Opera Software ASA (OPERA.OL – NOK89.20/$13.82)

October 2, 2014

Opera Software ASA (OPERA.OL) (1) develops and sells web browsers for desktops, devices, and mobile markets; (2) provides cloud-based mobile services and solutions to operators, consumers, publishers, and advertisers; and (3) operates a mobile advertising platform through its Opera Mediaworks brand. The Company offers various products across desktop and mobile devices. It generates revenue through licenses/royalties, advertising, and search agreements, among other sources. The Company is headquartered in Oslo, Norway, and its fiscal year end is 12/31.

Thesis Summary

We are concerned with intensifying competitive pressures and potential market share losses in the Company's browser business. Further, we are concerned about potential margin pressure from a mix shift towards advertising revenue. Additionally, we believe revenue growth may be pressured due to potential underperformance by recent acquisitions. Our concerns are heightened given (1) a surge in unbilled and past due receivables, (2) a decline in deferred revenue, (3) an increase in capitalized R&D, (4) deterioration in cash flow from operations, and (5) significant (in our view) insider divestitures. **We are initiating coverage of OPERA.OL on *The Short List*.**

Catalysts and Timing

- Potential for H2 14 gross margin below the consensus estimate.
- A slowdown in advertising revenue growth.
- Potential AdColony acquisition underperformance (which could be evidenced by downward earn-out estimate revisions).
- Potential for below consensus FY 15 guidance with the Q4 14 earnings report.

Company Data

Country/Exchange	Norway/Oslo
Reporting Currency	USD
Accounting Standard	IFRS
Shares Outstanding (mil)	142.6
Float (mil)	108.1
Avg. Volume (mil)	0.6
52 Week Range	NOK63.50 - NOK95.00
Dividend Yield	0.3%
Market Cap (bil)	NOK11.8/$1.8
Net Cash (mil)	$117.0
TTM Rev (mil)/Rev Growth	$327.6/38.2%
TTM EBITDA (mil)	$82.4
TTM Gross Margin %/Change	79.3%/(810 bps)
TTM Op. Margin %/Change	18.4%/80 bps

Historical EPS

	Actual	Expected	Surprise
Q2 14	$0.13	$0.08	62.5%
Q1 14	$0.11	$0.07	57.1%
Q4 13	$0.18	$0.13	50.0%

Estimate Drift

	Est.	1M Ago	6M Ago	1Yr Ago
Q3 14 Rev	$868.7	$831.5	$618.2	$576.0
FY 14 Rev	$3,123	$2,959	$2,439	$2,334
FY 15 Rev	$4,682	$4,606	$3,078	$2,863
Q3 14 EPS	$0.54	$0.52	$0.76	$0.78
FY 14 EPS	$2.73	$2.60	$2.91	$3.13
FY 15 EPS	$4.82	$4.74	$4.09	$4.17

Peers Mentioned In This Piece

- Criteo SA (CRTO)
- Facebook, Inc. (FB)
- Google Inc. (GOOG)
- Microsoft Corporation (MSFT)
- Millennial Media Inc. (MM)
- Rocket Fuel Inc. (FUEL)
- the Rubicon Project, Inc. (RUBI)
- Tremor Video, Inc. (TRMR)
- Yahoo! Inc. (YHOO)
- YuMe, Inc. (YUME)

Please refer to the end of this report for an updated version of *The Short List*.

11975 El Camino Real, Suite 100 San Diego, CA 92130 Tel: (858) 793-2420 Fax: (858) 793-1065

Background and Bull Story

Company Background

Company description: Opera Software ASA (OPERA.OL) (1) develops and sells web browsers for desktops, devices, and mobile markets; (2) provides cloud-based mobile services and solutions to operators, consumers, publishers, and advertisers; and (3) operates a mobile advertising platform through its Opera Mediaworks brand. The Company offers various products across desktop and mobile devices. It generates revenue through licenses/royalties, advertising, and search agreements, among other sources. The Company is headquartered in Oslo, Norway, and its fiscal year end is 12/31.

Revenue sources and types: In FY 13, mobile publishers and advertisers accounted for 39.7% of revenue, operators for 20.7%, desktop consumers for 20.3%, mobile consumers for 12.6%, device OEMs for 6.1%, and other sources for 0.6%. Further, 47.6% of revenue was generated from advertising; 28.1% from licenses/royalties; 18.4% from search; 2.6% from maintenance, support, and hosting; 2.5% from development fees; 0.5% from application content; and 0.5% from subscriptions.

Revenue by Source (as % of total revenue)	FY 13	Revenue by Type (as % of total revenue)	FY 13
Mobile publishers and advertisers	39.7%	Advertising	47.6%
Operators	20.7%	Licenses/royalties	28.1%
Desktop consumers	20.3%	Search	18.4%
Mobile consumers	12.6%	Maintenance, support, and hosting	2.6%
Device OEMs	6.1%	Development fees	2.5%
Other	0.6%	Application content	0.5%
--	--	Subscription	0.4%
Total	100.0%	Total	100.0%

Licenses/royalties, development fees, and maintenance and support revenue type: Customer device agreements with operators and device OEMs form the basis of multiple sources of revenue including licenses/royalties, development fees, and maintenance and support.

Search revenue type: Search revenue is generated when an Opera user conducts a qualified search using an Opera search partner (e.g. Google or Yandex) through the built-in combined search bar provided in Opera's browsers.

