

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549  
**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**  
*COMMISSION FILE NUMBER 0-30961*

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**Sohu.com Inc.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

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Delaware  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

98-0204667  
(I.R.S. EMPLOYER  
IDENTIFICATION NUMBER)

Suite 1519, Tower 2  
Bright China Chang An Building  
7 Jianguomen Nei Avenue  
Beijing 100005  
People's Republic of China  
86-10-6510-2160

(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE,  
OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

<u>Class</u>	<u>Outstanding at August 10, 2001</u>
Common stock, \$.001 par value	35,625,716

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**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**SOHU.COM INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited, in thousands of US Dollars)

	June 30, 2001	December 31, 2000
	_____	_____
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 54,207	\$ 62,593
Accounts receivable, net	2,362	2,092
Prepaid and other current assets	944	1,688
	_____	_____
Total current assets	57,513	66,373
Fixed assets, net	7,404	7,404
Intangible assets, net	21,878	30,283
Other assets, net	1,935	1,780
	_____	_____
	\$ 88,730	\$ 105,840
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 411	\$ 1,459
Accrued liabilities and deferred revenues	3,165	3,312
	_____	_____
Total current liabilities	3,576	4,771
Commitments and contingencies		
Shareholders' equity:		
Common Stock	36	36
Additional paid-in capital	130,504	129,759
Deferred compensation and other	(707)	(161)
Accumulated deficit	(44,679)	(28,565)
	_____	_____
Total shareholders' equity	85,154	101,069
	_____	_____
	\$ 88,730	\$ 105,840
	=====	=====

**SOHU.COM INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited, in thousands of US Dollars except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2001	June 30, 2000	June 30, 2001	June 30, 2000
Revenues:				
Advertising	\$ 2,227	\$ 1,330	\$ 4,314	\$ 2,172
Non-advertising	651	-	1,017	-
Total revenues	2,878	1,330	5,331	2,172
Cost of revenues:				
Advertising	1,762	1,172	3,613	1,989
Non-advertising	522	-	819	-
Total cost of revenue	2,284	1,172	4,432	1,989
Gross profit	594	158	899	183
Operating expenses:				
Product development	1,295	543	2,933	895
Sales and marketing	2,141	2,951	4,617	4,502
General and administrative	1,197	1,488	2,450	2,177
Amortization of intangibles	4,202	-	8,405	-
Total operating expenses	8,835	4,982	18,405	7,574
Operating loss	(8,241)	(4,824)	(17,506)	(7,391)
Interest income	593	402	1,392	433
Net loss	(7,648)	(4,422)	(16,114)	(6,958)
Accretion on mandatorily redeemable convertible preferred stock	-	(2,106)	-	(3,665)
Net loss attributable to common stockholders	\$ (7,648)	\$ (6,528)	\$ (16,114)	\$ (10,623)
Basic and diluted net loss per share attributable to common stockholders	\$ (0.21)	\$ (0.69)	\$ (0.45)	\$ (1.13)
Shares used in computing basic and diluted net loss per share	35,626	9,416	35,626	9,416

Basic and diluted pro forma net loss per share (unaudited)	\$ (0.21)	\$ (0.17)	\$ (0.45)	\$ (0.26)
Shares used in computing basic and diluted pro forma net loss per share (unaudited)	35,626	26,624	35,626	26,287

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**SOHU.COM INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited, in thousands of US Dollars)

	Six Months Ended	
	June 30, 2001	June 30, 2000
Cash flows from operating activities:		
Net loss	\$ (16,114)	\$ (6,958)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of intangible assets	8,405	-
Depreciation and amortization	1,951	449
Stock-based compensation expense	167	438
Allowance for doubtful accounts receivable	75	-
Loss on disposal of fixed assets	-	2
Changes in assets and liabilities:		
Accounts receivable	(345)	(708)
Prepaid and other current assets	744	(209)
Accounts payable	(1,048)	728
Accrued liabilities and deferred revenues	(147)	1,387
Net cash used in operating activities	(6,312)	(4,871)
Cash flows from investing activities:		
Acquisition of fixed assets	(1,581)	(2,820)
Acquisition of other assets	(522)	(2,929)
Disposal of other assets	-	122
Net cash used in investing activities	(2,103)	(5,627)
Cash flows from financing activities:		
Issuance of Series D Mandatorily Redeemable Convertible Preferred Stock	-	29,947
Short-term loan	-	2,899
Repayment of short-term loan	-	(2,899)
Other	29	-
Net cash provided by financing activities	29	29,947
Net increase/(decrease) in cash and cash equivalents	(8,386)	19,449
Cash and cash equivalents at beginning of period	62,593	3,924

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**SOHU.COM INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

### **1. THE COMPANY AND BASIS OF PRESENTATION**

Sohu.com Inc. ("Sohu" or the "Company") was incorporated in Delaware, USA in August 1996 under the name of Internet Technologies China Incorporated, and changed its name to Sohu.com Inc. in September 1999.

The accompanying unaudited consolidated interim financial statements reflect all normal recurring adjustments which, in the opinion of management, are necessary for a fair statement of the results for the interim periods presented. Results for the three months ended June 30, 2001 are not necessarily indicative of the results expected for the full fiscal year or for any future period.

These financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

### **2. RECENT ACCOUNTING PRONOUNCEMENTS**

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets". SFAS No. 142 addresses financial accounting for acquired goodwill and other intangible assets and how such assets should be accounted for in financial statements upon their acquisition and after they have been initially recognized in the financial statements. The Company will adopt SFAS No. 142 beginning January 1, 2002. The Company is currently evaluating the impact of this pronouncement to determine the effect it will have on the January 1, 2002 unamortized balance of goodwill of \$13 million that arose from the ChinaRen, Inc. acquisition. Also upon adoption of this pronouncement, the Company would cease to amortize the goodwill which is currently being amortised over 24 months with a monthly charge of \$1.4 million.

### **3. NET LOSS PER SHARE**

Net loss per share is computed using the weighted average number of shares of common stock outstanding during the period. Since the Company has a net loss for all periods presented, net loss per share on a diluted basis is equivalent to basic net loss per share because the effect of converting stock options, warrants and mandatorily redeemable convertible preferred stock would be anti-dilutive. Pro forma basic and diluted net loss per share is computed as described above and also gives effect, under SEC guidance, to the automatic conversion of all outstanding shares of mandatorily redeemable convertible preferred stock (using the as-converted method) in connection with the Company's initial public offering in July 2000.

### **4. SEGMENT INFORMATION**

Based on the criteria established by SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company operates in two principal business segments. The Company does not allocate any operating costs or assets to its non-advertising revenue segment as management does not use this information to measure the performance of the operating segment. Management does not believe that allocating these expenses or assets is material in evaluating the segment's performance.

### **5. RELATED PARTY TRANSACTIONS**

During the three and six months ended June 30, 2001, the Company recorded net revenue of \$368,000 and \$691,000, respectively, pursuant to a technical and advertising services agreement with an investee company. Accrued liabilities and deferred revenue on June 30, 2001 and December 31, 2000 includes \$210,000 and \$962,000 of deferred revenue from the investee company, respectively.

### **6. COMMITMENTS AND CONTINGENCIES**

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The People's Republic of China ("PRC") market in which the Company operates poses certain macro-economic and regulatory risks and uncertainties. These uncertainties extend to the ability of the Company to operate an Internet business and to conduct online advertising in the PRC. Though the PRC has, since 1978, implemented wide range market-oriented economic reforms, continued reforms and progress towards a full market-oriented economy are uncertain. In addition, the telecommunication, information, and media industries remain highly regulated. Restrictions are currently in place regarding the specific segments of these industries in which foreign owned entities, like the Company, may operate, although the scope of some of these restrictions is

unclear. The Company's legal structure and scope of operations in China could be subjected to restrictions which could result in severe limits to the Company's ability to conduct business in the PRC and this could have a material adverse effect on the Company's financial position, results of operations and cash flows.

Pursuant to the Company's 2000 Stock Incentive Plan, during the six months ended June 30, 2001, the Company granted 1,126,838 stock options which will be issued to designated employees upon meeting certain performance criteria as set by the Company's Board of Directors for the year ended December 31, 2001. During the quarter ended June 30, 2001, the Company recognized stock compensation expense of \$123,000 and deferred compensation of \$735,000 related to these 1,126,838 options. The compensation expense and deferred compensation amounts could vary in future periods due to fluctuations in the Company's stock price. Additionally, if the Plan's criteria are not met, these amounts would be reversed in future periods.

