Yahoo investors unimpressed with Microsoft deal

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An Internet search and advertising partnership that Yahoo Inc. struck with Microsoft Corp. last month has so far failed to inspire the Sunnyvale, Calif.-based company's investors.

Yahoo billed the deal -- announced on July 29 -- as a "significant opportunity," though initial reaction was tepid. Yahoo would be handing control of the inner workings of its search service to Microsoft, to team up on market leader Google Inc. However, many investors had anticipated an up-front payment to Yahoo, or even revenue guarantees as part of any tie-up.

While subsequent disclosures have helped brighten the general sentiment, and both companies have sought to publicly tout the deal's mutual benefits, doubts remain.

Yahoo shares have stagnated since details of the partnership became public. The stock slid 12 percent the day the deal was announced, and has remained largely flat. Over the same period of time, the Nasdaq Composite Index has risen about 2 percent.

"Investors continue to be concerned there were no revenue guarantees, and that Yahoo didn't extract as high a value as they could have for this business," said Ben Schachter, an analyst covering Yahoo for Broadpoint AmTech.

Some investors have acted on their concern. George Kurian, an analyst at

Tradition Capital Management, noted that the firm sold its Yahoo holdings after the Microsoft partnership was announced.

"The dream of Yahoo as a Silicon Valley giant playing a lead role in one of the fastest growing and most profitable parts of the Internet business is now over," Kurian said. Tradition retains shares in Microsoft.

Under the terms of the partnership, Microsoft would provide the search technology used to power Yahoo sites while Yahoo focuses on advertising sales, and any resulting revenue would be divvied up. Yahoo would retain user data gleaned through its search service for use in targeting online display advertising, and would receive about $150 million over three years from Microsoft to cover its costs in implementing the deal.

In addition to a large share of all advertising revenue derived through the Microsoft partnership, other benefits anticipated for Yahoo included a reduction in related costs, and an opportunity for the firm to focus more of its energy on display ads -- a segment expected to greatly expand in coming years.

But Kurian said simply cutting expenses won't offer Yahoo investors much optimism about the company's prospects for future growth. "While the cost savings obtained are a modest tactical positive for Yahoo, it is strategically weakened by this deal," he added.

Yahoo still depends heavily on the paid search business it intends to open up to Microsoft, and has fought to maintain the second-largest market share in the U.S. behind that of Google.

According to recent data, Yahoo has clung to 19 percent of the U.S. market, far behind Google's 65 percent but also well ahead of Microsoft's 9 percent.

"Yahoo's deal with Microsoft is aimed at creating true competition in search," Yahoo general counsel Michael Callahan said in a statement.

The company firmly committed to search in 2003, when it acquired paid search pioneer Overture Services Inc. for roughly $1.6 billion. Subsequently, Yahoo invested heavily in its search service under a project code-named Panama. Still, search was a business seen as constantly under threat thanks to the growing dominance of Google -- a situation some had hoped a Microsoft deal would address.

"There was uncertainty before the deal about what (Yahoo's) search revenue would be, and there's uncertainty after the deal about what search revenue will be," Broadpoint AmTech's Schachter said.

Some of investors' reluctance to embrace the deal may also stem from the potential for regulatory roadblocks. The Justice Department has begun an initial review of the Microsoft and Yahoo partnership, which is expected to elicit close scrutiny both because of the considerable size of the search advertising market, and because the deal would shrink that market from two major players to three.

Still, Microsoft and Yahoo argue that the reduction in the number of search competitors is a relatively minor point, given that their tie-up could produce the first formidable competition for Google in a long time.

"The antitrust laws look favorably on deals that increase competition with dominant players," said Jonathan Kanter, an attorney representing Microsoft.

The Justice Department is expected to issue a second request for information about the planned partnership in September, which should extend its initial antitrust review by an uncertain number of weeks. The review is likely taking into account the feedback of search advertising customers, as well as competitors such as Google. Microsoft and Yahoo hope to be able to close the deal by early next year.

While some Yahoo investors might cheer interference with, or even a scuttling of the deal by antitrust regulators, Microsoft shareholders may not share their enthusiasm.

Microsoft shares have risen by more than 3 percent since the Yahoo partnership was announced.

"From a Microsoft standpoint, this deal was probably among the best of the decade," Tradition Capital's Kurian said. "With Yahoo's user base and its technology, Microsoft transformed itself from an impossible position to a strong No. 2 in search almost overnight."