Advertising revenue type: The Company recognizes advertising revenue from users viewing ads through Opera-owned properties, developer applications, and mobile websites. The Company sells advertising on several bases CPM (cost per thousand impressions), CPC (cost per click), and CPA (cost per action). The majority of advertising revenue was earned on a CPM basis, but the Company expects CPC and CPA revenue to increase in the future.

Mobile publishers and advertisers revenue source: The Company offers mobile advertising services and technology solutions through its Opera Mediaworks brand. The mobile publishers and advertisers revenue source primarily relates to the advertising revenue type.

Operators revenue source: The Company offers four major cloud-based solutions and services to operators worldwide: (1) Opera Mini, (2) Rocket Optimizer, (3) Horizon, and (4) Opera Web Pass. Operators revenue primarily relates to the licenses/royalties; development fees; and maintenance, support, and hosting revenue types.

Mobile consumers revenue source: Opera owns and operates various mobile consumer properties. These mobile properties include various browsers (i.e. Opera Mini), the Speed Dial, the Smart Page, the Opera Mobile Store, and the Discover feature. Mobile consumer revenue primarily relates to the search and advertising revenue types.

Desktop consumers revenue source: The Company offers desktop browser products. The majority of the Company's desktop users are in the Russia/CIS region and emerging markets. The desktop consumer revenue source primarily relates to the search and advertising revenue types.

Device OEMs revenue source: The Company offers a Software Developer Kit (SDK), for manufacturers to be able to offer web browsing, full internet access, and customized web applications to operator and consumer end customers. The device OEMs revenue source primarily relates to the licenses/royalties revenue type.

Revenue by Source	Primary Associated Revenue Types
Mobile publishers and advertisers	Advertising
Operators	Licenses/royalties; development fees; and maintenance, support, and hosting
Desktop consumers	Search and advertising
Mobile consumers	Search and advertising
Device OEMs	Licenses/royalties

Geography and customers: In FY 13, the Company generated 55.4% of revenue from the Americas; 34.7% from Europe, the Middle East, and Africa (EMEA); and 10.0% from Asia Pacific.[1] The Company had one customer that accounted for more than 10.0% of revenue in FY 13. This customer generated revenue between $35.0 million and $40.0 million (compared to total FY 13 revenue of $300.1 million).

Revenue by Region (as % of total revenue)	FY 13
Americas	55.4%
EMEA	34.7%
Asia Pacific	10.0%
Total	100.0%

AdColony acquisition: In its 06/24/14 Press Release, Opera announced that it had reached an agreement to acquire AdColony, a mobile video advertising company. Opera paid $75.0 million in cash at closing plus $18.4 million for the net cash on AdColony's balance sheet. In addition, the deal carries earn-outs that could total up to $275.0 million. The earn-outs are tied to AdColony mobile video advertising revenue and non-IFRS EBITDA targets in FY 14, FY 15, and FY 16. The acquisition closed on 07/24/14.

Competition: In its browser business, Opera's primary competitors are Google Inc. (GOOG) with the Google Chrome browser, Microsoft Corporation (MSFT) with the Internet Explorer browser, and Mozilla Corp. (private) with the Firefox browser. Opera competes with various companies for advertising dollars, such as Facebook, Inc. (FB), Google, and Twitter, Inc. (TWTR). Further, Opera faces competition from a wide array of public and private advertising technology (ad-tech) companies including but not limited to Millennial Media Inc. (MM), the Rubicon Project, Inc. (RUBI), and Rocket Fuel, Inc. (FUEL).

The Bull Story: Publishers and Advertisers, Acquisitions, and Mobile Users

Growth in mobile publishers and advertisers revenue: In Q2 14, mobile publishers and advertisers revenue

[1] The geographical breakdown reflects revenues from external customers attributed to the entity's country of domicile. The breakdown does not reflect where the Company's derivative products are actually used.

increased 83.2% (to $51.1 million). In its Q2 14 Quarterly Report, the Company attributed the increase to revenue from premium and performance advertisers and "app-install" driven spend primarily from the mobile gaming sector. On its Q2 14 Conference Call, the Company indicated that mobile publishers and advertisers revenue was "above expectations." Further, it guided for strong growth in mobile publishers and advertisers revenue.

> We saw, basically, our business come in as expected, but on Opera Mediaworks it came in due to very strong revenue, above expectations. (CEO Mr. Lars Rahbaek Boilesen, Q2 14 Conference Call, 08/21/14)

Mobile Publishers and Advertisers Revenue ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Mobile publishers and advertisers revenue	$51.1	$31.7	$43.1	$29.6	$27.9
Year-over-year change	*83.2%*	*72.3%*	*119.9%*	*109.9%*	*106.7%*

Acquisitions drive advertising revenue growth: On 01/19/10, Opera acquired AdMarvel, Inc. for $8.3 million in cash and up to $15.0 million in contingent cash consideration. Prior to the AdMarvel acquisition, Opera had limited experience in the advertising industry. Subsequently, Opera has acquired Mobile Theory Inc., 4th Screen Advertising, Ltd, Hunt Mobile Advertising, and AdColony (most recently) to boost its advertising business. In FY 13, advertising revenue increased 126.1% year-over-year to $142.7 million. As such, strategic acquisitions drove a majority of advertising revenue growth.

