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Microsoft Makes Grab for Yahoo

Software Giant's Bid Is Aimed at Google; Tapping Ads, Customers

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The battle for supremacy in the Internet era is entering a tumultuous new phase.

Microsoft Corp. placed a bold $44.6 billion bet that buying Yahoo Inc. can transform both companies' flagging efforts to catch Google Inc.

The software giant's unsolicited offer for Yahoo represents a 62% premium over the Internet company's recent share price and is a sign of Microsoft's determination to narrow Google's growing lead in the online advertising and Web search-engine wars.

By absorbing Yahoo, Microsoft hopes to gain the heft it has long sought with consumers, advertisers and other online publishers, providing access to roughly 500 million world-wide monthly users of Yahoo's Internet services. These range from email to online dating and help generate Yahoo's roughly 16% share of total U.S. online-ad revenue.

The offer, made in a letter sent Thursday by Chief Executive Steve Ballmer to Yahoo's board of directors, comes after Yahoo had resisted Microsoft's behind-the-scenes advances over more than a year. One person familiar with the matter said that Microsoft decided to "go hostile" with its bid -- ending years of internal debate over whether to buy Yahoo -- within the past few weeks after Yahoo ignored its latest overtures.

The bid is the biggest Internet-related deal since the ill-fated 2001 merger between America Online Inc. and Time Warner Inc. The Microsoft deal -- the company's first known unsolicited bid since its founding in 1975 -- comes with its own risks. Buying Yahoo would be the largest acquisition in the company's history, carrying immense complexity: Mr. Ballmer would need to pull Yahoo's 14,300 employees into Microsoft's ranks of 80,000 people. That challenge could mean job cuts at either Microsoft, Yahoo or both companies.

Even so, Microsoft believes that buying Yahoo is essential for gaining ground on Google. In his letter to Yahoo's board, Mr. Ballmer said the online-advertising market is "increasingly dominated by one player" -- a clear reference to Google. The combination with Yahoo will "accelerate our path forward," he said in an interview Friday.

A Google spokesman said that it would be "premature for us to comment at this time," about Microsoft's bid.

While combining the companies would pose enormous management and technical challenges, a Yahoo acquisition could make Microsoft a more viable one-stop alternative to Google for advertisers and media companies looking to spend money and distribute their content online. It could also help buttress Microsoft's core software business against encroachment by Google as more consumers access services and applications over the Web instead of installing software on their PCs.

The deal, more broadly, would reshape the competition among many other Web, media and telecommunications players.

People familiar with the matter said Yahoo is looking for other potential suitors and would at the least push for a higher price before conceding to Microsoft. One of the people said no rival bidders had immediately emerged.

Yahoo in a statement said its directors would "evaluate this proposal carefully and promptly in the context of Yahoo's strategic plans and pursue the best course of action to maximize long-term value for shareholders."

Having announced disappointing 2008 guidance Tuesday, Yahoo Chief Executive Jerry Yang -- who has in the past opposed selling to Microsoft -- would likely face an uphill battle arguing that Yahoo can anytime soon boost the company's share price to match Microsoft's offer.

In recent years, Yahoo has suffered from disappointing online-ad sales, declining Web-search market share and staff turnover, while failing to capitalize on booms in areas such as social networking and online video. As part of an effort to streamline, the company Tuesday announced it was laying off approximately 1,000 of its employees.

For Microsoft, the move is an acknowledgment that its expensive foray into online services is failing, or at least not moving fast enough. The company has tried to build a strong presence in Internet search and other online services. But it hasn't dented Google's leading market share or stayed in step with the growth of online advertising.

While Google continues to add new services at a rapid rate, its two biggest competitors could be distracted by the complications associated with combining their operations. Google also may get a greater opportunity to poach any staff from Yahoo's Silicon Valley headquarters, which are near its own.

In the interview, Mr. Ballmer and other Microsoft executives argued that the deal will expand its research and development capabilities and eliminate overlap with similar Yahoo efforts. Microsoft said that the union could result in at least $1 billion in annual savings.

In preparation for its Yahoo bid, Microsoft last year studied Hewlett-Packard Co.'s difficult $19 billion acquisition of Compaq Computer Corp. in 2002, says a person familiar with the matter. It also sought the help of an outside consultant who had advised the integration of those two companies.

The deal, meanwhile, could potentially be bad news for some smaller Internet players such as Time Warner Inc.'s AOL and IAC/InterActiveCorp's Ask.com search engine. Both could see themselves marginalized with consumers and advertisers. Officials at Time Warner, AOL and IAC declined to comment.

"This ups the stakes for AOL. What will they do to expand?" says Mark Kingdon, chief executive officer at Organic, a digital-marketing firm owned by ad holding giant Omnicom Group Inc.

