Microsoft sees size as search answer in Yahoo deal

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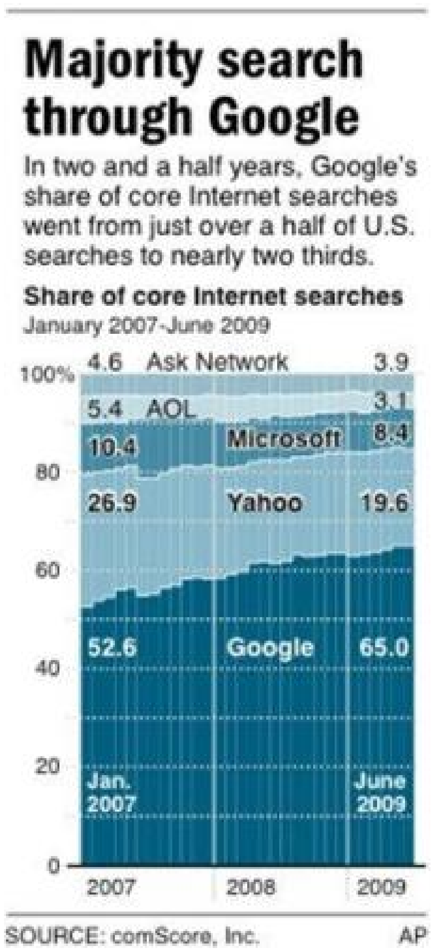

Graphic shows the share of core Internet searches of Google, Yahoo, Microsoft, AOL and Ask Networks

(AP) -- Microsoft is hoping that a long-term partnership with rival

Yahoo will give it the size and insight it needs to bring in more traffic, more advertisers and ultimately more revenue.

By handling Yahoo Inc.'s searches along with its own, Microsoft Corp. can learn more quickly what works and what doesn't. A smarter search engine might draw more Internet users, and more advertisers could follow, driving up prices.

Size, though, may wind up being far from the magic bullet that Microsoft is counting on in forging a 10-year partnership to power all Yahoo searches.

Search leader Google Inc. has had a head start in technical development, and Microsoft already has had plenty of search queries to analyze - yet it remains stuck at No. 3. Adding more data might not make a difference.

"They have lots of scale. They have lots of traffic. Even being the third-place player, they have huge amounts of data to understand their own relevancy," said Danny Sullivan, editor of the search news site Searchengineland.com. "I just don't know why they keep putting that argument out."

The deal still needs regulatory review on such issues as whether it will promote or hinder competition and how the two companies will share the personal data collected in searches.

If approved, Microsoft's technology will process Yahoo's searches behind the scenes. The only nod to Microsoft will appear - with credit placed at the bottom of the page - when a user gets results from a Web search.

In exchange, Microsoft will keep 12 percent of the ad revenue those searches generate. That's a better deal for Yahoo than most agreements of this sort, though the terms go up for review halfway through the deal.

Microsoft has yet to turn a profit on its search and advertising business despite having invested billions.

The software maker's stockholders so far have been guardedly positive about the deal, perhaps because it did not require a $9 billion upfront payment to Yahoo, a condition of a similar deal proposed last year. If Microsoft can't use this partnership to improve its search finances, though, they will eventually run out of patience.

Microsoft expects to spend up to $700 million to get the arrangement up and running, something that could take two years to fully deploy worldwide. It may spend up to $200 million within the next 12 months alone.

But the company believes it's worth it.

With the partnership, Microsoft will funnel Yahoo's nearly 3 billion monthly Web searches. Add that to the 1 billion Microsoft gets on its own, and the software maker will quadruple the queries it processes, allowing its search engine to gain even more insight into how to improve the experience.

Every move a search user makes is fed back into the system, so when the next person comes along with a similar problem, the search engine is a little bit smarter about solving it. For example, if five people in a row click on the fifth link on the results page for "Seattle Space Needle," the search engine - a sophisticated computer program - might try moving that link up to the top.

When search results give people what they're looking for right away, they're more likely to come back. It's a case of the sum totaling more than its parts: The deal is about more than simply combining search traffic from the two sites.

More people doing more searching on Microsoft-powered sites should then attract more companies wanting to peddle their products through short text ads next to search results. Some may not have bothered advertising on Microsoft and Yahoo separately, because as separate sites their audiences were too small to make up for the hassle of recreating Google search ad campaigns on a second and even a third system. Those advertisers may be enticed by the convenience and reach of this partnership, or by the idea of having a solid second place to spend their ad dollars to keep Google in check.

A bigger number of ads in the hopper gives Microsoft's technology a better chance of plucking out one that entices someone to click. The more times Microsoft watches someone click an ad - or not - the better its formula becomes for making the right match.

And because search ads are sold auction-style, more advertisers vying for those spots should drive up prices, ultimately helping Microsoft eke out a bit more from every ad it sells.

Right now, Microsoft estimates that Google gets 7 cents in ad revenue for every search, while Yahoo gets 4.3 cents and Microsoft gets 3.9 cents, according to a PowerPoint slide Microsoft mistakenly posted online.

Once Microsoft is handling Yahoo's searches, Microsoft predicts revenue per search for both companies will rise to 5 cents. Subtracting the commission Microsoft will pay Yahoo, Microsoft expects to start making a "decent" return of $400 million.

"The number of searchers is a vital driver of success," said Tim

Cadogan, CEO of online advertising company OpenX and a former senior vice president in Yahoo's advertising division. "Being able to get nearly 30 percent catapults Microsoft from a tougher position to a more viable place from which they can build."

And build it must. Google gets about two-thirds of U.S. search queries, according to comScore Inc. Yahoo handled about a fifth of U.S. searches in June, and Microsoft fielded less than half of that. The partnership would bring the two companies' combined share to nearly 30 percent, still less than half of Google's total.

Staying a distant second to Google will leave Microsoft perpetually playing catch-up while Google keeps getting better. In other words, there are almost never enough data.

And that assumes size is all that's holding Microsoft back, a premise that Gartner analyst Andrew Frank described as "an overly simplistic view of Google's accomplishments."

Google had a head start on Microsoft and Yahoo in fine-tuning its search advertising system based on what works and what doesn't, making note of everything from the number of ads on a search results page to their exact size, placement, spacing and color.

When someone does a Web search, Google does more than simply spit out an ad that matches the keyword. Google weighs many factors to figure out how likely a user will click on an ad. An oft-clicked ad on a common search might be shown first, even if it brings in less revenue than a less popular but more lucrative one.

Microsoft has smart computer scientists working full-time on the same puzzle, but Google's lead is formidable, and Microsoft's devotion to search pales compared with cash cows like Office and Windows.

Ultimately, the Redmond, Wash.-based software maker may have to settle for something less tangible.

Google has been making incursions onto Microsoft's home turf, the software that makes computers run and helps people get their work done. By stepping up its game in search, Microsoft may ultimately force Google to focus on its core search engine rather than its fledgling software business, including a recently announced Chrome operating system that could challenge Windows.

Microsoft may be able to claim victory even if it cannot turn size into dramatic search revenue growth.