Advertising Revenue ($ in millions)	FY 13	FY 12	FY 11
Advertising revenue	$142.7	$63.1	$14.8
Change	*126.1%*	*326.4%*	--

Growth of mobile user base: In June 2014, the Company's mobile browser users increased 46.1% year-over-year to 113.5 million. On its Q2 14 Conference Call, the Company indicated that it expects the mobile advertising market to grow from $18.0 billion in revenue to $95.0 billion globally by 2018. The Company represented that, despite 20.0% of time spent on mobile devices, only 4.0% of advertising spend was spent on mobile. Further, the Company indicated the markets that it is in are "fast growing." The Company is focused on the mobile market with both its mobile browsers and mobile advertising offerings.

> And the big picture is that the markets that Opera is in are huge and are really fast growing. So, if you look at mobile advertising, for example, this is a market that that will do, according to estimates, around $18 billion of revenue globally, is expected to grow at $95 billion… what you have is you have this big gap where 20% of time spent is on mobile devices, but there's only 4% of ad spend. (CFO Mr. Erik Carson Harrell, Q2 14 Conference Call, 08/21/14)

Mobile Browser Users (in millions)	June 2014	May 2014	April 2014	March 2014	February 2014	June 2013
Mobile users	113.5	113.8	111.6	112.0	103.7	77.7
Year-over-year change	*46.1%*	*53.0%*	*63.6%*	*67.9%*	*73.4%*	*95.2%*

Valuation: As of the date of this publication the price-to-next twelve months earnings ratio (NTM P/E) was 28.2, 14.2% above the NTM P/E ratio one year ago of 24.7. We believe this expansion was driven, in part, by recent mobile publishers and advertisers revenue growth levels and investor optimism regarding the AdColony acquisition.

Valuation Analysis	Date of Publication	One Year Ago
NTM P/E	28.2	24.7

Voyant's Earnings Risk Assessment

We are concerned with intensifying competitive pressures and potential market share losses in the Company's browser business. Further, we are concerned about potential margin pressure from a mix shift towards advertising revenue. Additionally, we believe revenue growth may be pressured due to potential underperformance by recent acquisitions. Our concerns are heightened given (1) a surge in unbilled and past due receivables, (2) a decline in deferred revenue, (3) an increase in capitalized R&D, (4) deterioration in cash flow from operations, and (5) significant (in our view) insider divestitures. We are initiating coverage of OPERA.OL on *The Short List*.

Q2 14 Earnings Beat Estimates, FY 14 Guidance Increased

On 08/21/14, the Company reported Q2 14 revenue (non-IFRS earnings) of $100.6 million ($0.13), 3.4% (62.5%) above the consensus estimate. Non-IFRS EBITDA increased 24.4% year-over-year to $27.0 million, 7.1% above the consensus estimate.[2] In its Q2 14 Earnings Presentation on 08/21/14, the Company attributed the better-than-expected results to strong growth in its Opera Mediaworks (advertising) business.

Q2 14 Results Analysis ($ in millions, except per share data)	Reported Results	Consensus Estimate	*Surprise*
Revenue	$100.6	$97.3	*3.4%*
Non-IFRS EBITDA	$27.0	$25.2	*7.1%*
Non-IFRS earnings	$0.13	$0.08	*62.5%*

Upward guidance revision driven by AdColony acquisition: In its Q2 14 Earnings Release on 08/21/14, the Company increased its FY 14 revenue (non-IFRS EBITDA) guidance 22.5% (7.6%) to $490.0 million ($120.5 million) at midpoint. On its Q2 14 Conference Call on 08/21/14, the Company indicated it increased guidance due to growth in the core business and the AdColony acquisition closing sooner-than-expected and performing better-than-expected.

FY 14 Guidance Analysis ($ in millions, at midpoint)	Revised Guidance	Previous Guidance	*Change*
Revenue	$490.0	$400.0	*22.5%*
Non-IFRS EBITDA	$120.5	$112.0	*7.6%*

Increased Competitive Pressure in the Browser Market, in Our View

Background on browser products: The Company offers browsers for both desktop and mobile devices. In Q2 14, Opera browsers had approximately 51.0 million desktop users and 270.8 million mobile users, on a monthly basis. A majority of the Company's desktop users are in Russia. As mentioned, the Company's primary browser competitors are Google Chrome, Mozilla Firefox, and Microsoft Internet Explorer.

Desktop users decline: In Q2 14, desktop users per month declined 1.9% year-over-year (to 51.0 million) from a depressed base (declined 5.5% in Q2 13). Since Q2 12, Opera's desktop browser market share worldwide (in Russia) has declined 30 basis points (750 basis points) to 1.5% (13.2%).[3] In our view, the significant decline in browser market share in the Company's primary market may reflect a high level of competitive pressure.

[2] Non-IFRS EBITDA excludes stock-based compensation expenses, extraordinary/one-time items, and acquisition related costs.
[3] Browser market share data is from http://gs.statcounter.com/ based on page views by browser per quarter.

Desktop Users Analysis (in millions, monthly)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Desktop users	51.0	51.0	51.0	51.0	52.0
Year-over-year change	*(1.9%)*	*(7.3%)*	*(7.3%)*	*(7.3%)*	*(5.5%)*

We have the following observations:

1. **Doubling of desktop engineering team may be unwarranted, in our view:** On its Q4 13 Conference Call, the Company represented that it doubled the number of engineers working on the desktop products. Given the decline in users and a shift towards consumer time spent on mobile devices, we believe the desktop browser market is in decline. Accordingly, we believe doubling desktop engineer count may represent a low return on investment decision and contribute to margin pressure in future periods.

