exchange: Nasdaq		Float: 40.6 M
Market Cap: \$ 1.93 B	EV*: \$1.93 B	Short Interest: 5.3 M
P/S: 15.6	EV/S: 15.6	Closing Price: (5/28/04): \$ 40.40
P/E: 78.7		52 Week Range: \$ 11.65 - \$ 44.66
Level of Concern: C (Scale: A – E; with “E” the highest level of concern)		

*Enterprise value – defined as market capitalization plus debt minus cash and equivalents.

Description of Business: Ask Jeeves, Inc. (the “Company” or “ASKJ”) is a provider of Web-based search technologies.

Summary

- Company predicts “stand-alone” revenue will decline sequentially this quarter.
- Recent acquisition has lower margins and revenue per query than ASKJ.
- Projected revenue growth rate in FY 04 approximately half the growth rate of FY 03 (including acquisition).
- Increasing and material reliance on paid placement revenues from Google, Inc.
- Decline in deferred revenue (q/q and y/y) and deferred revenue will terminate in Q3 04.
- Increasing employee stock option expense.

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Financial Statement Review

Company predicts “stand-alone” revenue will decline sequentially this quarter – For the quarter ended March 31, 2004 (Q1 04), ASKJ reported its highest quarterly revenue to date of \$39.2 million, a 73% increase in revenue from its year ago quarter. Its margins also expanded impressively. Gross margins were 84.5% and operating margins were 35.4% in Q1 04 versus 75.7% and 10.9%, respectively, in the year ago quarter. The Q1 04 results continued the Company’s streak of sequential increases in quarterly revenue reported since June 2002.

ASKJ’s Quarterly Revenue

\$ - M’s	9/01	12/01	3/02	6/02	9/02	12/02	3/03	6/03	9/03	12/03	3/04
Rev.	15.43	15.36	13.61	15.38	15.89	20.17	22.71	25.57	27.18	31.83	39.23

\$ - M’s	3/99	6/99	9/99	12/99	3/00	6/00	9/00	12/00	3/01	6/01
Rev.	1.50	2.82	6.80	10.90	17.76	25.87	29.03	23.05	19.08	16.67

However, during the Q1 04 conference call, ASKJ predicted “stand-alone” revenue of **\$38 million** in Q2 04.¹ This would represent a 49% increase over Q2 03 – impressive, but down from the Q1 04 year-over-year growth rate of 73% - and a **sequential decline** from Q1 04 results. (Total revenue for Q2 04 is projected to be \$55 million due to a recent acquisition discussed further in the next section). In its 10-Q, ASKJ stated: *“For the second quarter of 2004, we expect that a seasonal decrease in Web traffic will result in revenues that are slightly lower than those of the first quarter. We believe that our traffic generally corresponds with overall Internet usage, which historically has declined slightly in the second and third quarters during the summer months and returned in the fourth quarter.”*²

Revenue declined sequentially in ASKJ’s second and third quarters in **only one (1) year (FY 2001) out of the last five (5) fiscal years** (see the previous tables). This seems contrary to the Company’s quote above regarding its traffic corresponding to the historical decline in Internet usage in the second and third quarters.

The Company has discussed the seasonal slowdown in Internet usage in the second and third quarters of the year in its S.E.C. filings since its September 2003 10-Q.³ However, prior to that filing, ASKJ just discussed the possibility that seasonal patterns may emerge in Internet usage.⁴ We also note that one of ASKJ’s competitors, Google, Inc., has not experienced a sequential decline in any quarter’s revenue for the last two years (though Google did say that user traffic tends to be seasonal, but its *“..rapid growth has masked the cyclicity and seasonality of [its] business.”*)⁵

¹ . Q1 2004 Ask Jeeves, Inc. Earnings Conference Call – Final, FD Wire (April 20, 2004).

² . ASKJ, 10-Q (3/04), p. 16.

³ . ASKJ, 10-Q (9/03), p. 22.

⁴ . See, e.g., ASKJ, 10-Q (6/03), p. 22 and ASKJ, 10-Q (3/03), p. 23.

⁵ . Google, Inc.’s Form S-1 filed 4/29/04, p. 6.

Google, Inc.'s Quarterly Revenue⁶

\$ - M's	3/02	6/02	9/02	12/02	3/03	6/03	9/03	12/03	3/04
Rev.	41.87	66.91	102.53	136.53	178.89	217.38	257.60	307.99	389.64

ASKJ's year-over-year U.S. revenue growth in Q1 04 was **60%** while its European revenue growth was double that percentage at **120%** (though off a lower base number).⁷ ASKJ's participation in Google, Inc.'s paid placement program was responsible for **69%** of ASKJ's total revenue in Q1 04 (see the section of this report entitled "Increasing and material reliance on paid placement revenues from Google, Inc.," *infra*). However, ASKJ's United Kingdom subsidiary did not sign a paid placement agreement with Google until the **second quarter of 2003**. (ASKJ's U.S. business entered into a similar agreement with Google in September 2002).⁸ Therefore, Q1 03 European results did not have the benefit of the U. K. Google agreement.

