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EXECUTIVE SUMMARY

Yahoo!, Inc. (Nasdaq: YHOO; “Yahoo!”, “Company”) was the first of its kind. Guided by the technological and entrepreneurial spirit that defined the 1990s, Yahoo! was the first Internet resource that allowed users to keep track of their favorite websites. As Yahoo! transformed into a full-fledged web portal it attracted users with its innovative and fresh products and services, the likes of which the Internet had never seen before. One of the few survivors of the crash of the Internet bubble in 2000, Yahoo! is once again enjoying much success as it sits atop the industry and remains one of the most frequently visited websites in the world. Its position as the industry’s clear-cut leader, however, has been stripped away by up-and-coming competitor Google, Inc. (“Google”).

Despite the numerous products and services Yahoo! offers on its portal – everything from e-mail to maps, classifieds to news, sports to horoscopes, job searches to finance, picture hosting to weather – Yahoo! is lacking the same innovation that allowed it to quickly dethrone AltaVista in the late-1990s. While Yahoo! continues to expand its user base, the competition from Internet giants like Google and Microsoft is proving a tough challenge to the tried-and-true business model that made Yahoo! the hit it is today. The once-popular fee-based premium services are losing popularity as more of these Internet services becomes available free of charge, and Yahoo!’s heavy reliance on revenues from such services is hurting its profitability. At the same time, Google’s focus on advertisement-based revenue over the past few years has resulted in a more efficient revenue gathering system, one which greatly outperforms Yahoo!’s.

To remain competitive in the ever-changing and cutthroat Internet technology industry, Yahoo! must continuously rethink its business model by returning to its roots and using the same innovative spirit that made it the success it was in the late-1990s. Gotham Global will call attention to several strategic issues Yahoo! currently faces, including the need for a new advertisement-based revenue system, the matter of reducing focus on its fee-based premium services, and the always-important concern of increasing Yahoo!’s user base. While the
interrelation between these issues may not be apparent, the solutions to all of them are founded on one primary idea: Yahoo! cannot afford to continue relying on its current users to remain loyal in the face of increasing competition; the once-nimble and adaptive Internet smash hit is on the verge of becoming a lethargic leviathan too big and slow to keep up with the fast-paced Internet industry. Yahoo! needs to regain that ingenuity and originality that led to its success thus far, and it needs to regain it fast.

The remainder of the analysis is organized as follows. We begin with a history of the Company, including a timeline of some of Yahoo!’s major acquisitions and deals over the past seven years. Section II describes Yahoo!’s current situation through brief discussions of the Company’s business model, financials, and its strengths, weaknesses, opportunities, and threats. We include the impacts of the industry, and specifically Google, in a summary of Yahoo!’s competition in Section III. Section IV concludes with main strategic issues facing Yahoo and Gotham Global’s recommendations for addressing these issues.
Headquartered in Sunnyvale, California, Yahoo! is currently one of the most popular websites on the Internet, offering users a variety of services including free e-mail, news, maps, and a powerful search engine. The idea for the company began not in a high-tech computer lab, but rather in a campus trailer at Stanford University in 1994. David Filo and Jerry Yang, Ph.D. candidates in Electrical Engineering at Stanford, sought a way to organize their favorite sites on the Internet. Rather than creating a searchable index of websites, Filo and Yang organized a hierarchy of their favorites. As the duo’s lists of personal sites grew larger, they began breaking them down by category, then repeated the subdivision process as the categories themselves grew too large. This creation of categories and subcategories of favorite websites became the guiding idea behind the creation of Yahoo!.