   When you look for desktop, it is a very important product for us going forward. Since the technology suites, **we actually have doubled our number of engineers in desktop**. (CEO Mr. Lars Rahbaek Boilesen, Q4 13 Conference Call, 02/11/14) [emphasis added]

2. **Increased competition for smartphone browser users, in our view:** In its FY 13 Annual Report, the Company disclosed that only 39.0% of its mobile browser users were using smartphones.[4] We note that Google Chrome is only compatible with iOS 6 or later and Android 4.0 or later, and Firefox is only compatible with Android 2.3 or later. In FY 13, smartphone sales surpassed feature phone sales for the first time.[5] As Opera's mobile users upgrade to smartphones, we believe certain users will switch to other browser options that are only available on smartphones. To the extent that smartphone sales continue to outpace feature phone sales, we believe the mobile consumers revenue source and mobile search and advertising revenue types may be pressured.

Mobile Users Analysis (in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Mobile users	270.8	273.9	270.1	261.6	251.4
Year-over-year change	*7.7%*	*10.0%*	*17.8%*	*26.3%*	*25.4%*

3. **Decline in search revenue suggests decline in active browser users:** The Company defines search revenue as revenue generated when an Opera user conducts a qualified search using an Opera search partner (e.g. Google). In Q2 14, search revenue declined 9.0% year-over-year to $12.1 million from a depressed base (down 13.2% in Q2 13). Search revenue-per-browser user declined 14.3% to $38,000.[6] We believe browser users may have multiple browsers installed on their devices. For example, the default iPhone browser is Safari but certain users download and use a different browser (i.e. Google Chrome). In addition, we believe mobile users often use apps in lieu of browsers. For example, mobile users in the US spend 86.0% of their time in apps versus 14.0% of time on the Web. Accordingly, we believe the decline in search revenue suggests Opera browser users may be less active on the Opera browsers and/or the terms of Opera's search partner agreements may have been altered in an unfavorable manner. In our view, a decline in browser user activity may result in further deterioration in search revenue and deterioration in advertising revenue because the Company may have fewer advertising impressions and click-throughs on its browser properties. This deterioration would likely impact the desktop consumer and mobile consumer revenue sources.

[4] Feature phones may include Internet browsers and other advanced features, but generally do not incorporate advanced operating systems capable of running sophisticated mobile apps, full-sized touchscreens, etc.
[5] Smartphones accounted for 53.6% of mobile phone sales in FY 13 according to Gartner Inc. (IT).
[6] Browser users include both mobile and desktop users.

Search Revenue Analysis	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Search revenue (in millions)	$12.1	$12.1	$14.7	$13.0	$13.3
Browser users (in millions)	321.8	324.9	321.1	312.6	303.4
Search revenue-per-browser user	$38,000	$37,000	$46,000	$42,000	$44,000
Year-over-year change	*(14.2%)*	*(20.8%)*	*(19.2%)*	*(26.8%)*	*(27.0%)*

4. **Significant revenue generated from competitor may pressure browser revenue, in our view:** In its FY 13 Annual Report, Opera represented that Yandex N.V. (YNDX) and Google were its major search partners. Based on our estimate, we believe Google accounted for $33.6 million of search revenue (11.2% of total revenue) in FY 13.[7] Given Google Chrome is one of Opera's primary browser competitors, we are concerned that Opera generates a significant amount of browser revenue from Google. In our view, the Google Chrome browser may take browser market share as smartphone proliferation increases.

Significant Customer Analysis ($ in millions)	FY 13
Search revenue from Google (Voyant estimate)	$33.6
Total revenue	$300.1
Search revenue from Google as % of revenue	11.2%

Advertising Revenue Growth May Pressure Margins, in Our View

Advertising revenue recognition: The Company sells advertising on CPM (cost per thousand impressions), CPC (cost per click), and CPA (cost per action) bases. In its FY 13 Annual Report, the Company represented that a majority of revenue was earned on a CPM basis, but it expects CPC and CPA revenue to increase in the future. Advertising revenue earned through the Company's owned and operated properties is recorded on a gross basis, while revenue generated where the advertiser and publisher have a direct relationship (i.e. Opera is an agent) is recorded on a net basis. The advertising revenue type is primarily related to the mobile publishers and advertisers, mobile consumers, and desktop consumers revenue sources.

Publisher costs increase: Publisher costs consist of agreed-upon payments made to publishers for advertising space in which the Company delivers mobile ads. Publisher costs are typically determined in advance for either a fixed percentage of advertising revenue or as a fixed fee. Given that the majority of the Company's other products and services carry very little in the way of direct cost of goods sold, publisher revenue is a low-margin revenue source. In Q2 14, publisher costs (the primary component of cost of goods sold) increased 70.8% to $23.4 million. The Company does not separately disclose publisher revenue. Publisher revenue is included in the mobile advertisers and publishers revenue source, which increased 83.2% year-over-year in Q2 14.

Publisher Costs Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Publisher costs	$23.4	$16.1	$20.7	$14.9	$13.7
Year-over-year change	*70.8%*	*80.9%*	*122.6%*	*136.5%*	*121.8%*

Gross margins deteriorate due to the higher publisher costs: In Q2 14, consolidated gross margin declined 450 basis points year-over-year to 76.7%. In its Q2 14 Quarterly Report, the Company represented that cost of goods

[7] To calculate search revenue from Google we estimated search revenue attributable to Yandex based on Yandex's disclosures. We assumed the remaining search revenue (11.2% of revenue) was attributable to Google (Opera only discloses Yandex and Google as search partners).

sold increased due to higher publisher costs related to higher revenue from its mobile publishers and advertisers business.

