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Online giants explore a tie-in

A Yahoo-Microsoft pact would target Google

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By Elise Ackerman and Jack Davis

Friday's dramatic bounce in Yahoo's stock price on reports of a deal with Microsoft reflects the pressure facing the third- and second-largest Internet companies as they struggle to gain market share from Google.

Microsoft was reported early in the day to be pursuing a $50 billion deal to buy Yahoo. Later stories reported that the talks had ended, sending Yahoo's shares lower, but that the two companies were still discussing some kind of partnership.

Behind Friday's flurry is the fact that Yahoo is the only meaningful acquisition Microsoft can make to significantly strengthen its Internet business, said Ben Schachter, an analyst with UBS.

That's in part because promising Internet advertising companies like DoubleClick have shown a clear preference for being bought by Mountain View-based Google, rather than Microsoft or Yahoo, making it hard for those two to expand into areas not yet dominated by Google.

Last year, Microsoft sold $2.3 billion in Internet advertising, compared with $4.6 billion for Yahoo and $7.3 billion for Google. Internet advertising is becoming an increasingly big part of the overall ad market, as companies shift their dollars online.

While Microsoft would prefer to create its own successes, it's not clear it can do that on the Internet. "They are not getting any traction," Schachter said.

Microsoft and Yahoo have explored working together since Microsoft moved its advertising sales onto its own platform - and off of Yahoo's - in the spring of 2006. One idea, strongly rebuffed by Yahoo, was that Microsoft take an equity stake in Yahoo while simultaneously spinning off its Internet division and folding it into Yahoo.

"My impartial advice to Microsoft is that you have no chance," Yahoo Chief Executive Terry Semel said last May after the proposal was leaked. Semel added that it would not be smart to sell "your right arm while keeping your left."

Insiders say Yahoo is still not interested in putting itself up for sale. While the company declined to comment on Friday's rumor roller coaster, executives have repeatedly expressed confidence in Yahoo's efforts to succeed alone.

In an interview with the Mercury News last week, Semel said he is confident in Yahoo's strategy to sell advertising both on its own network of Web sites and throughout the Internet.

The strategy has included a wide-ranging advertising partnership with more than 260 newspapers, as well as with eBay and Viacom. Yahoo also purchased Right Media, an online advertising exchange that allows Yahoo to broker advertising sales between any advertiser and Web site, regardless of whether they are Yahoo affiliates.

Most important, Yahoo redesigned its advertising software to be more competitive with Google. Code-named "Panama," the system was launched in the United States at the end of March.

Some analysts have calculated that the effect of these changes will increase Yahoo's market value 35 percent this year.

Friday's roller-coaster ride started with a New York Post report that Microsoft was ready to bid $50 billion for Yahoo. That news boosted the stock 18 percent in midday trading Friday. Yahoo closed at $30.98, up about 10 percent, after a sell-off followed a Wall Street Journal report that the talks between the companies were no longer active.

"I think there are probably as many forces against doing this deal as it would be for it," said Glover Lawrence, an investment banker with McNamee Lawrence.

While the combined company would benefit from the largest audience on the Web, it would face the challenge of blending two dramatically different corporate cultures.

Microsoft's 71,000 employees are used to developing - and selling - software; while Yahoo's 11,400 employees primarily create Internet services, program online content and sell advertising.

There is also the risk that key Yahoo talent would defect to Google, and there is no guarantee that the new entity would be able to retain current levels of market share.

And even if the two combined, the "Google effect" would remain powerful. According to recent calculations by the Bank of America, Google has 65 percent of the search advertising market, while Microsoft and Yahoo combined have just 27 percent.

Google grew to dominance, first by offering better search results than its competitors, and then by cleverly ranking the text-based ads that run alongside search results so that the most popular (and lucrative) ads show up first.

Yahoo does better than Google in display advertising. But Google's $3.1 billion purchase of DoubleClick last month could end up jeopardizing that lead. Microsoft reportedly was ready to match Google's bid, but DoubleClick preferred to enter into exclusive negotiations with Google, industry sources say.

"To survive going forward, Microsoft needs to have a robust online strategy and Live.com/MSN just doesn't cut it," Charlene Li, an analyst with Forrester Research, wrote Friday in her blog. Li said she thought a deal made sense, "but in the end it's going to be so hard that I don't think it will happen."