## 7. SUBSEQUENT EVENT

In July 2001, the Company's Board of Directors adopted a stockholder rights plan (the "Plan"). Under the Plan, the Company will distribute a dividend in the form of a right to purchase a unit of preferred stock to each holder of common stock of record as of the close of business on July 23, 2001. The Plan is designed to deter coercive takeover tactics, including the accumulation of shares in the open market or through private transactions, and to prevent an acquirer from gaining control of the Company without offering a fair and adequate price and terms to all of the Company's stockholders. The Rights will expire on July 25, 2011.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*As used in this report, references to "us," "we," "our," "our company," "Sohu" and "Sohu.com" are to Sohu.com Inc., our subsidiaries ChinaRen Inc. (or ChinaRen), Sohu.com (Hong Kong) Limited (or Sohu Hong Kong), Sohu ITC Information Technology (Beijing) Co., Ltd. (or Beijing ITC), Sandhill Information Technology (Beijing) Co., Ltd. (or Beijing Sandhill), and our affiliate Beijing Sohu Online Network Information Services, Ltd. (or Beijing Sohu), and these references should be interpreted accordingly. Except where the context requires otherwise, these references include all of our subsidiaries. Unless otherwise specified, references to "China" or "PRC" refer to the People's Republic of China and do not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words "expect," "anticipate," "intend," "believe," or similar language. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth below under the caption "Risk Factors." Readers are cautioned not to place undue reliance on these forward-looking statements.*

## OVERVIEW

Sohu, having introduced the first Chinese language online directory, is a leading Internet portal in China in terms of brand recognition, page views and registered users. We averaged 127 million page views per day for the month of June, a 17% increase from 107 million per day averaged in March 2001. We define a page view as a single screen of content which refers to the sum total of what a user sees in a browser window. Registered users totaled 25.4 million as of June 30, 2001, up 37% from 18.7 million users registered as of March 31, 2001. A registered user is someone who has completed the registration through our web site and received a user name and password. Our portal consists of the following:

- sophisticated Chinese language Web navigational and search capabilities utilizing proprietary technology;

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- seventeen main content channels containing multi-level sub-channels that cover a comprehensive range of topics, including news, business, entertainment, sports and career;
- Web-based communications and community services providing free Chinese language e-mail, online bulletin boards, chat rooms, instant messaging, short messaging and alumni club; and
- a platform for e-commerce services.

We were incorporated in Delaware, USA during August 1996 as Internet Technologies China Incorporated and in September 1999 we changed our corporate name to Sohu.com Inc.

On October 18, 2000, Sohu acquired ChinaRen. Revenues and expenses from ChinaRen's operations after the acquisition date have been included in Sohu's consolidated financial statements.

On April 20, 2001, Beijing ITC, Dr. Charles Zhang, and two affiliates of one of Sohu's stockholders agreed to cancel Dr. Charles Zhang's July 2000 agreement to procure Sohu to purchase \$6 million of services from one such affiliate and to cancel a contract which requires the other affiliate to purchase an aggregate of \$6 million of advertising and technical services from Beijing ITC in 2000, 2001 and 2002.

Pursuant to the Company's 2000 Stock Incentive Plan, during the six months ended June 30, 2001, the Company granted 1,126,838 stock options which will be issued to designated employees upon meeting certain performance criteria as set by the Company's Board of Directors for the year ended December 31, 2001. During the quarter ended June 30, 2001, the Company recognized stock compensation expense of \$123,000 and deferred compensation of \$735,000 related to these 1,126,838 options. If the performance criteria are not met, these amounts would be reversed in future periods.

In July 2001, the Company's Board of Directors adopted a stockholder rights plan (the "Plan"). Under the Plan, the Company will distribute a dividend in the form of a right to purchase a unit of preferred stock to each holder of common stock of record as of the close of business on July 23, 2001. The Plan is designed to deter coercive takeover tactics, including the accumulation of shares in the open market or through private transactions, and to prevent an acquirer from gaining control of the Company without offering a fair and adequate price and terms to all of the Company's stockholders. The Rights will expire on July 25, 2011.

Total employees were 432 at June 30, 2001, a reduction of 18% from the 524 full-time and temporary employees at December 31, 2000.

We have incurred significant net losses and have negative cash flows from operations since inception. These losses have been funded with proceeds of preferred stock private placements. We may increase spending on marketing and brand development, content enhancements and technology and infrastructure. As a result, net losses could increase in the foreseeable future. We anticipate funding these expected losses with the remaining proceeds from our initial public offering completed in July 2000.

## **RESULTS OF OPERATIONS FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2001 AND 2000**

### **REVENUES**

Total revenues increased by \$1.6 million to \$2.9 million for the three months ended June 30, 2001 and increased by \$3.1 million to \$5.3 million for the six months ended June 30, 2001 as compared to the corresponding three and six month periods in 2000. For the three months ended June 30, 2001, advertising revenues constituted \$2.2 million or 77% of total revenues and non-advertising revenues were \$651,000 or 23% of total revenues. For the six months ended June 30, 2001, advertising revenues were \$4.3 million or 81% of total revenues and non-advertising revenues were \$1 million or 19% of total revenues. There were no non-advertising revenues in the corresponding three and six month periods in 2000.

#### **Advertising Revenues**

Advertising revenues increased by \$897,000 to \$2.2 million for the three months ended June 30, 2001, and increased by \$2.1 million to \$4.3 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2000. The increase was due primarily to the increasing number of advertisers purchasing space on our online media properties as well as larger and longer-term purchases by certain advertisers. Sales to Sohu's five largest advertisers were 28% and 28% of total revenues for the three and six months ended June 30, 2001, respectively, as compared to 26% and 26% of total revenues for the three and six months ended June 30, 2000. Included in advertising revenues for the three and six months ended June 30, 2001 was \$368,000 and \$691,000 from a related party, respectively.

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#### **Non-advertising Revenues**

Non-advertising revenues were \$651,000 and \$1 million for the three and six months ended June 30, 2001, respectively. We did not receive any non-advertising revenues for the three and six months ended June 30, 2000. Non-advertising revenues were generated from e-business, subscription and e-commerce services. E-business revenues are derived from the sale of technology solutions. E-commerce revenues included direct sales of CDs, cosmetics and other consumer products from the Sohu Shopping Channel. There was no comparable revenue for the three and six months ended June 30, 2000 because these were new business lines started in 2001.

### **COSTS AND EXPENSES**

#### **Cost of Revenues**

Total cost of revenues increased by \$1.1 million to \$2.3 million for the three months ended June 30, 2001, and increased by \$2.4 million to \$4.4 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2000. For the three months ended June 30, 2001, advertising cost of revenues constituted \$1.8 million or 77% of total cost of revenues and non-advertising cost of revenues was \$522,000 or 23% of total cost of revenues. For the six months ended June 30, 2001, advertising cost of revenues constituted \$3.6 million or 82% of total cost of revenues and non-advertising cost of revenues was \$819,000 or 18% of total cost of revenues.

#### **Advertising cost of revenues**

Advertising cost of revenues increased by \$590,000 to 1.8 million for the three months ended June 30, 2001, and increased by \$1.6 million to \$3.6 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2000. The increase was a result of the ongoing development of our Web site over the past year and the acquisition of ChinaRen in October 2000. We incurred additional personnel costs associated with increasing the breadth and depth of our channel and feature offerings, higher bandwidth leasing charges due to leasing of additional bandwidth from the Beijing Telecom Administration and higher hardware and software amortization costs associated with the acquisition of additional servers and storage devices.

### **Non-advertising cost of revenues**

Non-advertising cost of revenues was \$522,000 and \$819,000 for the three and six months ended June 30, 2001, respectively. Non-advertising cost of revenues included personnel expenses, related overhead charges and the cost of inventory sold to customers as part of our e-business and e-commerce services. There were no non-advertising revenues for the three and six months ended June 30, 2000, and therefore no non-advertising costs of revenues for those periods.

### **Product Development Expenses**

Product development expenses increased by \$752,000 to \$1.3 million for the three months ended June 30, 2001, and increased by \$2 million to \$2.9 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2000. The increase was attributable to increased staffing and related costs, and additional technology and license fees for new products.