Gross Margin Analysis	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Gross margin	76.7%	81.5%	76.9	80.3%	81.3%
Year-over-year change	*(450 bps)*	*(420 bps)*	*(780 bps)*	*(860 bps)*	*(690 bps)*

<u>We have the following observations:</u>

1. **Increasing contribution of mobile publishers and advertisers revenue may pressure margins, in our view:** In Q2 14, mobile publishers and advertisers revenue increased 83.2% year-over-year on an absolute basis and 1,260 basis points as a percentage of revenue (the highest ever revenue contribution). As mentioned, publisher costs are the primary component of cost of goods sold. To the extent the contribution from mobile publishers and advertisers revenue continues to increase, we believe margins may be pressured.

Mobile Publishers & Advertisers Revenue Contribution Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Mobile publishers & advertisers revenue	$51.1	$31.7	$43.1	$29.6	$27.9
Year-over-year change	*83.2%*	*72.3%*	*119.9%*	*109.9%*	*106.7%*
Mobile publishers & advertisers as % of rev.	50.8%	36.4%	48.2%	39.2%	38.2%
Year-over-year change	*1,260 bps*	*680 bps*	*1,580 bps*	*1,420 bps*	*1,220 bps*

2. **Gross margin estimates may be difficult to achieve, in our view:** As of the date of this publication, the gross margin consensus estimates for Q3 14 and Q4 14 imply a 30 basis point year-over-year increase for both quarters. Given the Company guided for continued mobile publishers and advertisers revenue growth (discussed above) and the recent deterioration in gross margin (declined 450 basis points year-over-year in Q2 14 off a depressed base period that declined 210 basis points) due to an increase in publisher costs, we believe the Q3 14 and Q4 14 gross margin estimates may be difficult to achieve.

Gross Margin Estimates Analysis	Q4 14	Q3 14
Gross margin estimate	70.1%	72.9%
Implied year-over-year change	*30 bps*	*30 bps*

3. **Intensifying advertising technology competition may pressure margins, in our view:** Over the past year, there were various IPOs of advertising technology companies including Rocket Fuel Inc. (FUEL), Tremor Video, Inc. (TRMR), Criteo SA (CRTO), the Rubicon Project, Inc. (RUBI), and YuMe, Inc. (YUME). Further, there has been significant consolidation in the industry: for example, Facebook, Inc.'s (FB) acquisition of video ad platform LiveRail, Yahoo! Inc.'s (YHOO) acquisition of video broadcasting platform RayV, and Millennial Media Inc.'s (MM) acquisition of mobile ad technology firm Nexage. Advertising technology startups have received significant (in our view) venture capital funding including xAd ($50.0 million in funding) and AppNexus ($25.0 million in funding), among others. To the extent IPOs, consolidation, and startups remain prevalent in the advertising technology industry, we believe Opera's advertising margins may be pressured and/or it may face more competition for strategic acquisition targets.

Weaker-Than-Anticipated Skyfire Acquisition Performance

Skyfire Labs, Inc. acquisition: On 03/14/13, Opera acquired Skyfire Labs, Inc., a company that focuses on mobile video optimization and cloud solutions for mobility, for an upfront payment of $49.1 million in cash and performance-based earn-out payments over three years that could bring the total deal size to $155.2 million. The Company calculated the fair value of the earn-out payments at the acquisition date and recorded a contingent consideration of $40.5 million. On its Q4 13 Conference Call on 02/11/14, the Company represented that it adjusted the earn-outs for the Skyfire acquisition down by $35.0 million. The Company attributed the adjustment to the targets for the Skyfire acquisition being set too high.

> We adjusted down by $35 million what we expect in terms of payments – earn-out payments to Skyfire. So we expect to pay $35 million less in earn-out payments to Skyfire than we expected. Basically, the targets that were set by the Skyfire management team that were the basis behind the earn –outs turned out to be too high, in our minds, and so we've reduced the earn-out payments as a result. (CFO Mr. Erik Carson Harrell, Q4 13 Conference Call, 02/11/14)

Background on Rocket Optimizer product: Rocket Optimizer was Skyfire's primary product prior to the acquisition by Opera. Rocket Optimizer is a mobile video optimization solution, which can detect when specific users are facing poor network connections and then intervene to improve network quality and performance for these users. It is offered to operators for a platform fee for the core technology as well as a network capacity fee tied to traffic levels. On its Q4 13 Conference Call, the Company indicated that Skyfire's Rocket Optimizer cloud compression product was Opera's "flagship product." Further, in its Q2 14 Quarterly Report, the Company represented that Rocket Optimizer was a "key element" to Opera's growth plan with operators. Rocket Optimizer is primarily related to the operator revenue source and the licenses/royalties revenue type.