ASKJ Reported Revenue

	Three Months Ended	
	March 31, 2004	March 31, 2003
<i>(dollars in thousands)</i>		
U.S.	\$ 24,953	\$ 15,602
Europe	13,145	5,982
Japan	1,131	1,131
Total	\$ 39,229	\$ 22,715

ASKJ's revenue increases and margin expansion through March 2004 have been impressive. However, one of our concerns is that the sequential revenue decline predicted for the "stand-alone" business in Q2 04 may indicate that growth rate in ASKJ's "stand-alone" business is slowing and may not exceed that of the industry. We are also concerned as to whether the anniversary of the Google U.K. agreement this quarter may be part of the reason for the predicted sequential decline in revenue. This leads us to wonder whether the Company's recent acquisition of Interactive Search Holdings (discussed further in the next section) was prompted by concerns of a declining growth rate in its "stand-alone" business.

Recent acquisition has lower margins and revenue per query than ASKJ - On May 6, 2004, ASKJ announced it had acquired Interactive Search Holdings ("ISH"), a privately held online search and media company, for \$501 million.⁹

Revenues for ISH's first quarter 2004 and full year 2003 were approximately \$39 million and \$85 million, respectively. Operating margins for the first quarter 2004 and

⁶ . Google, Inc.'s Form S-1 filed 4/29/04, p. 47.

⁷ . ASKJ, 10-Q (3/04), p. 10.

⁸ . ASKJ, 10-Q (3/04), p. 22.

⁹ . ASKJ, press release dated May 6, 2004. In the release, ASKJ stated: "Under the terms of the agreement, Ask Jeeves issued 9.3 million shares of common stock and options and paid approximately \$144 million in cash. This reflects an aggregate purchase price of \$501 million based on Ask Jeeves' closing price on May 5, 2004." Id.

full year 2003 were approximately 23 percent and 13 percent, respectively.¹⁰ Based on this information, ASKJ would have reported Q1 04 revenue of \$78.2 million had it owned ISH for all of Q1 04, but its operating margins would have declined to 29.2% in Q1 04 (assuming ISH's margins stayed the same in the combined entity). While the hypothetical 29.2% in “combined” operating margins in Q1 04 is impressive and higher than ASKJ reported in any quarter in fiscal year 2003, it still represents a decline from the 35.4% operating margins ASKJ reported in Q1 04 and may suggest ASKJ is giving up some of the leverage it realizes with higher revenue with the ISH acquisition. ISH's reported revenue per thousand queries (RPQ) of \$29 in Q1 04,¹¹ which was **40% lower** than RPQ of \$48 that ASKJ reported in Q1 04.¹²

ASKJ predicted that its “combined” revenue in Q2 04 (its “stand-alone” business plus ISH) would be **\$55 million**. Gross margins for the combined entity were targeted at 75%,¹³ which is a decline from 79.6% in gross margins ASKJ reported for FY 03 and the 84.5% reported in Q1 04, despite the higher predicted revenue for Q2 04.

Projected revenue growth rate in FY 04 approximately half the growth rate of FY 03 (including acquisition) - For the full year fiscal 2004, ASKJ targeted revenues of \$255 million, with operating margins for fiscal 2004 of 28% and ASKJ suggested that analysts target operating margins between 20% to 30% on a quarterly basis.¹⁴ Pro forma earnings were projected at approximately \$66 million, with pro forma earnings per share of \$1.00 and GAAP earnings per share projected to be \$0.75 (the difference primarily related to the non-cash amortization of intangibles).¹⁵ For FY 03, ASKJ reported \$107.3 million in revenue, \$26.1 million in GAAP net income and \$0.45 in GAAP diluted EPS from continuing operations.

If ASKJ achieves the \$255 million in revenue projected in FY 04, it will represent a 138% increase over ASKJ's reported revenue in FY 03. However, when we include ISH's FY 03 revenue of \$85 million with ASKJ's revenue last year, the projected FY 04 increase is reduced to **33%**. That is almost half the **65%** revenue growth rate ASKJ reported in FY 03 versus FY 02, and less than half the 73% year-over-year revenue growth ASKJ reported in Q1 04.

Increasing and material reliance on paid placement revenues from Google, Inc. – In September 2002, ASKJ began to participate in Google, Inc.'s sponsored links

¹⁰ . Ask Jeeves – ISH conference call, FD Wire (May 12, 2004).