Any deal could also close off an option for Time Warner's new CEO, Jeff Bewkes, who is currently trying to decide whether to hold onto AOL. Microsoft and Yahoo were long seen as the most obvious suitors for the online business. Their combination would likely rule that out.

Industry experts say the size of the deal, and Microsoft's war chest and determination for going after it, could deter other bidders from emerging. EBay Inc., AOL, AT&T Inc. and News Corp. (owner of Dow Jones & Co., publisher of The Wall Street Journal) are among the other companies that have at various moments and with different levels of seriousness discussed possible combinations with Yahoo over the years.

In an interview before the news broke, veteran cable-industry executive John Malone said that major cable companies have entertained the notion of trying to acquire Yahoo, but none had ever made a serious attempt because they all figured they would be outgunned by Microsoft.

Yahoo has "poison pill" provisions that would permit it to try to thwart a hostile takeover by issuing discounted shares. But people familiar with the matter say it is unlikely to activate those now that the company is in play. In many cases, such provisions mainly give a target company leverage to push for a higher price.

Microsoft's approach dates to a series of wide-ranging discussions with Yahoo late in 2006. The talks focused on how the two could cooperate on search and culminated early in 2007 with Microsoft suggesting the two companies merge. Yahoo responded that it wasn't ready to do a deal, preferring instead to pursue partnerships and other ways for the pair to cooperate on a commercial basis, say people familiar with the matter.

In the months after it was spurned, Microsoft executives worried that Google was becoming too dominant in the online advertising market and felt they could do a better job of running Yahoo, which in July lowered its financial outlook for 2007 amid slower-than-expected sales growth in graphical display ads, such as banner ads. Mr. Yang undertook an effort to refocus the company, trimming activities and staff but some investors grew impatient that he wasn't making bolder moves such as outsourcing its search advertising to Google.

Given the way Yahoo had responded last year, Mr. Ballmer and the company board finally concluded they "didn't have a choice but to take it to the shareholders," according to one person involved in the deliberations. About two weeks ago, Microsoft decided to move forward. Yahoo's latest earnings report Tuesday, which disappointed the market and pushed down its shares to 2003 levels, only strengthened Microsoft's resolve.

Microsoft outlined its offer in a letter to Yahoo's board at the close of business on Thursday. Mr. Yang interrupted a regular Yahoo board meeting in San Jose Thursday night to announce a call from Mr. Ballmer about Microsoft's proposed bid. The bombshell came just 15 minutes after the board had elected former advertising executive Roy Bostock as its new chairman. "The whole tone of the board meeting changed," says one person familiar with the situation.

When Microsoft didn't receive any encouragement from Yahoo, it decided to take the offer public.

Microsoft is betting that the public offer increases the pressure on Mr. Yang and Yahoo's board to come to the table. Mr. Ballmer said that Microsoft's management "has a lot of respect for Jerry, the Yahoo team."

Microsoft's bid surprised Mr. Yang as it "came out of left field," says Umesh Ramakrishnan, a vice chairman of recruiters CTPartners, after speaking with several Yahoo officials yesterday. The Yahoo CEO has been trying to restore Yahoo's luster by attracting fresh talent and hoped the company could remain independent, the recruiter added.

The deal would be a major financial windfall for Yahoo's co-founders. David Filo, who holds the title of "chief Yahoo" at the company, would receive roughly $2.4 billion in cash and Microsoft stock, based on a public filing listing his stock holdings as of July. Mr. Yang would receive about $1.67 billion, based on stock holdings reported in Yahoo's proxy last April.

Microsoft's $44.6 billion bid for Yahoo ranks as the second-largest among technology and media deals, only surpassed by AOL's $112 billion deal to buy Time Warner in 2001, according to Dealogic. That combination turned into one of the most disastrous deals in business history. Not only were attempts at integration stymied by culture clashes between AOL's new media folks and Time Warner's old-media veterans, but a slump in AOL's business undercut much of the promise of the deal.

A Yahoo purchase by Microsoft would rank as the biggest-ever pure technology deal, nearly two times as big as Lucent Technologies' $23.9 billion purchase of Ascend Communications Inc. in 1999 and eclipsing H-P's acquisition of Compaq in 2002, Dealogic says.

Any combination would likely attract the attention of antitrust enforcers and lawmakers in the U.S. and Europe, possibly delaying a completed deal for six months or more. But merger-law experts predicted that a buyout ultimately would win approval -- even in Europe. Authorities there filed antitrust charges against Microsoft and have been closely scrutinizing Google's proposed purchase of DoubleClick, an online advertising-services firm.