### **Sales and Marketing Expenses**

Sales and marketing expenses decreased by \$810,000 to \$2.1 million for the three months ended June 30, 2001, and increased by \$100,000 to \$4.6 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2000. The decrease for the three months ended June 30, 2001 was due primarily to the changes of marketing strategy and marketing expense reduction. The increase for the six months ended June 30, 2001 was attributable to the launch of more advertising campaigns during the first three months of 2001 than during the first three months in 2000.

### **General and Administrative Expenses**

General and administrative expenses decreased by \$291,000 to \$1.2 million for the three months ended June 30, 2001, and increased by \$273,000 to \$2.4 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2001. The decrease for the three months ended June 30, 2001 was due primarily to reduced spending on professional fees and office expenses. The increase for the six months ended June 30, 2001 was primarily attributable to increased staffing, office space expansion and professional fees and increased expenditures in the first three months in 2001 as compared to the corresponding period in 2000.

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### **Amortization of Intangible Assets**

Intangible assets of \$33.6 million including \$392,000 for assembled workforce and \$33.2 million in goodwill arose as a result of the October 18, 2000 acquisition of ChinaRen, and are being amortized over their estimated useful life of two years. The amortization expense for the three and six months ended June 30, 2001 was \$4.2 million and \$8.4 million, respectively. There was no amortization expense for the three and six months ended June 30, 2000.

### **Operating Loss**

As a result of the foregoing, we had an operating loss of \$17.5 million for the six months ended June 30, 2001 as compared to \$7.4 million for the six months ended June 30, 2000, and an operating loss of \$8.2 million for the three months ended June 30, 2001 as compared to \$4.8 million for the three months ended June 30, 2000.

### **Interest Income**

**Interest income** increased by \$191,000 to \$593,000 for the three months ended June 30, 2001, and increased by \$959,000 to \$1.4 million for the six months ended June 30, 2001, as compared to the corresponding three and six month periods in 2001. The increase is attributable to higher cash and short-term investment balances as a result of investment of the net proceeds from our initial public offering completed in July 2000.

### **Net Loss**

As a result of the foregoing, we had a net loss of \$16.1 million for the six months ended June 30, 2001 as compared to \$7 million for the six months ended June 30, 2000, and a net loss of \$7.6 million for the three months ended June 30, 2001 as compared to \$4.4 million for the three months ended June 30, 2000.

Net loss attributable to common stockholders was \$16.1 million for the six months ended June 30, 2001 compared to \$10.6 million for the six months ended June 30, 2000, and net loss attributable to common stockholders was \$7.6 million for the three months ended June 30, 2001 compared to \$6.5 million for the three months ended June 30, 2000. The difference between the net loss and the net loss attributable to common stockholders for the three and six months ended June 30, 2000 resulted from accretion on mandatorily redeemable preferred stock. There is no comparable distinction for the three and six months ended June 30, 2001 because all of the mandatorily redeemable preferred stock was converted into common stock effective upon the closing of the initial public offering of Sohu's common stock in July 2000.

## **LIQUIDITY AND CAPITAL RESOURCES**

We have financed our operations principally through private sales of preferred stock. From inception through June 30, 2001, we have raised net proceeds of \$39.2 million through the sale of preferred stock in private placements and \$52.4 million from the sale of common stock in our initial public offering. As of June 30, 2001, we had \$54.2 million in cash and cash equivalents.

Net cash used in operating activities during the six months ended June 30, 2001 increased to \$6.4 million as compared to \$4.9 million during the six months ended June 30, 2000. This increase was due to costs associated with increases in personnel, bandwidth, office space expansion and other operating expenses.



Net cash used in investing activities during the six months ended June 30, 2001 decreased to \$2 million as compared to \$3.6 million during the six months ended June 30, 2000. The decrease was primarily the result of less fixed assets expenditures and no investment of proceeds from our initial public offering during the six months ended June 30, 2001.

During the six months ended June 30, 2001, there was no significant cash provided by financing activities.

Our principal commitments consist of obligations under various operating leases for office facilities. We expect that capital expenditures in 2001 will primarily consist of purchases of additional servers, computer software, workstations and technological improvements to network infrastructure.

We believe that current cash and cash equivalents will be sufficient to meet anticipated increases in working capital (net cash used in operating activities), commitments and capital expenditures cash needs for at least the next twelve months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments or acquisitions we may decide to pursue. If these sources are insufficient to satisfy cash requirements, we may seek to sell additional equity or debt securities or to obtain a credit facility. The sale of additional equity or convertible debt securities could result in additional dilution to stockholders. The incurrence of indebtedness would result in debt service obligations and could result in

10 operating and financial covenants that would restrict operations. Financing may not be available in amounts or on terms acceptable to us, if at all.

Chinese regulations limit our ability to convert renminbi into foreign currency for capital items. While operations in China are currently a net user of cash, the ability to use future cash generated in China for expenditures outside of China may be restricted. If the renminbi were to decline in value, our revenues in US dollar terms would be reduced.

## **Risk Factors**

### **Risks relating to Sohu.com**

#### **We have incurred net losses since inception and anticipate that losses will continue.**

We have incurred significant net losses since our inception in August 1996 and had an accumulated deficit of approximately \$44.7 million at June 30, 2001. We anticipate that we will continue to incur substantial net losses due to a high level of planned operating and capital expenditures, including sales and marketing costs, personnel hires, and product development. Our net losses may continue to increase in the future and we may never achieve or sustain profitability.

#### **We have a limited operating history, which may make it difficult for investors to evaluate our business.**

We began offering products and services under the www.Sohu.com Web site in February 1998. Accordingly, we have a limited operating history upon which investors can evaluate our business. In addition, our senior management and employees have worked together at our company for only a relatively short period of time. As an early stage company in the new and rapidly evolving PRC Internet market, we face numerous risks and uncertainties. Some of these risks relate to our ability to:

- increase our online advertising revenues and successfully build an e-commerce business, given the early stage of development of the PRC Internet industry;
- continue to attract a larger audience to our portal by expanding the type and technical sophistication of the content and services we offer; and
- maintain our current, and develop new, strategic relationships to increase our revenue streams as well as product and service offerings.

#### **PRC Internet laws and regulations are unclear and will likely change in the near future. If we are found to be in violation of current or future PRC laws or regulations, we could be subject to severe penalties.**

We conduct our Internet business solely in the PRC through our wholly owned subsidiaries, Beijing ITC and Beijing Sandhill. Beijing ITC and Beijing Sandhill are wholly foreign owned enterprises, or WFOEs, under PRC law. We are a Delaware corporation and a foreign person under PRC law. Accordingly, our Internet business is 100% foreign-owned. In addition, pursuant to our restructuring, we transferred certain of our assets and operations to Beijing Sohu, a PRC company that is 80% owned by our chief executive officer. We do not have any ownership interest in Beijing Sohu.

The PRC has recently begun to regulate its Internet sector by making pronouncements or enacting regulations regarding the legality of foreign investment in the PRC Internet sector and the existence and enforcement of content restrictions on the Internet. We believe that our current ownership structure complies with all existing PRC laws, rules and regulations. There are, however, substantial uncertainties regarding the interpretation of current PRC Internet laws and regulations. In addition, new PRC Internet laws and regulations were recently adopted. Accordingly, it is possible that the PRC government will ultimately take a view contrary to ours.

Issues, risks and uncertainties relating to PRC government regulation of the PRC Internet sector include the following:

- The PRC recently enacted regulations applying to Internet-related services and telecom-related activities. While many aspects of these recently-enacted regulations remain unclear, they purport to limit and require licensing of various aspects of the provision of Internet information services. If these

new regulations are interpreted to be inconsistent with our restructuring, our business will be severely impaired.

- A limitation on foreign investment in businesses providing value-added telecommunication services, including computer information services or electronic mail box services, is expected to be applied to Internet businesses such as ours. However, under regulations published to date, the extent of the limitation is unclear. In the past, some officials of the MII have taken the position that foreign investment in the Internet sector is prohibited.
- Under the agreement reached in November 1999 between the PRC and the United States concerning the United States' support of China's entry into the World Trade Organization, or WTO, foreign investment in PRC Internet services will be liberalized to allow for 30% foreign ownership in key telecommunication services, including PRC Internet ventures, for the first year after China's entry into the WTO, 49% in the second year and 50% thereafter. However, the implementation of this agreement is still subject to various conditions.
- The MII has also stated that the activities of Internet content providers are subject to regulation by various PRC government authorities, depending on the specific activities conducted by the Internet content provider. Various government authorities have stated publicly that they are in the process of preparing new laws and regulations that will govern these activities. The areas of regulation may include online advertising and online news reporting.