At first, Filo and Yang chose the descriptive yet bland name of “Jerry and David’s Guide to the World Wide Web” for their creation, but in April, 1994 changed the name to Yahoo!. The name carries the backronym “Yet Another Hierarchical Officious Oracle” but the two creators claim they selected the name because they liked the definition of a yaho o given in Jonathan Swift’s *Gulliver’s Travels*: someone who is “rude, unsophisticated, and uncouth”. Filo and Yang kept Yahoo! and its necessary software on their personal student workstations, but soon discovered that many others were interested in organizing their favorite Internet sites in this manner. A short time after its launch, the friends’ guide to the Internet was being accessed by hundreds of people. In the fall of 1994, Yahoo! recorded its first million-hit day, indicating that almost one hundred thousand unique visitors accessed the site.

Realizing they had stumbled upon a potentially successful and lucrative website, Filo and Yang incorporated their business on March 2nd, 1995 and began seeking a financial backing. After pitching their idea to several venture capitalists in the now-famous Silicon Valley, Sequoia Capital – the same firm who invested in Apple Computer, Atari, Oracle, and Cisco Systems – agreed to fund Yahoo! with
an initial $2 million investment. Yahoo! was up and running and was primed for future financial success.

Yahoo! quickly assembled a management team consisting of several veterans of the technology sector. Tim Koogle, a Stanford Engineering alum and former Motorola employee, became the company’s Chief Executive Officer. Founder of Novell’s WordPerfect consumer division, Jeffrey Mallett, signed on as Yahoo!’s Chief Operating Officer. With the new management, Yahoo! was easily able to gain additional funding from Reuters Ltd. and Softbank in the fall of 1995. Just a few months later on April 12th, 1996, Yahoo! – then made up of just 49 employees – launched a successful IPO, selling 2.6 million shares at $13 each (raising a total of $33.8 million). Yahoo! then teamed with Softbank and its affiliates to form Yahoo! Japan and Yahoo! Europe in 1996.

Yahoo! soon diversified into a Web portal, acquiring several companies to add services to its site in hopes of attracting more users. On March 8th, 1997 Yahoo! acquired online communications company Four11 and transformed its Rocketmail into Yahoo! Mail. Similarly, Yahoo! bought ClassicGames.com which became Yahoo! Games. In addition to these two companies, Yahoo! acquired GeoCities and eGroups in order to launch its Yahoo! Groups and Yahoo! Messenger services.

In 1997, Yahoo! created the Internet navigation service Netscape Guide for Netscape Communications (now part of America Online) and launched Yahoo! Korea. The company’s growth continued in 1998 with acquisitions of Viaweb (eCommerce software), WebCal (internet scheduling products), and Yoyodyne (Internet direct marketing). In the same year, the company offered Yahoo Visa cards for customers. The company launched Yahoo Radio broadcast internet radio service in 1999.

Yahoo! acquired software provider Encompass in 1999, then later inked a deal with Sprint to provide information to Sprint’s cell phone customers. The next year Yahoo! launched its Yahoo! B2B Marketplace, signaling its entrance into the
business-to-business market. It later teamed with partners Inktomi, Critical Path, and Tibco to develop enterprise information portals.

In 2000 Yahoo! moved heavily into the Internet media arena by acquiring e-mail communications firm eGroups and a minority stake in Internet phone services firm Net2Phone. Yahoo! also launched its streaming media application Yahoo! Player the same year in addition to Web broadcast channel FinanceVision. In June, 2002 Yahoo! dropped Inktomi as its search engine provider and switched to Google.

Yahoo! was hit hard by the burst of the dot-com bubble in 2000, but was one of only a few companies to survive the burst. In response to the stock hitting an all-time low of $8.11 on September 26th, 2001 (down from an all-time high of $475.00 on January 3rd, 2000), Yahoo! aimed to compete with AOL by forming partnerships with telecommunications and Internet providers such as AT&T Wireless and SBC in 2002. Yahoo!’s toughest competition, however, would come from search-engine Google.