¹¹ . Ask Jeeves – ISH conference call, FD Wire (May 12, 2004).

¹² . The \$48 figure is derived by dividing ASKJ's Q1 04 revenue of \$39.229 million by the 822 million in proprietary queries ASKJ reported having during its Q1 04 conference call. The transcript of the Q1 04 conference call quoted the Company as saying its RPQ was \$42. We cannot account for the difference. Q1 2004 Ask Jeeves, Inc. Earnings Conference Call – Final, FD Wire (April 20, 2004).

¹³ . Ask Jeeves – ISH conference call, FD Wire (May 12, 2004).

¹⁴ . Ask Jeeves – ISH conference call, FD Wire (May 12, 2004).

¹⁵ . These projections assumed a share count of 66 million. Ask Jeeves – ISH conference call, FD Wire (May 12, 2004).

program. Under this agreement, Google sells paid placements to tens of thousands of advertisers and ASKJ displays Google's paid placements on ASKJ's U.S. Web properties. ASKJ also syndicates Google's paid placements, together with ASKJ's search results, to third-party Web sites in ASKJ's syndication network. In exchange for making ASKJ's Web traffic available to Google's advertisers, ASKJ shares in the revenue generated from those advertisers. In the second quarter of 2003, the Ask Jeeves UK Partnership (ASKJ's U.K. subsidiary), entered into an agreement with a Google subsidiary to display Google's paid placements on ASKJ's U.K. Web site, replacing a previous paid placement provider.¹⁶

This arrangement has been responsible for an increasing percentage of ASKJ's revenue. For example, in fiscal year **2003**, paid listing revenues from Google comprised **55% of ASKJ's total revenue, up from 15% for fiscal year 2002.**¹⁷ Moreover, the percentage has increased materially in the last few quarters, rising from **49%** as recently as Q2 03 to **69%** in Q1 04 (see the following table). We were unable to locate how much of Interactive Search Holdings' revenue was derived from Google, though it appears to be similar to ASKJ's percentage as ASKJ recently stated: "*Our Google partnership would have represented 68 percent of our combined business [i.e., ASKJ and Interactive Search Holdings] in the first quarter [of 2004].*"¹⁸ This is approximately the same amount ASKJ derived on a "stand-alone" basis (69%) in Q1 04.

Percentage of Total Revenue ASKJ Derived from Google Agreement

	Q1 03	Q2 03	Q3 03	Q4 03	Q1 04
% of Rev.	*	49%	61%	65%	69%

* Unknown.

This means that ASKJ's non-Google revenue ("NG Rev.") fell in fiscal year 2003 versus 2002. It also indicates ASKJ's quarterly non-Google revenue fell sequentially in September 2003, though it has increased slightly sequentially in the last two (2) quarters.

ASKJ's Non-Google Revenue

\$ - in M's	FY 02	FY 03	Q1 03	Q2 03	Q3 03	Q4 03	Q1 04
NG Rev.	55.3	48.3	*	13.0	10.6	11.1	12.2

* Unknown.

ASKJ's U.S. agreement with Google could be terminated under its current contract as early as September 2004 (though we found no information as to whether either party has any intention of terminating the agreement). ASKJ includes the following among its "Risk Factors" regarding its relationship with Google:

*...Our U.S. agreement with Google is scheduled to terminate in **September 2005** (but allows for termination for convenience by either party during **September or October of 2004**), and our U.K. agreement with Google is scheduled to terminate in **May 2005**.*

¹⁶ . ASKJ, 10-Q (3/04), p. 22.

¹⁷ . ASKJ, 10-K (12/03), pp. 5 & 56.

¹⁸ . Ask Jeeves – ISH conference call, FD Wire (May 12, 2004).

*If our contracts with Google are not renewed, or if Google fails to perform under these contracts or if they are terminated for any other reason, we would need to find another suitable paid placement provider or otherwise replace the lost revenues. Although alternate paid placement providers (such as Yahoo! Inc. and Espotting Media/ FindWhat.com) are currently available in the market, **the paid placement market is consolidating**, (for example, Espotting Media is merging with FindWhat.com), and we face the risk that we might be unable to negotiate equally advantageous terms with such providers. Further, if Google's performance under these contracts unexpectedly deteriorates or our ability to generate traffic for paid placements decreases, our results of operations could be harmed.*¹⁹

Google states that it gives most of the advertiser fees to its Google Network members who participate in Google's AdSense program (like ASKJ) and keeps only a small portion for itself. Google acknowledged that it expects its operating margins to decline in 2004 versus 2003 as it anticipates an increased portion of its net revenues will be generated from the AdSense program.²⁰ This may be good for ASKJ as it may indicate that Google does not intend to back away from the program. However, we cannot help but wonder whether Google will be tempted to change the terms of the program in the future to keep a little more of the revenue for itself.