The interpretation and application of existing PRC laws and regulations, the stated positions of the MII and the possible new laws or regulations have created substantial uncertainties regarding the legality of existing and future foreign investments in, and the businesses and activities of, PRC Internet companies, including us.

Accordingly, it is possible that the relevant PRC authorities could, at any time, assert that any portion or all of our, Beijing ITC's, Beijing Sandhill's or Beijing Sohu's existing or future ownership structure and businesses violate existing or future PRC laws, regulations or policies. It is also possible that the new laws or regulations governing the PRC Internet sector that have been adopted or may be adopted in the future will prohibit or restrict foreign investment in, or other aspects of, any of our, Beijing ITC's, Beijing Sandhill's or Beijing Sohu's current or proposed businesses and operations. In addition, these new laws and regulations may be retroactively applied to us, Beijing ITC, Beijing Sandhill or Beijing Sohu.

If we, Beijing ITC, Beijing Sandhill or Beijing Sohu are found to be in violation of any existing or future PRC laws or regulations, the relevant PRC authorities would have broad discretion in dealing with such violation, including, without limitation, the following:

- levying fines;
- confiscating our, Beijing ITC's, Beijing Sandhill's or Beijing Sohu's income;
- revoking our, Beijing ITC's, Beijing Sandhill's or Beijing Sohu's business license;
- shutting down our, Beijing ITC's, Beijing Sandhill's or Beijing Sohu's servers and/or blocking our Web sites;
- requiring us, Beijing ITC, Beijing Sandhill or Beijing Sohu to restructure our ownership structure or operations; and
- requiring us, Beijing ITC, Beijing Sandhill or Beijing Sohu to discontinue any portion or all of our Internet business.

**We have attempted to comply with restrictions on foreign investment in the PRC Internet sector imposed by the PRC government by transferring our content-related assets and operations to, and entering into agreements with, Beijing Sohu, a PRC company controlled by our President and Chief Executive Officer. If the PRC government finds that these agreements do not comply with the relevant foreign investment restrictions, our business in the PRC will be adversely affected.**

Because the PRC government restricts foreign investment in Internet-related businesses, we have restructured our Internet operations by having Beijing Sohu acquire appropriate government approvals to conduct our content-related operations. In addition, we have transferred our content-related assets and operations to Beijing Sohu. The legal uncertainties associated with PRC government regulations and our restructuring may be summarized as follows:

- whether the PRC government may view our restructuring as being in compliance with its laws and regulations;
- whether the PRC government may impose additional regulatory requirements with which we or Beijing Sohu may not be in compliance; and

- whether the PRC government will permit Beijing Sohu to acquire future licenses necessary in order to conduct operations in the PRC.

We cannot be sure that our restructured operations and activities will be viewed by PRC regulatory authorities as in compliance with applicable PRC laws and regulations. Our business will be adversely affected if our business license is revoked as a result of non-compliance. In addition, we cannot be sure that we and Beijing Sohu will be able to obtain all of the licenses we or Beijing Sohu may need in the future. Future changes in PRC government policies affecting the provision of information services, including the provision of online services and Internet access, may impose additional regulatory requirements on us or Beijing Sohu or our service providers or otherwise harm our business.

**We depend upon contractual arrangements with Beijing Sohu for the success of our business and these arrangements may not be as effective in providing operational control as direct ownership of these businesses and may be difficult to enforce.**

Because we conduct our Internet business only in the PRC, and because we are restricted by the PRC government from owning Internet content operations in the PRC, we are dependent on Beijing Sohu, in which we have no ownership interest, to provide those services through contractual agreements between the parties. This arrangement may not be as effective in providing control over our Internet content operations as direct ownership of these businesses. For example, Beijing Sohu could fail to take actions required for our business, such as entering into content development contracts with potential content suppliers or failing to maintain the necessary permit for the content servers. If Beijing Sohu fails to perform its obligations under these agreements, we may have to rely on legal remedies under PRC law, which we cannot assure you would be effective or sufficient.

Beijing Sohu is controlled by Charles Zhang, our chief executive officer. As a result, our contractual relationships with Beijing Sohu could be viewed as entrenching his management position or transferring certain value to him, especially if any conflict arises with him.

**Even if we are in compliance with PRC governmental regulations relating to licensing and foreign investment prohibitions, the PRC government may prevent us from distributing, and we may be subject to liability for, content that it believes is inappropriate.**

The PRC has enacted regulations governing Internet access and the distribution of news and other information. In the past, the PRC government has stopped the distribution of information over the Internet that it believes to violate PRC law, including content that is obscene, incites violence, endangers national security, is contrary to the national interest or is defamatory. In addition, we may not publish certain news items, such as news relating to national security, without permission from the PRC government. Furthermore, the Ministry of Public Security has the authority to cause any local Internet service provider to block any Web site maintained outside the PRC at its sole discretion. Even if we comply with PRC governmental regulations relating to licensing and foreign investment prohibitions, if the PRC government were to take any action to limit or prohibit the distribution of information through our network or to limit or regulate any current or future content or services available to users on our network, our business would be harmed.

We are also subject to potential liability for content on our Web sites that is deemed inappropriate and for any unlawful actions of our subscribers and other users of our systems under regulations promulgated by the MII.

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Furthermore, we are required to delete content that clearly violates the laws of the PRC and report content that we suspect may violate PRC law. It is difficult to determine the type of content that may result in liability for us, and if we are wrong, we may be prevented from operating our Web sites.

**We may have to register our encryption software with PRC regulatory authorities, and if they request that we change our encryption software, our business operations will be disrupted as we develop or license replacement software.**

Pursuant to the Regulations for the Administration of Commercial Encryption promulgated at the end of 1999, foreign and domestic PRC companies operating in the PRC are required to register and disclose to PRC regulatory authorities the commercial encryption products they use. Because these regulations have just recently been adopted and because they do not specify what constitutes encryption products, we are unsure as to whether or how they apply to us and the encryption software we utilize. We may be required to register, or apply for permits with the relevant PRC regulatory authorities for, our current or future encryption software. If PRC regulatory authorities request that we change our encryption software, we may have to develop or license replacement software, which could disrupt our business operations. In addition, we may be subject to potential liability for using software that is subsequently deemed to be illegal by the relevant PRC regulatory authorities. These potential liabilities might include fines, product confiscation and criminal sanctions.

**We depend on online advertising for most of our revenues.**

We derive most of our revenues from the sale of online advertising on our Web sites. For the three and six months ended June 30, 2001, advertising revenues represented approximately 77% and 81% of our total revenues, respectively. In addition, our business plan is dependent on the anticipated expansion of online advertising in China and the growth of our revenue is dependent on online advertising.

The online advertising market in China is new and relatively small. Our ability to generate and maintain significant online advertising revenues in China will depend, among other things, on:

- the development of a large base of users possessing demographic characteristics attractive to advertisers;
- downward pressure on online advertising prices;
- the development of independent and reliable means of verifying traffic; and
- the effectiveness of our advertising delivery, tracking and reporting systems.

The development of Web software that blocks Internet advertisements before they appear on a user's screen may hinder the growth of online advertising. The expansion of ad blocking on the Internet may decrease our revenues because when an ad is blocked, it is not downloaded from our ad server. As a result, such advertisements will not be tracked as a delivered advertisement. In addition, advertisers may choose not to advertise on the Internet or on our portal because of the use by third parties of Internet advertisement blocking software.

In addition, an element of our strategy is to diversify our revenue stream by entering into more Web site sponsorship arrangements, by e-business solutions services, by introducing e-commerce services and by generating e-commerce revenue. We may not be successful in implementing this strategy.

Accordingly, we may not be successful in generating significant future online advertising revenue or in diversifying our revenue stream.

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**Our operating results are likely to fluctuate significantly and may differ from market expectations.**

Our annual and quarterly operating results have varied significantly in the past, and may vary significantly in the future, due to a number of factors, many of which are beyond our control. As a result, we believe that year-to-year and quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. It is likely that in some future quarter, our operating results may be below the expectations of public market analysts and investors. In this event, the trading price of our common stock may fall.