> We have a complete–really a complete new offering. And this is very much due to the Skyfire technology where we have launched Opera Max. We have the toolbar from Horizon and **we also have our flagship product, which is Rocket Optimizer**. (CEO Mr. Lars Rahbaek Boilesen, Q4 13 Conference Call, 02/11/14) [emphasis added]

<u>We have the following observations:</u>

1. **Rocket Optimizer faces potential demand weakness, in our view:** On its Q2 14 Conference Call, the Company represented that it did not have the "most efficient" sales tactics for the Rocket Optimizer product. Further, it indicated that Rocket Optimizer was dependent on certain external factors. Accordingly, we believe the Company may have experienced demand weakness for the Rocket Optimizer product. In our view, the reduction in expected earn-out payments and potential demand weakness for Rocket Optimizer suggests weaker-than-expected results at Skyfire. Given that Rocket Optimizer was Skyfire's flagship product, we believe weaker-than-expected performance of Skyfire products may pressure consolidated revenue growth.

   > We have learned in the last year that the sales cycle is fairly long in this business and we also learned that our approach to address Tier 1 operators one by one is not the most efficient way. Also when we go into live trials, that's lot of dependencies in the network on other components. (CEO Mr. Lars Rahbaek Boilesen, Q2 14 Conference Call, 08/21/14)

2. **Former CEO of Skyfire leaves Opera:** In its 02/15/13 Press Release, the Company represented that Mr. Jeffery S. Glueck (CEO of Skyfire from July 2009 until the acquisition) would assume the role of EVP of the Operator Business for Opera as well as CEO of Skyfire. Then, on its Q4 13 Conference Call, the Company represented that Mr. Glueck decided to leave Opera. On 01/01/14, Mr. Nitin Bhandari (co-founder of Skyfire) replaced Mr. Glueck. On 06/16/14, Mr. Glueck joined Foursquare Labs, Inc. as Chief Operating Officer. We are concerned with the departure of Skyfire's CEO less than one year after the acquisition. Given the sales inefficiencies and underperformance discussed above, our concerns around the management turnover at Skyfire are heightened.

3. **AdColony acquisition may face earn-out reversals, in our view:** As mentioned, the Company acquired AdColony on 07/24/14. In its Q2 14 Quarterly Report, the Company disclosed that the potential earn-outs related to the AdColony acquisition were based on "<u>ambitious</u>" revenue and non-IFRS EBIT targets. Given the Company attributed the Skyfire earn-out reversal to targets that were set "too high," we believe the Company may be compelled to reverse certain AdColony earn-outs due to the "ambitious" assumptions. Given significant

(in our view) investor focus on acquisition performance, we believe future reductions to acquisition earn-out estimates would have the potential to be significant catalysts.

> The deal may include additional variable cash and/or stock consideration of up to MUSD 275… **tied to ambitious 2014, 2015 and 2016 AdColony mobile video advertising revenue and Adjusted EBITDA targets**. (Q2 14 Quarterly Report) [emphasis added]

Surge in Unbilled and Past Due Receivables Heightens Earnings Sustainability Concerns

Unbilled receivables classification: In its FY 13 Annual Report, the Company indicated that development fees where the Company customizes the browser for its customers and/or ports the browser to an operating system are accounted for using the percentage-of-completion method. The Company divides the total number of hours delivered during an accounting period by the total estimated hours to fulfill the terms of the contract. The portion of revenue not yet invoiced to the customer is presented as an unbilled receivable. **We note that development fees and prepaid minimum licenses/royalties related to customized browsers are the only type of revenue accounted for using the percentage-of-completion method.**[8]

Unbilled receivables surge by an amount approximately equivalent to the entire year-over-year increase in revenue: In Q2 14, unbilled receivables surged 132.9% year-over-year to $48.9 million and 69.2% relative to revenue to 0.486, the highest level in at least 11 periods. The $27.9 million surge in unbilled receivables was $0.4 million more than the year-over-year increase in total revenue ($27.5 million). **Therefore, the increase in unbilled receivables amounted to the entire year-over-year revenue increase in Q2 14.**

Unbilled Receivables Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Unbilled receivables	$48.9	$34.1	$32.4	$29.6	$21.0
Revenue	$100.6	$87.0	$89.5	$75.5	$73.1
Unbilled receivables-to-revenue	0.486	0.392	0.362	0.392	0.287
Year-over-year change	*69.2%*	*(17.1%)*	*(17.8%)*	*3.3%*	*(30.8%)*

Past due receivables surge: In FY 13, past due receivables increased 130.8% to $49.4 million.[9] Specifically, receivables past due 0-30 days declined 3.0% to $9.7 million, 31-60 days increased 444.4% to $14.7 million, 61-90 days increased 382.8% to $14.0 million, and more than 90 days increased 89.7% to $11.0 million. In its FY 13 Annual Report, the Company represented that a majority of the FY 13 receivables more than 90 days outstanding had been paid in FY 14 or booked against deferred income.[10]

> The majority of the 2013 receivables that are more than 90 days outstanding have been paid in 2014 or booked against deferred income in the "Statement of financial position". (FY 13 Annual Report)

[8] The Company's Investor Relations department represented that analysis of unbilled and past due receivables would be "very little helpful" and did not provide any additional information. We believe prepaid royalties would not be included in unbilled receivables.
[9] The Company only discloses past due receivables on an annual basis.
[10] The Company did not disaggregate the amount of past due receivables paid versus booked against deferred income.