Decline in deferred revenue (q/q and y/y) and deferred revenue will terminate in Q3 04 – Regarding its deferred revenue ("Def. Rev."), ASKJ states: *"License payments received from our Japanese joint venture were initially recorded as deferred revenue and are recognized as revenues on a straight-line basis over a four-year period. The license revenue will terminate during the third quarter of 2004."*²¹

Deferred revenue contributed anywhere from \$830 thousand to \$2.2 million to revenue in each of the last six (6) quarters. This accounted for a material portion of the sequential revenue increases in some of the quarters in the following table (anywhere from 16.5% to 136%). In fact, in the September 2003 quarter, ASKJ would have reported a sequential decline in revenue but for the decline in deferred revenue. (Revenue increased sequentially by only \$1.6 million in Q3 03, while deferred revenue declined by \$2.2 million. See the following table).

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¹⁹ . ASKJ, 10-Q (3/04), p. 22 (emphasis supplied).

²⁰ . Google, Inc., Form S-1 filed 4/29/04, pp. 38-39.

²¹ . ASKJ, 10-Q (3/04), p. 14.

N.B. The row marked “DR v. Rev.” in the following table calculates how much the sequential decline in deferred revenue was as a percentage of the sequential increase in revenue that quarter. The rows marked “Rev.” and “Def. Rev.” represent the reported revenue and ending balance in deferred revenue in the respective quarters.

\$ - 000's	12/02	3/03	6/03	9/03	12/03	3/04
Rev.	20,168	22,714	25,568	27,176	31,834	39,229
Def. Rev.	10,790*	9,242*	8,412	6,220	5,367	4,147
DR v. Rev.		60.8%	29.1%	136%	18.3%	16.5%

* These were figures reported before entering into an agreement in May 2003 to sell its Jeeves Solutions business to Kinasa, Inc.²²

ASKJ is predicting a sequential decline in “stand-alone” quarterly revenue in June 2004 despite the (we presume) continued, sequential decline in deferred revenue. Admittedly, the loss of the deferred revenue will have less impact on ASKJ’s “combined” results with ISH than the “stand-alone” business, though there still will be some, small impact from the loss of the deferred revenue.

Increasing employee stock option expense – In Q1 04, ASKJ’s employee stock option expense increased to \$3.5 million from \$1.6 million in the year ago quarter. Had it included employee stock option expense in its reported compensation expense on its income statement (“pro forma”), ASKJ’s reported year-over-year increase in diluted earnings per share of 44% (7 cents) would have been reduced to 23% (3 cents).²³

(In thousands, except per share information)	Three Months Ended	
	March 31, 2004	March 31, 2003
Net income, as reported	\$ 13,379	\$ 7,691
Deduct:		
Total stock-based employee compensation expense determined under fair value based method for Employee Stock Purchase Plan	(139)	(107)
Total stock-based employee compensation expense determined under fair value based method for stock options	(3,539)	(1,590)
Net income, pro forma	\$ 9,701	\$ 5,994
Net income per share:		
Basic, as reported	\$ 0.29	\$ 0.18
Basic, pro forma	\$ 0.21	\$ 0.14
Diluted, as reported	\$ 0.23	\$ 0.16
Diluted, pro forma	\$ 0.16	\$ 0.13

²² . After entering into that agreement, ASKJ began to report the assets and liabilities associated with that business as a discontinued operation. Consequently, in its June 2003 financial statement, its December 2002 deferred revenue balance was reduced to \$8.633 million. We presume the decline was due to the discontinued operation.

²³ . ASKJ, 10-Q (3/04), p. 7.

1-Year Stock Chart



Chart courtesy of StockCharts.com (<http://stockcharts.com>).

12 Month Short Interest Data*

<u>Settlement Date</u>	<u>Short Interest</u>	<u>Avg Daily Share Volume</u>	<u>Days to Cover</u>
May 14, 2004	5,277,480	4,528,619	1.17
Apr. 15, 2004	5,649,164	3,480,729	1.62
Mar. 15, 2004	6,209,184	4,029,315	1.54
Feb. 13, 2004	5,074,829	1,755,889	2.89
Jan. 15, 2004	6,794,156	2,138,204	3.18
Dec. 15, 2003	6,988,011	2,082,162	3.36
Nov. 14, 2003	5,738,474	2,412,044	2.38
Oct. 15, 2003	5,943,712	2,763,592	2.15
Sep. 15, 2003	6,923,452	2,434,844	2.84
Aug. 15, 2003	6,748,413	2,374,003	2.84
Jul. 15, 2003	7,649,519	2,803,219	2.73
Jun. 13, 2003	4,624,417	2,781,721	1.66

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