**We will not be able to attract visitors, advertisers and e-commerce merchants if we do not maintain and develop the Sohu brand.**

Maintaining and further developing our brand is critical to our ability to expand our user base and our revenues. We believe that the importance of brand recognition will increase as the number of Internet users in China grows. In order to attract and retain Internet users, advertisers and e-commerce partners, we intend to increase substantially our expenditures for creating and maintaining brand loyalty. If our revenues do not increase proportionately, our results of operations and liquidity will suffer.

Our success in promoting and enhancing our brand, as well as our ability to remain competitive, will also depend on our success in offering high quality content, features and functionality. If we fail to promote our brand successfully or if visitors to our portal or advertisers do not perceive our content and services to be of high quality, we may not be able to continue growing our business and attracting visitors, advertisers and e-commerce partners.

**We may need additional capital and we may not be able to obtain it.**

Our capital requirements are difficult to plan in our rapidly changing industry. We currently expect that we will need capital to fund additions to our portal and computer infrastructure, including any acquisitions of complementary assets, technologies or businesses we may pursue, as well as the expansion of our sales and marketing activities.

Our ability to obtain additional financing in the future is subject to a variety of uncertainties, including:

- investors' perceptions of and appetite for Internet-related securities;
- conditions in the U.S. and other capital markets in which we may seek to raise financing;
- our future results of operations, financial condition and cash flows;
- the amount of capital that other PRC entities may seek to raise in foreign capital markets;
- PRC governmental regulation of foreign investment in Internet companies;
- economic, political and other conditions in the PRC;
- PRC governmental policies relating to foreign currency borrowings; and

- any new laws and regulations that may require various PRC government approvals for securities offerings by companies engaged in the Internet sector in the PRC.

Our inability to raise additional funds on favorable terms, or at all, could force us to scale back our planned expenditures, which could adversely affect our growth prospects. For more information on our capital and financing requirements, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources.”

**If we fail to establish and maintain relationships with content providers, e-commerce merchants and technology providers, we may not be able to attract and retain users.**

We rely on a number of third party relationships to attract traffic and provide content in order to make our portal more attractive to users and advertisers. Some content providers have recently increased the fees they charge us for their content. This trend could increase our operating expenses and could adversely affect our ability to obtain content at an economically acceptable cost. Most of our arrangements with content providers are short-term and may be terminated at the convenience of the other party. In addition, much of the third party content provided to our portal is also available from other sources or may be provided to other Internet companies. If other Internet companies present the same or similar content in a superior manner, it would adversely affect our visitor traffic.

Our business also depends significantly on relationships with leading e-commerce merchants and technology and infrastructure providers and the licenses that the technology providers have granted to us. Our competitors may seek to establish the same relationships as we have, which may adversely affect us. We may not be able to maintain these relationships or replace them on commercially attractive terms.

**We depend on key personnel and our business may be severely disrupted if we lose the services of our key executives.**

Our future success is heavily dependent upon the continued service of our key executives, particularly Dr. Charles Zhang, who is the founder, President and chief executive officer of our company and the founder and President of Beijing Sohu. We rely on his expertise in our business operations and on his personal relationships with some of our principal stockholders, the relevant regulatory authorities, our customers and suppliers and Beijing Sohu. If one or more of our key executives are unable or unwilling to continue in their present positions, we may not be able to easily replace them and our business may be severely disrupted. In addition, if any of these key executives joins a competitor or forms a competing company, we may lose customers and suppliers and incur additional expenses to recruit and train personnel. Each of our executive officers has entered into a confidentiality, non-competition and non-solicitation agreement with us. These officers also have employment agreements with Beijing ITC, our PRC operating subsidiary, which contain substantially similar confidentiality and non-competition undertakings. However, the degree of protection afforded to an employer pursuant to confidentiality and non-competition undertakings governed by PRC law may be more limited when compared to the degree of protection afforded under the laws of other jurisdictions. We do not maintain key-man life insurance for any of our key executives.

**Rapid growth and a rapidly changing operating environment strain our limited resources.**

We have limited operational, administrative and financial resources, which may be inadequate to sustain the growth we want to achieve. As our audience and their Internet use increase, as the demands of our audience and the needs of our customers change and as the volume of online advertising and e-commerce activities increases, we will need to increase our investment in our network infrastructure, facilities and other areas of operations. If we are unable to manage our growth and expansion effectively, the quality of our services could deteriorate and our business may suffer. Our future success will depend on, among other things, our ability to:

- adapt our services and maintain and improve the quality of our services;
- continue training, motivating and retaining our existing employees and attracting and integrating new employees; and
- developing and improving our operational, financial, accounting and other internal systems and controls.

**Our advertising pricing model, which is based on charging a fixed fee to display advertisements for a specified time period, may not be profitable.**

There are currently no industry standard pricing models used to sell advertising on the Internet. This makes it difficult to project our future advertising rates and revenues. The models we adopt may prove not to be profitable. A significant portion of our advertising revenues in 2000 and 2001 were derived from charging a fixed fee to display an advertisement over a given time period. To the extent that minimum guaranteed impression levels are not met, we are required to provide additional impressions after the contract term and we accordingly defer the related revenue.

**We may not be able to track the delivery of advertisements through our portal, which may make us less attractive to potential advertisers.**

It is important to advertisers that we accurately measure the demographics of our user base and the delivery of advertisements through our portal. Companies may choose not to advertise on our portal or may pay less for advertising if they do not perceive our portal to be reliable. We depend on third parties to provide us with some of these measurement services. If they are unable to provide these services in the future, we would need to perform these services ourselves or obtain these services from other providers. This could cause us to incur additional costs or cause interruptions or slowdowns in our business during the time we are

replacing these services. We are currently implementing additional systems designed to collect information on our users. We may not be able to implement these systems successfully.

**The loss of one of our significant advertisers would reduce our advertising revenues as well as materially and adversely affect our financial conditions and results of operations.**

We depend on a small group of advertisers for a significant portion of our total revenues. During the three and six months ended June 30, 2001, our five largest advertisers accounted for approximately 28% and 28% of our total advertising revenues. Our business, financial condition and results of operations would be adversely affected by the loss of one or more of our significant advertisers or a decrease in the volume of advertising by any these advertisers.

**Our strategy of acquiring complementary assets, technologies and businesses may fail and may result in equity or earnings dilution.**

As a component of our growth strategy, we have acquired and intend to actively identify and acquire assets, technologies and businesses that are complementary to our existing portal business. Our acquisitions could result in the use of substantial amounts of cash, potentially dilutive issuances of equity securities, significant amortization expenses related to goodwill and other intangible assets and exposure to undisclosed or potential liabilities of acquired companies. Moreover the resources expended in identifying and consummating acquisitions may be significant. Furthermore, any acquisitions we decide to pursue may be subject to the approval of the relevant PRC governmental authorities, as well as any applicable PRC rules and regulations.

**We will rely on dividends and other distributions on equity paid by our wholly-owned operating subsidiaries to fund any cash requirements we may have.**

We are a holding company with no operating assets other than the shares of Beijing ITC and Beijing Sandhill, our wholly-owned subsidiaries in the PRC that own and conduct our Internet business. We will rely on dividends and other distributions on equity paid by Beijing ITC and Beijing Sandhill for our cash requirements in excess of any cash raised from investors and retained by us. If Beijing ITC and Beijing Sandhill incur debt on their own behalf in the future, the instruments governing the debt may restrict Beijing ITC and Beijing Sandhill's ability to pay dividends or make other distributions to us. In addition, PRC legal restrictions permit payment of dividends by Beijing ITC and Beijing Sandhill only out of their net income, if any, determined in accordance with PRC accounting standards and regulations. Under PRC law, Beijing ITC and Beijing Sandhill are also required to set aside a portion of their net income each year to fund certain reserve funds. These reserves are not distributable as cash dividends.

Beijing ITC and Beijing Sandhill have incurred losses since their inceptions and are expected to continue to incur losses in the foreseeable future. Therefore, we have not received any dividends or other distributions from Beijing ITC and Beijing Sandhill in the past and do not expect any dividends in the foreseeable future.

**We may not have exclusive rights over the mark "Sohu.com" in certain areas.**

We have applied for registration of the "Sohu.com" mark in Hong Kong and Taiwan, and plan to apply for registration in Malaysia and Singapore. Completion of these applications is subject to prior rights in the relevant jurisdictions. Any rejection of those applications may adversely affect our legal rights over the mark "Sohu.com" in those countries and regions.