Past Due Receivables Analysis ($ in millions)	FY 13	FY 12	FY 11
Past due 0-30 days	$9.7	$10.0	$2.7
Change	*(3.0%)*	*270.4%*	*(85.0%)*
Past due 31-60 days	$14.7	$2.7	$2.0
Change	*444.4%*	*35.0%*	*(81.6%)*
Past due 61-90 days	$14.0	$2.9	$0.3
Change	*382.8%*	*866.7%*	*(83.1%)*
Past due more than 90 days	$11.0	$5.8	$3.7
Change	*89.7%*	*56.8%*	*(80.1%)*

We have the following observations:

1. **Development fee revenue growth does not rationalize unbilled receivables growth, in our view:** In Q2 14, unbilled receivables-to-development fee revenue increased 97.9% to 24.450. Given unbilled receivables increased more than development fee revenue and have consistently been significantly greater than development fees, we believe certain other revenue types may be represented in unbilled receivables. The Company has not disclosed another revenue type recorded as unbilled receivables. We believe the Company may recognize revenue prior to sending invoices for certain revenue types. Accordingly, we are concerned that the surge in unbilled receivables may reflect demand weakness (i.e. delaying customer invoicing due to concerns about customer product acceptance/satisfaction) and/or issues in the billing process (i.e. a potential lack of internal control over the sales process).

Unbilled Receivables Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Unbilled receivables	$48.9	$34.1	$32.4	$29.6	$21.0
Development fees	$2.0	$2.4	$1.7	$1.8	$1.7
Unbilled receivables-to-development fees	24.450	14.208	19.059	16.444	12.353
Year-over-year change	*97.9%*	*16.4%*	*35.6%*	*92.1%*	*103.7%*

2. **Bad debt provision decreases as a percentage of past due receivables:** In FY 13, total past due receivables increased 130.8% to $49.4 million, while the provision for bad debt of past due receivables increased 73.3% to $5.2 million. Accordingly, the provision for bad debt of past due receivables as a percentage of past due receivables decreased 350 basis points to 10.5% from a depressed base (declined 670 basis points in FY 12). In our view, the decline in provision for bad debt relative to past due receivables may portend an increase in write-offs in future periods, and hence margin pressure.

Past Due Receivables Analysis ($ in millions)	FY 13	FY 12	FY 11
Total past due receivables	$49.4	$21.4	$8.7
Total provision for bad debt of past due receivables	$5.2	$3.0	$1.8
Provision as percentage of past due receivables	10.5%	14.0%	20.7%
Change	*(350 bps)*	*(670 bps)*	*300 bps*

3. **Increase in unbilled receivables may mask collection issues, in our view:** We believe the increase in unbilled receivables may mask collection issues as the Company may have delayed invoicing certain customers with

higher collection risk/long overdue accounts. In our view, the increase in unbilled receivables may be indicative of increased collection risk.

Deferred Revenue Levels Decline

Decline in deferred revenue levels may portend slower revenue growth, in our view: In its FY 13 Annual Report, the Company indicated deferred revenue consisted of prepaid license/royalty payments, prepaid maintenance and support, prepaid development fees, and prepaid advertising campaigns. In Q2 14, deferred revenue increased 18.7% year-over-year (to $18.4 million), while deferred revenue-to-revenue declined 13.7% (to 0.183) from a depressed base (declined 23.8% in Q2 13). In our view, the decline in deferred revenue levels may portend slower revenue growth in future periods (i.e. customer unwillingness to pay up front may reflect a deterioration in demand).

Deferred Revenue Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Deferred revenue	$18.4	$15.7	$17.9	$14.1	$15.5
Revenue	$100.6	$87.0	$89.5	$75.5	$73.1
Deferred revenue-to-revenue	0.183	0.180	0.200	0.187	0.212
Year-over-year change	*(13.7%)*	*(41.4%)*	*8.2%*	*(9.2%)*	*(23.8%)*

R&D Capitalization Surges, May Have Materially Benefitted Recently Reported Earnings

Capitalization of research and development: In FY 12, the Company began capitalizing and amortizing development costs related to building new features/significant improvements for its core platform (provided that the improvements generate probable future economic benefits).[11] The Company indicated it began capitalizing certain development costs because internal reporting and bookkeeping systems enabled it to account specifically for these costs. The capitalized costs are amortized over three years on a straight-line basis. Implementation of updates and "bug fixes" are expensed as incurred as maintenance.

> Cost of building new features, together with significant and pervasive improvements of the core platform, provided that the significant and pervasive improvements of parts or main components of the core platform will generate probable future economic benefits, are capitalized as development costs and amortized on a straight line 3-year basis. These costs were not capitalized in FY 2011, as Opera has from FY 2012 enabled internal reporting and bookkeeping systems to account distinctly for these costs. (FY 12 Annual Report)

Capitalized R&D Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Capitalized R&D	$3.2	$3.1	$4.0	$3.8	3.0
Year-over-year change	*6.7%*	*47.6%*	*185.7%*	*442.9%*	*130.8%*

Potentially unwarranted surge in capitalized R&D, in our view: In FY 13, capitalized R&D surged 323.5% to $14.4 million. In our view, the earnings impact of capitalizing R&D (instead of expensing it) was a $0.07 and $0.01 benefit in FY 13 and FY 12, respectively.[12] The Company did not discuss the surge in capitalized R&D in its Q4 13 Earnings Release, FY 13 Annual Report, or on its Q4 13 Conference Call. Therefore, we are concerned that the surge in capitalization may have been unwarranted.

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[11] Per *IAS 38.57* development costs are capitalized only after technical and commercial feasibility have been established. The entity must be able to demonstrate how the asset will generate future economic benefits (through either use or sale).

