TECHNOLOGY

Yahoo Forges Long-Awaited Microsoft Pact

By PETE BARLAS, INVESTOR'S BUSINESS DAILY

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Yahoo (YHOO) investors greeted the company's long-awaited pairing with **Microsoft** (MSFT) on Wednesday with all the excitement of a funeral.

Shares of the Web's leading portal plunged 12% to close at 15.14 after the company outlined details of a 10-year deal to use Microsoft's search technology on Yahoo-owned sites â€" a partnership that will not include what investors hoped would be a large upfront payment from the software giant.

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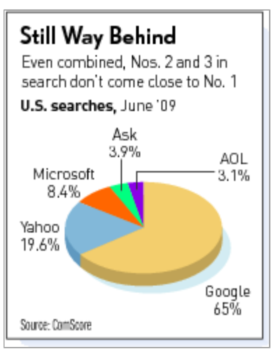
Though Microsoft shares rose a bit to close at 23.80, many question whether the two companies can mount a serious challenge to **Google** (GOOG), which dominates the lucrative market for search ads.

Whatever upside Yahoo sees from the deal is a far cry from the riches the company could have gotten a year ago if it had agreed to Microsoft's overture of an outright takeover, says Scott Kessler, an analyst for Standard & Poor's equity research services.



Hoping to get a larger share of the growing multibillion-dollar online ad market, Microsoft had offered as much as $33 a share â€" more than $45 billion â€" but walked away from negotiations after Yahoo's CEO at the time asked for more money.

"The market is telling you that the perceived winner is Microsoft, and it makes a lot of sense," Kessler said. "From Yahoo's perspective, there's no question that a sale at any price that was offered would have been a more compelling transaction than this."

More recent talks between the two companies sparked rumors that Yahoo would get $1 billion upfront. Before Wednesday's sell-off, Yahoo shares had been climbing in the last few weeks in anticipation of a more lucrative deal, says Youssef Squali, analyst for Jefferies & Co.

"The expectations were better than the reality," he said.

Under the terms, Yahoo will merge all of its search technologies with Microsoft's. Microsoft will install its new search service Bing on all of Yahoo's Web properties, including its newly redesigned home page. And Yahoo will take charge of all ad sales.

The deal still needs regulatory approval, which the companies expect by early next year.

With the pairing fully in place, Yahoo expects its operating income to increase by $500 million annually. It also expects to increase its annual operating cash flow by $275 million annually, saving $200 million a year on capital spending by outsourcing its search operations.

As part of the agreement, Yahoo will get an 88% share of ad sales from its Web properties.

Yahoo shares ad revenue with partner sites that carry its ads, but this will be the first time it splits sales from ads posted on its own Web sites, Squali says.

"On their own, they keep 100% of whatever they kill," he said. "They are going to take a 12% revenue hit (from ads sold on the site)."

Yahoo CEO Carol Bartz conceded as much in a conference call Wednesday morning.

"Our revenue will come down a bit due to the revenue share," she said.

Yahoo CEO Carol Bartz had said she'd want a "boatload" of money to hand search to Microsoft. She got no upfront payment Wednesday. AP View Enlarged Image

Despite vows to get a bigger share of the market, Microsoft has failed to make headway against Google in Web search.

Its Bing appears to be gaining share, but still ranked a distant third to Google and Yahoo in June with 8.4% of all Web searches in the U.S. Google ranked first with 65% followed by Yahoo with 19.6%, according to market tracker comScore.

The 24 months Yahoo and Microsoft will need to complete the merger could work in Google's favor, says Danny Sullivan, editor in chief of Search Engine Land, an online newsletter.

"Throwing two smaller things together and having up to a 24-month delayed implement gives Google another two years to keep getting stronger," he said.

Yahoo is risking a bigger drop-off in search-ad revenue if users reject Bing on Yahoo properties, says Jefferies & Co.'s Squali.

"Eighty-eight percent of zero is still zero," he said. "Microsoft is not guaranteeing the revenue. They are just guaranteeing the revenue share."

Advertisers are already voicing concerns about what options they will have when Yahoo and Microsoft complete the deal.

Some want to advertise only on Yahoo; others want to stick with Bing only, says Danielle Leitch, executive vice president of client strategy for MoreVisibility, a search-marketing firm that helps companies advertise online.

"If the value of a Yahoo lead isn't as good as the value of a Bing lead, then it could hurt you," she said.

Bing advertisers could see less return on their ad spending from ads shown on Yahoo sites, because the two properties attract different audiences, Leitch says.

"(The partnership) might dilute the value of that traffic," she said.

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