**Unauthorized use of our intellectual property by third parties, and the expenses incurred in protecting our intellectual property rights, may adversely affect our business.**

We regard our copyrights, service marks, trademarks, trade secrets and other intellectual property as critical to our success. Unauthorized use of our intellectual property by third parties may adversely affect our business and reputation. We rely on trademark and copyright law, trade secret protection and confidentiality agreements with our employees, customers, business partners and others to protect our intellectual property rights. Despite our precautions, it may be possible for third parties to obtain and use our intellectual property without authorization. Furthermore, the validity, enforceability and scope of protection of intellectual property in Internet-related industries is uncertain and still evolving. In particular, the laws of the PRC and certain other countries are uncertain or do not protect intellectual property rights to the same extent as do the laws of the United States. Moreover, litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Future litigation could result in substantial costs and diversion of resources.

**We may be subject to intellectual property infringement claims, which may force us to incur substantial legal expenses and, if determined adversely against us, materially disrupt our business.**

We cannot be certain that our products and services do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. We have in the past been, and may in the future be, subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. In particular, if we are found to have violated the intellectual property rights of others, we may be enjoined from using such intellectual property, and we may incur licensing fees or be forced to develop alternatives. We may incur substantial expenses in defending against these third party infringement claims, regardless of their merit. Successful infringement claims against us may result in substantial monetary liability or may materially disrupt the conduct of our business.

**We may be subject to, and may expend significant resources in defending against, claims based on the content and services we provide over our portal.**

As our services may be used to download and distribute information to others, there is a risk that claims may be made against us for defamation, negligence, copyright or trademark infringement or other claims based on the nature and content of such information. Furthermore, we could be subject to claims for the online activities of our visitors and incur significant costs in their defense. In the past, claims based on the nature and content of information that was posted online by visitors have been made in the United States against companies that provide online services. We do not carry any liability insurance against such risks.

We could be exposed to liability for the selection of listings that may be accessible through our portal or through content and materials that our visitors may post in classifieds, message boards, chat rooms or other interactive services. If any information provided through our services contains errors, third parties may make claims against us for losses incurred in reliance on the information. We also offer Web-based e-mail services, which expose us to potential liabilities or claims resulting from:

- unsolicited e-mail;
- lost or misdirected messages;
- illegal or fraudulent use of e-mail; or
- interruptions or delays in e-mail service.

Investigating and defending any such claims may be expensive, even if they do not result in liability.

**Risks relating to our markets**

**We rely on online advertising sales for a significant portion of our future revenues, but the Internet has not been proven as a widely accepted medium for advertising.**

We expect to derive most of our revenue for the foreseeable future from online advertising, and to a lesser extent, from e-commerce. If the Internet is not accepted as a medium for advertising, our ability to generate revenues will be adversely affected.

The acceptance of the Internet as a medium for advertising depends on the development of a measurement standard. No standards have been widely accepted for the measurement of the effectiveness of online advertising. Industry-wide standards may not develop sufficiently to support the Internet as an effective advertising medium. If these standards do not develop, advertisers may choose not to advertise on the Internet in general or through our portals or search engines.

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**Many of our current and potential advertising and e-commerce customers have only limited experience using the Internet for advertising or commerce purposes, and may not be willing to fully embrace the products and services we offer, which would adversely affect our future revenues and business expansion.**

The online advertising and e-commerce markets are new and rapidly evolving, particularly in China. As a result, many of our current and potential advertising and e-commerce customers have limited experience using the Internet for advertising or commerce purposes and historically have not devoted a significant portion of their advertising and sales budgets to Internet-based advertising and e-commerce. Moreover, customers that have invested substantial resources in other methods of conducting business may be reluctant to adopt a new strategy that may limit or compete with their existing efforts. In addition, companies may choose not to advertise or sell their products on our portal if they do not perceive our online advertising and e-commerce platform to be effective or our audience demographics to be desirable. The failure to successfully address these risks or execute our business strategy would significantly reduce our profitability.

**We face intense competition which could reduce our market share and adversely affect our financial performance.**

The PRC Internet market is characterized by an increasing number of entrants because, among other reasons, the barriers to entry are relatively low. The market for Internet services and products, particularly Internet search and retrieval services and online advertising, is intensely competitive. In addition, the Internet industry is relatively new and constantly evolving and, as a result, our competitors may better position themselves to compete in this market as it matures.

There are many companies that provide or may provide Web sites and online destinations targeted at Internet users in China. Some of our major competitors in China are major United States Internet companies, such as Yahoo! Inc. In addition, we may face competition from existing or new domestic PRC Internet companies that are either affiliated with large corporations such as America Online and Softbank Corporation, or controlled or sponsored by PRC government entities. These competitors may have certain advantages over us, including:

- substantially greater financial and technical resources;
- more extensive and well developed marketing and sales networks;

- better access to original content;
- greater global brand recognition among consumers; and
- larger customer bases.

With these advantages, our competitors may be better able to:

- develop, market and sell their products and services;
- adapt more quickly to new and changing technologies; and
- more easily obtain new customers.

We may not be able to compete successfully against our current or future competitors.

**The telecommunications infrastructure in China, which is not as well developed as in the United States, may limit our growth.**

The telecommunications infrastructure in China is not well developed. Our growth will depend on the PRC government and state-owned enterprises establishing and maintaining a reliable Internet and telecommunications infrastructure to reach a broader base of Internet users in China. The Internet infrastructure, standards, protocols and complementary products, services and facilities necessary to support the demands associated with continued growth may not be developed on a timely basis or at all by the PRC government and state-owned enterprises.

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**We depend on ChinaNet, China Telecom and the Beijing Telecom Administration for telecommunications services, and any interruption in these services may result in severe disruptions to our business.**

Although private Internet service providers exist in China, almost all access to the Internet is maintained through ChinaNet, currently owned by China Telecom, under the administrative control and regulatory supervision of the MII. In addition, local networks connect to the Internet through a government-owned international gateway. This international gateway is the only channel through which a domestic Chinese user can connect to the international Internet network. We rely on this infrastructure and China Telecom to provide data communications capacity primarily through local telecommunications lines. Although the government has announced aggressive plans to develop the national information infrastructure, this infrastructure may not be developed and the Internet infrastructure in China may not be able to support the continued growth of Internet usage. In addition, we will have no access to alternative networks and services, on a timely basis if at all, in the event of any infrastructure disruption or failure.

We may not be able to lease additional bandwidth from the Beijing Telecom Administration on acceptable terms, on a timely basis or at all. In addition, we will have no means of getting access to alternative networks and services on a timely basis, if at all, in the event of any disruption or failure of the network.

**The high cost of Internet access may limit the growth of the Internet in China and impede our growth.**

Access to the Internet in China remains relatively expensive, and may make it less likely for users to access and transact business over the Internet. Unfavorable rate developments could further decrease our visitor traffic and our ability to derive revenues from transactions over the Internet.

**The acceptance of the Internet as a commerce platform in China depends on the resolution of problems relating to fulfillment and electronic payment.**

Our future growth of revenues depends in part on the anticipated expansion of e-commerce activities in China. As China currently does not have a reliable nationwide product distribution network, the fulfillment of goods purchased over the Internet will continue to be a factor constraining the growth of e-commerce. An additional barrier to the development of e-commerce in China is the lack of reliable payment systems. In particular, the use of credit cards or other viable means of electronic payment in sales transactions is not as well developed in China as in some other countries, such as the United States. Various government entities and businesses are working to resolve these fulfillment and payment problems, but these problems are expected to continue to hinder the acceptance and growth of the Internet as a commerce platform in China, which could in turn hinder our growth.

**Risks Related to the Internet and Our Technology Infrastructure**

**To the extent we are unable to scale our systems to meet the increasing PRC Internet population, we will be unable to expand our user base and increase our attractiveness to advertisers and merchants.**

As Web page volume and traffic increase in China, we may not be able to scale our systems proportionately. To the extent we do not successfully address our capacity constraints, our operations may be severely disrupted, and we may not be able to expand our user base and increase our attractiveness to advertisers and merchants.