On February 18th, 2004 Yahoo! dropped Google-powered search results and returned to using its own technology. Then, when Google introduced GMail, which offered 1GB of storage, Yahoo! increased the storage of both its free and premium subscription e-mail services. Since 2004, competition with the services offered by Google has been fierce and Yahoo! has acquired Flickr, launched its blogging and social networking service Yahoo! 360, and bought online social event calendar Upcoming.org to try to keep the upper hand on its Mountain View-based rival.

As Yahoo! says on their website, they are “a leading global Internet communications, commerce and media company that offers a comprehensive branded network of services to more than 345 million individuals each month worldwide.” As of November, 2006 Yahoo! and MySpace have been competing for the honor of top U.S. visited website. Since Yahoo! – like Google and MySpace – earns a profit from advertising revenue, it is imperative that Yahoo!
remains atop the list of the most popular websites. In order to stay ahead of the curve, Yahoo! Next, an incubation ground for future Yahoo! technologies, is actively working on new services to add to the company’s Web portal to attract and retain as many Internet users as possible.

**HISTORY OF MAJOR TRANSACTIONS**

Below is a brief history of some of the major transactions Yahoo! has made recently to broaden its range of services. It is important to note that many of these transactions were made in response to a similar move by Google.

- **GeoCities** (May 1999) – Free website hosting service. Now with paid plans that offer additional space, bandwidth, and tools.

- **Launch Media** (June 2001) – An online music service that allows users to create playlists from a vast collection of songs, and can offer recommendations based on past plays. Also provides music videos and other video footage.


- **Inktomi** (December 2002) – Back-end software for internet service providers, specially catered to search engine technology. Inktomi technologies gave HotBot the competitive advantage over AltaVista and structured a framework for media stream for AOL.

- **Overture** (October 2003) – Formerly GoTo.com. The first search engine to incorporate “pay per click” or “sponsored” searches. Became the basis for Yahoo! search-based revenue. The acquisition also included AltaVista and AllTheWeb.

- **Kelkoo** (April 2004) – European price comparison service, comparable to Froogle. Kelkoo has a broader reach across retailers and provides more results than its competitors, plus it allows retailers to bid for high-traffic listings on its site, providing additional revenue.

- **Musicmatch** (September 2004) – Personalized music software and services. Yahoo! already had some music offerings, especially after the acquisition of Launch Media in 2001, but Musicmatch competes more with iTunes and RealNetworks. The service will be integrated with Yahoo! Music Unlimited.

1 [http://www.seobythesea.com/?p=75](http://www.seobythesea.com/?p=75)
• **Verdisoft** (February 2005) – Server software which carries a users settings and preferences to synch from one device to another. For example, an email read on a phone is then marked as read on the same person’s desktop computer.

• **Ludicorp**, maker of **Flickr** (March 2005) – Image storage and display. Flickr has been one of the leaders in social tagging, and is the second-most popular photo sharing website after Facebook. This acquisition elevated Yahoo! to a company that is paying attention to some of the new social movements going on upon the web.

• **Dialpad** (June 2005) – Internet Telephony. Yahoo! plans on leveraging Dialpad’s PSTN calling capabilities to add to Yahoo! Messenger’s recently enhanced VOIP offering.

• **Pixoria**, maker of **Konfabulator** (July 2005) – JavaScript runtime engine running Widgets, not unlike Apple Computer’s Dashboard. Yahoo kept the development team on board to develop new technology and made it the core of a new Yahoo Developers Network, providing support to third party software code writers who want to make tools that work with Yahoo! content.

• **Alibaba** (August 2005) – Yahoo! purchased a 40% share in this Chinese e-commerce site, proceeding together as a joint venture.

