Is Wall Street warming to Yahoo's Microsoft pact?

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When Yahoo Inc. unveiled the details of its anticipated search and advertising partnership with Microsoft Corp. in late July, the reaction from Wall Street mostly ranged from skeptical to disappointed.

But analysts following Yahoo now seem to be increasingly assured that the pact will be a net positive. The only question is: When?

Yahoo shares have risen more than 15 percent since the partnership was announced July 29, far outpacing the Nasdaq Composite Index over the same period. While much of the stock's recent movement may be attributable to the value of Yahoo's Asia investments, sentiment on the Microsoft partnership could also be playing a role.

"The current (stock) price has yet to fully reflect the total accretive impact of Microsoft deal, in our view," Youssef Squali of Jefferies & Co. wrote in a note to clients.

Under the terms of the deal, Sunnyvale, Calif.-based Yahoo will focus on selling advertising for a search service powered by Redmond, Wash.-based Microsoft's technology -- with Yahoo receiving the lion's share of any resulting revenue.

Critics of the partnership have pointed out that it doesn't include revenue guarantees for Yahoo, while effectively making U.S. Internet search a two-player contest between Microsoft and market leader Google Inc.

In addition, the partnership is being scrutinized by antitrust regulators at the Justice Department, and the companies say they won't be able to start putting all of the necessary pieces together until the deal is closed -- most likely early next year.

Yahoo has spent heavily over the years in an effort to build its search service and compete with Google, which now captures over 60 percent of the U.S. market in any given month.

Yahoo meanwhile has struggled to retain a share of 20 percent or less of the search market, while Microsoft's remains below 10 percent. Combined, however, the Yahoo and Microsoft search engines could theoretically draw in a larger number of advertisers, thanks to their potential to reach a larger single combined audience.

Squali cited the Microsoft deal when he raised his price target for Yahoo shares to $23 from $20. Yahoo should be able cut search-related costs and expand its margins by roughly 19 percent in 2011, the analyst estimated.

In addition, Cowen & Co. analyst Jim Friedland told clients that he recently raised his estimate for a key earnings measure for Yahoo in 2011 by some $350 million, as a result of the Microsoft deal.

To be sure, benefits from the Microsoft partnership will only be realized after a lengthy wait for investors. Meanwhile, both companies need to maintain their businesses while facing an aggressive rival in Google.

"It will be a long-term positive," Brigantine Advisors analyst Colin Gillis said of Yahoo's deal with Microsoft. "The concern is, is there going to be pain coming in the near term that people aren't focusing on?"

Gillis noted online retailer eBay Inc.'s recent decision to use Google search, and dump Yahoo's service. Such affiliate search relationships are key for any search provider, Gillis said, and a partner with the heft of eBay -- which may have accounted for as much as 1 percent of Yahoo's revenue through the arrangement, according to Gillis -- will be sorely missed.

It remains unclear whether the Microsoft deal, if ultimately sealed, could cause other affiliates to defect from Yahoo to Google, the analyst added.

"We want to see Yahoo get fixed, before getting too excited," Gillis said.