**Unexpected network interruptions caused by system failures may result in reduced visitor traffic, reduced revenue and harm to our reputation.**

Our portal operations are dependent upon Web browsers, Internet service providers, content providers and other Web site operators in China, which have experienced significant system failures and system outages in the past. Our users have in the past experienced difficulties due to system failures unrelated to our systems and services. Any system failure or inadequacy that causes interruptions in the availability of our services, or increases the response time of our services, as a result of increased traffic or otherwise, could reduce our user satisfaction, future traffic and our attractiveness to users and advertisers.

**Our operations are vulnerable to natural disasters and other events, as we only have limited backup systems and do not maintain any backup servers outside of China.**

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We have limited backup systems and have experienced system failures and electrical outages from time to time in the past, which have disrupted our operations. All of our servers and routers are currently hosted in a single location within the premises of Beijing Telecom Administration. We do not maintain any back up servers outside Beijing. We do not have a disaster recovery plan in the event of damage from fire, floods, typhoons, earthquakes, power loss, telecommunications failures, break-ins and similar events. If any of the foregoing occurs, we may experience a complete system shutdown. We do not carry any business interruption insurance. To improve the performance and to prevent disruption of our services, we may have to make substantial investments to deploy additional servers or one or more copies of our Web sites to mirror our online resources. Although we carry property insurance with low coverage limits, our coverage may not be adequate to compensate us for all losses, particularly with respect to loss of business and reputation, that may occur.

**Concerns about security of e-commerce transactions and confidentiality of information on the Internet may increase our costs, reduce the use of our portal and impede our growth.**

A significant barrier to e-commerce and confidential communications over the Internet has been the need for security. Internet usage could decline if any well-publicized compromise of security occurred. We may incur significant costs to protect against the threat of security breaches or to alleviate problems caused by these breaches. If unauthorized persons are able to penetrate our network security, they could misappropriate proprietary information or cause interruptions in our services. As a result, we may be required to expend capital and resources to protect against or to alleviate these problems.

**Our network operations may be vulnerable to hacking, viruses and other disruptions, which may make our products and services less attractive and reliable.**

Internet usage could decline if any well-publicized compromise of security occurs. "Hacking" involves efforts to gain unauthorized access to information or systems or to cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment. Hackers, if successful, could misappropriate proprietary information or cause disruptions in our service. We may be required to expend capital and other resources to protect our Web site against hackers. We cannot assure you that any measures we may take will be effective. In addition, the inadvertent transmission of computer viruses could expose us to a material risk of loss or litigation and possible liability, as well as materially damage our reputation and decrease our user traffic.

**Political, Economic and Regulatory Risks**

**Regulation and censorship of information distribution in China may adversely affect our business.**

China has enacted regulations governing Internet access and the distribution of news and other information. Furthermore, the Propaganda Department of the Chinese Communist Party has been given the responsibility to censor news published in China to ensure, supervise and control a particular political ideology. In addition, the MII has published implementing regulations that subject online information providers to potential liability for content included on their portals and the actions of subscribers and others using their systems, including liability for violation of PRC laws prohibiting the distribution of content deemed to be socially destabilizing. Because many PRC laws, regulations and legal requirements with regard to the Internet are relatively new and untested, their interpretation and enforcement may involve significant uncertainty. In addition, the PRC legal system is a civil law system in which decided legal cases have limited binding force as legal precedents. As a result, in many cases it is difficult to determine the type of content that may result in liability for a Web site operator.

Periodically, the Ministry of Public Security has stopped the distribution over the Internet of information which it believes to be socially destabilizing. The Ministry of Public Security has the authority to cause any local Internet service provider to block any Web site maintained outside China at its sole discretion. If the PRC government were to take action to limit or eliminate the distribution of information through our portal or to limit or regulate current or future applications available to users of our portal, our business would be affected.

The State Secrecy Bureau, which is directly responsible for the protection of state secrets of all PRC government and Chinese Communist Party organizations, is authorized to block any Web site it deems to be leaking state secrets or failing to meet the relevant regulations relating to the protection of state secrets in the distribution of online information. Under the applicable regulations, we may be held liable for any content transmitted on our portal. Furthermore, where the transmitted content clearly violates the laws of the PRC, we will be required to delete it. Moreover, where the transmitted content is considered suspicious, we

are required to report such content. We must also undergo computer security inspections, and if we fail to implement the relevant safeguards against security breaches, we may be shut down. In addition, under recently adopted

21 regulations, Internet companies which provide bulletin board systems, chat rooms or similar services, such as our company, must apply for the approval of the State Secrecy Bureau. As the implementing rules of these new regulations have not been issued, however, we do not know how or when we will be expected to comply, or how our business will be affected by the application of these regulations.

### **Political and economic policies of the PRC government could affect our business.**

All of our business, assets and operations are located in China and all of our revenues are derived from our operations in China. Accordingly, our business could be adversely affected by changes in political, economic or social conditions in China, adjustments in PRC government policies or changes in laws and regulations.

The economy of China differs from the economies of most countries belonging to the Organization for Economic Cooperation and Development in a number of respects, including:

- structure;
- level of government involvement;
- level of development;
- level of capital reinvestment;
- growth rate;
- control of foreign exchange; and
- methods of allocating resources.

Since 1949, China has been primarily a planned economy subject to a system of macroeconomic management. Although the Chinese government still owns a significant portion of the productive assets in China, economic reform policies since the late 1970s have emphasized decentralization, autonomous enterprises and the utilization of market mechanisms. We cannot predict what effects the economic reform and macroeconomic measures adopted by the Chinese government may have on our business or results of operations.

### **The PRC legal system embodies uncertainties which could limit the legal protections available to us and you.**

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the PRC government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. Our PRC operating subsidiaries, Beijing ITC and Beijing Sandhill, are wholly foreign owned enterprises, or WFOEs, which are enterprises incorporated in mainland China and wholly-owned by foreign investors. Beijing ITC and Beijing Sandhill are subject to laws and regulations applicable to foreign investment in mainland China. However, these laws, regulations and legal requirements are relatively recent, and their interpretation and enforcement involve uncertainties. These uncertainties could limit the legal protections available to us and other foreign investors, including you. In addition, we cannot predict the effect of future developments in the PRC legal system, particularly with regard to the Internet, including the promulgation of new laws, changes to existing laws or the interpretation or enforcement thereof, or the preemption of local regulations by national laws.

### **Restrictions on currency exchange may limit our ability to utilize our revenues effectively.**

Substantially all of our revenues and operating expenses are denominated in Renminbi. The Renminbi is currently freely convertible under the “current account,” which includes dividends, trade and service-related foreign exchange transactions, but not under the “capital account,” which includes foreign direct investment.

Currently, Beijing ITC and Beijing Sandhill may purchase foreign exchange for settlement of “current account transactions,” including payment of dividends, without the approval of the State Administration for Foreign Exchange, or SAFE. Beijing ITC and Beijing Sandhill may also retain foreign exchange in its current account (subject to a ceiling approved by the SAFE) to satisfy foreign exchange liabilities or to pay dividends. However, the relevant PRC governmental authorities may limit or eliminate our ability to purchase and retain foreign currencies in the future.

Since a significant amount of our future revenues will be in the form of Renminbi, the existing and any future restrictions on currency exchange may limit our ability to utilize revenue generated in Renminbi to fund our business activities outside China, if any, or expenditures denominated in foreign currencies.

Foreign exchange transactions under the capital account are still subject to limitations and require approvals from the SAFE. This could affect Beijing ITC’s and Beijing Sandhill’s ability to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions from us.

## **We may suffer currency exchange losses if the Renminbi depreciates relative to the U.S. Dollar.**

Our reporting currency is the U.S. Dollar. However, substantially all of our assets and revenues are denominated in Renminbi. Our assets and revenues as expressed in our U.S. Dollar financial statements will decline in value if the Renminbi depreciates relative to the U.S. Dollar. Very limited hedging transactions are available in China to reduce our exposure to exchange rate fluctuations. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure, if at all. In addition, our currency exchange losses may be magnified by PRC exchange control regulations that restrict our ability to convert Renminbi into U.S. Dollars.

