Yahoo's $7.1B deal with Alibaba offers ray of hope

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In this Aug. 11, 2005, file photo, a man walks past a screen displaying the Yahoo and Ali Baba.com logos before a joint news conference by the companies at the China World hotel in Beijing. Yahoo announced that it has agreed to sell half of its 40 percent stake in Chinese e-commerce company Alibaba for about $7.1 billion. The deal will see Alibaba Group buying back the stake from Yahoo Inc. for $6.3 billion cash and up to $800 million of Alibaba preference shares. (AP Photo/Elizabeth Dalziel, File)

After years of mortifying missteps, Yahoo Inc. finally has something to boast about: a multibillion-dollar windfall from a savvy investment in China.

Yahoo is selling half of its roughly 40 percent stake in Alibaba Group Holding Ltd., one of the most successful companies in China's rapidly growing Internet market. The $7.1 billion price ensures that Yahoo will get a hefty return from its $1 billion investment in Alibaba in 2005.

The deal, coming a week after Yahoo's CEO abruptly resigned over misstatements in his official biography, will provide more financial firepower for the latest regime trying to turn around the long-struggling Internet company. It came after more than two years of negotiations on how Yahoo will sell the stake.

Alibaba started out in 1999 as a business-to-business website linking factories in China to buyers around the world. It grew into a company that's larger than Yahoo, with more than 25,000 employees working at a wide range of websites and online services.

Alibaba's portfolio includes Taobao.com, China's version of eBay, and TMall, which brand owners can use to sell directly to consumers. Alibaba also runs a search engine for shoppers and an online payment service.

Things have been going so well at Alibaba that it now accounts for a large portion of Yahoo's earnings.

While Yahoo has profited from the Alibaba investment, Yahoo's stock price has plunged by more than 55 percent since the company invested in Alibaba.

Yahoo's revenue has been steadily shrinking as rivals Google Inc. and Facebook Inc. developed more products to grab the attention of Web surfers and attract more online advertising.

Alibaba is buying back its stock from Yahoo to gain more control of its own destiny, something that CEO Jack Ma wanted, especially as Yahoo became mired in its own internal disarray in recent years.

"The transaction will establish a balanced ownership structure that enables Alibaba to take our business to the next level as a public company in the future," Ma said in announcing the deal with Yahoo late Sunday.

The deal calls for Alibaba to raise the money needed to buy Yahoo's stake within the next six months. Yahoo will get $6.3 billion in cash and $800 million in a new class of preferred stock in Alibaba, a privately held company.

Yahoo also will license its brand and some of its technology to Alibaba during the next four years as part of an arrangement that will include an upfront payment of $550 million.

After taxes, Yahoo estimates it will receive $4.2 billion just from the upcoming sale of half its Alibaba stake. Yahoo had been trying to work out a tax-free deal, but it wound up too complicated to pull off.

In a conference call Monday with analysts, Yahoo Chief Financial Officer Tim Morse hailed the outcome as a "home run" for Yahoo's shareholders.

Yahoo will sell another quarter of its original investment as part of Alibaba's initial public offering of stock, expected by the end of 2015. Yahoo will then have the option of selling its remaining holdings on the open stock market.

By staggering the sale of its stake over several years, Yahoo conceivably will make even more money if Alibaba is as successful as it has been in recent years. Alibaba is now worth an estimated $35 billion, up from $2.5 billion seven years ago.

Both Alibaba and Yahoo said they may collaborate on other joint ventures in the future, despite the increasingly strained relations between the companies that contributed to more than two years of sometimes-prickly negotiations.

Yahoo intends to distribute most of the proceeds from its initial Alibaba sale to Yahoo shareholders, although its recently reshuffled board of directors hasn't decided yet how the money will be paid out. For now, the company is adding $5 billion to its pool of funds for buying back its stock, raising its total commitment to $5.5 billion over an unspecified time frame.

The Alibaba windfall provides a measure of comfort to Yahoo's long-suffering shareholders, many of whom still lamenting the company's squandered opportunity to sell itself to Microsoft Corp. for $47.5 billion, or $33 per share, in May 2008.

Yahoo's stock was at $34.14 when Yahoo announced the Alibaba investment in August 2005. It fell to $19.18 before Microsoft made its initial bid, in January 2008. Yahoo's stock is now trading at less than $16.

The Alibaba announcement couldn't have come at a better time for Yahoo. A week ago, newly hired CEO Scott Thompson left after just four months because of fallout from a bogus college degree listed on his official biography. As part of the shake-up, the company appointed a disgruntled shareholder, hedge fund manager Daniel Loeb, along with two of his allies to the board of directors, while accelerating the exit of five other directors.

Morse described the timing of the Alibaba deal as coincidental, but that didn't stop analysts from theorizing that the company is operating with a new sense of urgency and direction under the new board and interim CEO Ross Levinsohn. His background is more deeply rooted in Internet content and advertising than Thompson's was.

Citigroup analyst Mark Mahaney called the Alibaba deal as a "meaningful win" for Yahoo, while BGC Financial Partners analyst Colin Gillis is so encouraged by the recent developments that he believes Yahoo's stock price can hit $20 within the next year, up from its previous target of $18. Yahoo's stock hasn't touched $20 since September 2008 when the company was still run by co-founder Jerry Yang. Levinsohn is the fifth person to run Yahoo since then, counting an interim CEO stint by Morse.

Having been burned by the company so many times, investors were less enthusiastic about the Alibaba breakthrough than most analysts. The company's shares gained just 16 cents, or 1 percent, to close Monday at $15.58.

"I am not sure people could have reasonably expected a lot more than what they got out of this deal," said Standard & Poor's Capital IQ analyst Scott Kessler. "There are far too many people who are too cynical about the Yahoo story at this point."

J.P. Morgan analyst Douglas Anmuth believes investors are worried about Alibaba's ability to raise the money needed to pay Yahoo. He says they are also disappointed by the lack of clarity about when Yahoo will be buying back its stock.

"This feels like the market's just not willing to give Yahoo much credit until a deal is officially done," Anmuth wrote in a Monday research note.

Wedge Partners analyst Martin Pyykkonen believes most investors realize the Alibaba windfall won't solve the problems that have been eroding Yahoo's revenue, especially because the money will be funneled to shareholders instead of invested in acquisitions or content-licensing deals that might help the business.

"This is really just a short-term fix," Pyykkonen said of the Alibaba sale.

Yahoo faces its biggest challenge in the online advertising market, where it has been losing market share to Google and Facebook as advertisers shift more of their budgets to the Internet.

Investors also want Yahoo to sell its 35 percent stake in Yahoo Japan so it can reel in even more cash on sharpen its focus on its U.S. business. But Yahoo has said it isn't close to agreeing on an acceptable price with Softbank, the controlling owner of Yahoo Japan.

The Alibaba deal still represents one of the few times in recent years when Yahoo has outshined Google in an area of business. While Google has been able to dominate Internet search and advertising, some of the company's high-profile investments outside its specialty have proven to be busts. Google lost most of its money on a $1 billion investment made in AOL Inc. in 2006 and a $500 million investment in wireless service provider Clearwire Corp. in 2008.

When it trims its Alibaba stake, Yahoo will also be shaving its profits. Yahoo's earnings from its investments totaled $172 million during the first quarter, with most of that flowing from Alibaba.

Gillis expects Yahoo to offset the reduced earnings from Alibaba by buying back about 277 million shares under its expanded repurchase program. With less stock outstanding, Yahoo's earnings per share should rise by about 9 cents per share next year, even after accounting for the decreased income from Alibaba.

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