[12] The Company uses a three-year amortization period for capitalized R&D. We used the three-year amortization period to calculate the earnings impact.

Capitalized R&D Analysis ($ in millions)	FY 13	FY 12
Capitalized R&D	$14.4	$3.4
Change	*323.5%*	--
Reported earnings	$0.48	$0.14
R&D capitalization earnings impact	$0.07	$0.01
Percent of reported earnings	14.2%	8.9%

R&D capitalization levels above the peer group, in our view: In FY 13, Opera capitalized R&D as a percentage of revenue increased 320 basis points to 4.8%. In addition, it was 210 basis points higher than the peer group average of 2.7%.[13] Given the significant increase in capitalized R&D and the higher-than-peer levels of capitalized R&D, we believe margins may be pressured in future periods as the capitalized R&D costs are amortized. Further, the peer analysis heightens our concerns regarding the surge in capitalized R&D in FY 13.

Capitalized R&D Peer Analysis	Capitalized R&D as a Percent of Sales
Opera Software ASA (OPERA.OL)	4.8%
Asseco Poland SA (ACPPEUR.Vlp)	1.3%
Hexagon AB (HEXAb.ST)	5.9%
Swisslog Holding AG (SLOG.S)	0.5%
Temenos Group AG (TEMN.S)	3.0%
Peer group average	2.7%
Bps Opera above (below) peer group average	*210 bps*

Cash Flow Deterioration Heightens Earnings Sustainability Concerns

In Q2 14, twelve-month cash flow from operations increased 55.1% year-over-year to $55.1 million, while profit after taxes paid increased 145.1% to $47.4 million. Accordingly, CFO-to-profit after taxes paid declined 36.7% to 1.162. In our view, the deterioration in cash flow levels suggests earnings may be unsustainable.

12M Cash Flow Analysis ($ in millions)	Q2 14	Q1 14	Q4 13	Q3 13	Q2 13
Cash flow from operations	$55.1	$61.5	$49.5	$50.7	$35.5
Profit after taxes paid	$47.4	$45.1	$54.5	$10.8	$19.3
CFO-to-profit after taxes paid	1.162	1.364	0.908	4.694	1.837
Year-over-year change	*(36.7%)*	*(40.4%)*	*(60.4%)*	*295.7%*	*62.8%*

Observations on Share Offering and Insider Sales

Share offering to strengthen capital base for current and future strategic acquisitions: On 06/26/14, the Company announced an offering of up to 10.0 million shares (7.5% of the existing share capital of the Company). The offering was a private placement to institutional investors. The Company represented the purpose of the

[13] The peer group average consists of other European software companies that use IFRS accounting and capitalize certain R&D costs.

placement was to strengthen its capital base for current and future strategic acquisition activities and obligations; specifically, to meet the earn-out obligations in connection with the AdColony acquisition. On 06/27/14, the Company announced the successful completion of the offering. In our view, the Company may reverse certain AdColony earn-outs based on the "ambitious" targets it set and/or face increasing competition for future strategic acquisitions.

Significant (in our view) insider divestitures: In FY 14, Mr. Lars Aarhus (Director) sold 35.4% of his beneficial ownership and Ms. Kari Stautland (Board Member) sold 13.9% of her beneficial ownership. In FY 13, Mr. Erik C. Harrell (CFO) and Mr. Lars Boilesen (CEO) sold 30.9% and 53.0% of their beneficial ownership, respectively. In addition, Mr. Jeffrey S. Glueck (EVP of Operator Solutions) sold 50.0% of his beneficial ownership in FY 13. As mentioned, Mr. Glueck was the former CEO of Skyfire and left Opera at the end of FY 13. We are concerned with Mr. Glueck's divestitures prior to his departure. In our view, Mr. Glueck's divestitures may be indicative of demand weakness for Skyfire products. The significant (in our view) insider divestitures during the last two years heighten our concerns about earnings sustainability.

Insider Sales Analysis	Position	Date Sold	Shares Sold	% of Beneficial Ownership
Mr. Lars Aarhus	Director	03/05/14	13,575	35.4%
Ms. Kari Stautland	Board Member	02/18/14	1,325,000	13.9%
Mr. Jeffery S. Glueck	EVP of Operator Solutions	12/16/13 and 09/17/13	19,476	50.0%
Mr. Erik C. Harrell	CFO	12/06/13 and 09/06/13	308,500	30.9%
Mr. Lars Boilesen	CEO	12/06/13 and 09/06/13	800,000	53.0%

Risks to Our Thesis and Conclusion

Risks to our thesis: The following developments could present challenges to our thesis:

- New product releases facilitate market share growth in mobile browsers and/or advertising.
- The Company makes additional strategic acquisitions and acquisition execution improves (relative to Skyfire).
- Acquisition synergies drive advertising revenue growth.
- The Company is acquired.

Conclusion: We are concerned with intensifying competitive pressures and potential market share losses in the Company's browser business. Further, we are concerned about potential margin pressure from a mix shift towards advertising revenue. Additionally, we believe revenue growth may be pressured due to potential underperformance by recent acquisitions. Our concerns are heightened given (1) a surge in unbilled and past due receivables, (2) a decline in deferred revenue, (3) an increase in capitalized R&D, (4) deterioration in cash flow from operations, and (5) significant (in our view) insider divestitures. We are initiating coverage of OPERA.OL on *The Short List*.

Disclaimer and Disclosure