## **It may be difficult to enforce any civil judgments against us or our board of directors or officers, because most of our assets are located outside of the United States.**

Although we are incorporated in the State of Delaware, substantially all of our assets are located in the PRC. As a result, it may be difficult for investors to enforce outside the United States in any actions brought against us in the United States, including actions predicated upon the civil liability provisions of the federal securities laws of the United States or of the securities laws of any state of the United States. In addition, certain of our directors and officers (principally in the PRC) and all or a substantial portion of their assets may be located outside the United States. As a result, it may not be possible for investors to effect service of process within the United States upon those directors and officers, or to enforce against them or us judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the federal securities laws of the United States or of the securities laws of any state of the United States. We have been advised by our PRC counsel that, in their opinion, there is doubt as to the enforceability in the PRC, in original actions or in actions for enforcement of judgments of United States courts, of civil liabilities predicated solely upon the federal securities laws of the United States or the securities laws of any state of the United States.

## **Risks Related to the Market for Our Common Stock**

### **The market price of our common stock has been and will likely continue to be volatile.**

The market price of our common stock has been volatile, and is likely to continue to be so. In addition, the Nasdaq Stock Market's National Market has from time to time experienced significant price and volume fluctuations that have affected the market prices for the securities of technology companies, particularly Internet companies. As a result, investors in our shares may experience a decrease in the value of their shares regardless of our operating performance or prospects.

### **The sale or availability for sale of substantial amounts of our common stock could adversely affect its market price.**

There were approximately 35,625,716 shares of our common stock outstanding as of August 10, 2001, as well as options and warrants to purchase approximately an additional 5,365,494 shares of our common stock. Of the outstanding shares, 26,624,216 were issued prior to the initial public offering of our common stock. These shares are either freely tradeable without restriction under Rule 144(k) under the Securities Act or are tradable subject to the notice, volume and manner of sale restrictions of Rule 144 under the Securities Act.

Sohu issued 4,600,000 shares of common stock in connection with the initial public offering. All of these shares are freely tradable without restriction unless they are held by our "affiliates" as that term is defined in Rule 144 under the Securities Act.

On October 18, 2000, we issued an aggregate of 4,401,500 shares of our common stock to the former stockholders of ChinaRen in connection with our acquisition of that company. Commencing on October 18, 2001, these shares will be tradable subject to the notice, volume and manner of sale restrictions of Rule 144.

A number of our stockholders, including some of the former stockholders of ChinaRen, are parties to an agreement with us that provides these stockholders with the right to require us to register the sale of shares owned by them. Registration of these shares of our common stock would permit the sale of these shares without regard to the restrictions of Rule 144.

### **We are controlled by a small group of our existing stockholders, whose interests may differ from other stockholders.**

Our three largest stockholders currently beneficially own approximately 64% of the outstanding shares of common stock. Accordingly these three stockholders acting together will have significant influence in determining the outcome of any corporate transaction or other matter submitted to the stockholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets, election of directors and other significant corporate actions. They will also have significant influence in preventing or causing a change in control. In addition, without the consent of these stockholders, we could be prevented from entering into transactions that could be beneficial to us. The interests of these stockholders may differ from the interests of the other stockholders.

Holders of a majority of the outstanding shares of our common stock are parties to an agreement under which they have agreed to vote together in favor of a nominee of one of our stockholders to our board of directors. As a result of their voting power, they will

have the ability to cause that nominee to be elected.

### **Anti-takeover provisions of the Delaware General Corporation Law, our certificate of incorporation and Sohu's Stockholder Rights Plan could delay or deter a change in control.**

Some provisions of our certificate of incorporation and bylaws, as well as various provisions of the Delaware General Corporation Law, may make it more difficult to acquire our company or effect a change in control of our company, even if an acquisition or change in control would be in the interest of our stockholders or if an acquisition or change in control would provide our stockholders with a premium for their shares over then current market prices. For example, our certificate of incorporation provides for the division of the board of directors into two classes with staggered two-year terms and provides that stockholders have no right to take action by written consent and may not call special meetings of stockholders, each of which may make it more difficult for a third party to gain control of our board in connection with, or obtain any necessary stockholder approval for, a proposed acquisition or change in control.

In addition, we have adopted a stockholder rights plan under the terms of which, in general, if a person or group acquires more than 20% of the outstanding shares of common stock, all other Sohu stockholders would have the right to purchase securities from Sohu at a substantial discount to those securities' fair market value, thus causing substantial dilution to the holdings of the person or group which acquires more than 20%. The stockholder rights plan may inhibit a change in control and, therefore, could adversely affect the stockholders' ability to realize a premium over the then-prevailing market price for the common stock in connection with such a transaction.

### **The power of our Board of Directors to designate and issue shares of preferred stock could have an adverse effect on holders of our common stock.**

Our certificate of incorporation authorizes our board of directors to designate and issue one or more series of preferred stock, having rights and preferences as the board may determine, and any such designations and issuances could have an adverse effect on the rights of holders of common stock.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

### **FOREIGN CURRENCY EXCHANGE RATE RISK**

The majority of our revenues, expenses and liabilities are denominated in Chinese renminbi. Thus, revenues and operating results may be impacted by exchange rate fluctuations in the renminbi when financial results are translated in U.S. dollars on consolidation. Currency fluctuations and restrictions on currency exchange may adversely affect our business, including limiting the ability to convert Chinese renminbi into foreign currencies

24 and, if the renminbi were to decline in value, reducing revenue in U.S. dollar terms. We have not tried to reduce exposure to exchange rate fluctuations by using hedging transactions but may choose to do so in the future. We may not be able to do this successfully. Accordingly, we may experience economic losses and negative impacts on earnings and equity as a result of foreign exchange rate fluctuations. The effect of foreign exchange rate fluctuations on us in the three months ended June 30, 2001 was not material.

### **INVESTMENT RISK**

In the year 2000, we invested in a privately-held company for business and strategic purposes. This investment is included in other assets and is accounted for under the cost method as ownership less than 5%, and we do not have the ability to exercise significant influence over its operations. For investments in privately-held companies, we identify and record impairment losses when events and circumstances indicate that such assets have been permanently impaired.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

There are no material legal proceedings pending or, to our knowledge, threatened against us. From time to time we become subject to legal proceedings and claims in the ordinary course of our business. Such legal proceedings or claims, even if not meritorious, could result in the expenditure of significant financial and management resources.

### **ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

On July 17, 2000, we completed an underwritten initial public offering of our common stock pursuant to a Registration Statement on Form S-1 (SEC file No. 333-96137), which became effective on July 10, 2000. Public trading of the common stock offered in the initial public offering commenced on July 12, 2000. The U.S. underwriters for the offering were Credit Suisse First Boston Corporation, BOCI Asia Limited and Donaldson, Lufkin & Jenrette Securities Corporation and the International managers were Credit Suisse First Boston (Hong Kong) Limited, BOCI Asia Limited and Donaldson, Lufkin & Jenrette Asia Limited. We sold an aggregate of 4,600,000 shares of common stock in the offering at a price to the public of \$13 per share, resulting in gross proceeds of \$59.8 million. Our net proceeds, after deduction of the underwriting discount of \$4.2 million and other offering expenses of \$3.2 million, were approximately \$52.4 million. All shares sold in the offering were sold by us.

No proceeds of the offering were used during the quarter ended June 30, 2001.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On May 17, 2001, Sohu held its Annual Meeting of Stockholders. At the meeting, the stockholders elected as directors Charles Zhang (with 23,104,488 affirmative votes and 629,446 votes withheld), Edward B. Roberts (with 23,717,608 affirmative votes and 16,326 votes withheld), James McGregor (with 23,717,608 affirmative votes and 16,326 votes withheld), George Chang (with 23,715,008 affirmative votes and 18,926 votes withheld), Thomas Gurnee (with 23,717,608 affirmative votes and 16,326 votes withheld), and Philip Revzin (with 23,717,608 affirmative votes and 16,326 votes withheld).

The stockholders also approved an amendment to Sohu's 2000 Incentive Stock Option Plan to increase the number of shares of common stock authorized for issuance under the plan from 2,340,000 to 7,000,000 (with 18,770,684 shares voting for, 657,109 against, and 18,657 abstaining).

The stockholders also ratified the appointment of PricewaterhouseCoopers as Sohu's independent accountants for the fiscal year ending December 31, 2001 (with 23,723,452 shares voting for, 5,767 against, and 4,715 abstaining).

### ITEM 5. OTHER INFORMATION

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On June 22, 2001, Philip Revzin resigned as a Director of Sohu.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None.

(b) Reports on Form 8-K.

None.

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**SOHU.COM INC.**

Dated: August 10, 2001

**By: /s/Derek Palaschuk**

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**Chief Financial Officer & Senior Vice President (Principal Financial Officer)**

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