• **Del.icio.us** (December 2005) – A bookmark service that saves users favorites and allows them to share links. Del.icio.us is the most popular website for this kind of service and is a valuable addition to Yahoo!’s brand.
CURRENT STATUS

BUSINESS MODEL

Despite its broad range of products and services, Yahoo! has a fairly simple corporate structure with two major lines of business. One way Yahoo! generates revenues is by providing marketing services to businesses across the majority of its products and services. Yahoo! charges business clients both (1) for advertisements that appear on Yahoo!’s site when a certain keyword is typed into the search bar or when a Yahoo! portal user is viewing certain content and (2) for placing targeted, contextually relevant advertising on Yahoo!’s affiliates sites (called “impressions”). Yahoo! earns revenue either when users view the impressions advertisements or when users click the advertisement links offered on its or its affiliates’ sites. This “click-through” rate is an extremely useful tool in measuring Yahoo!’s profitability, and while not explicitly published by Yahoo!, it is clearly proportional to the size of Yahoo!’s user base. These revenues are classified as marketing services. Yahoo! also generates revenue by establishing paying relationships with its users for premium services, classified as fees. In 2006, Yahoo!’s marketing services accounted for 88% of total revenues while fees counted for just 12%.²

FINANCIAL ANALYSIS

On the surface – especially thus far in 2007 – Yahoo!’s financial situation looks relatively stable. A summary of Yahoo!’s basic financial statistics can be found in Table 1 below³.

² Yahoo! 2006 Annual Report
³ Statistics as of 4/15/2007
Yahoo!’s stock has risen dramatically in 2007 in anticipation of the effects of its new search engine technology – called Panama – and as is clear from the below chart of stock price in recent years its stock has increased over 6% thus far this year.

While Yahoo!’s stock has enjoyed recent success, a serious concern for Yahoo! is the year-over-year growth of quarterly earnings for 2006Q4. Year over year revenues increased by 13.4%, but earnings slipped a staggering 60.7%. Yahoo! finished 2005 strong with impressive fourth quarter earnings, but the income slide at the end of 2006 (when compared with fourth quarter 2006) could be a
sign of bad things to come for the once-dominant web portal. Yahoo! continued this trend of declining earnings as it announced its operating income for the first quarter of 2007 fell 16% year-over-year. Revenue from both marketing services and fees increased (6% and 9%, respectively), but the Company once again demonstrated its inability to increase year-over-year income. Accounting for much of the decline were the Company’s high operating expenses, which increased 11.5% to an amount equal to 47% of revenue for the quarter. While the news of lower-than-expected earnings is troubling, the cause for the news is actually a sign that Yahoo! is becoming more forward-looking in its operations. Yahoo! CFO Susan Decker offered the following quote which explains the increase in operating expenses: “Our first quarter financial results reflect solid execution against our plan. We maintained strong profitability and cash flow, while remaining focused on building innovative products and services for our large and growing base of users, advertisers and publishers. As we look ahead, we are very excited about the transformational changes taking place on the Internet, creating great opportunities for both users and marketers, and we are confident that Yahoo! has the right combination of assets to help lead this evolution. That is, Yahoo!’s operating expense increase comes in the form of increased research and design aimed at preparing the Company for the changing future of the Internet. This is a positive strategic sign for Yahoo!.

Yahoo! and its Internet technology counterparts experienced a major drop off in performance due to the popping of the dotcom bubble in 2000, but have recovered significantly in recent years; the technology sector is far from dead. In

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4 It should be noted that for the year ended December 31, 2006, as a result of adopting Statement of Financial Accounting Standard No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123R”), Yahoo!’s income from operations was lower by $324 million and net income was lower by $222 million, than if Yahoo! had continued to account for stock-based compensation under Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB 25”). Basic and diluted net income per share for the year ended December 31, 2006 was $0.16 and $0.15 lower, respectively, than if Yahoo! had continued to account for stock-based compensation under APB 25.

5 Upon this news, as of the time of the writing of this analysis, Yahoo!’s stock has retreated nearly 12% to $28.33 per share.

fact, Yahoo! has exhibited solid revenue growth the past few years, evidenced by the graph below.7

![Revenue and Net Income, 2002-2006 (thousands)](image)

Overall Yahoo! is performing adequately and is experiencing solid growth in revenues from both marketing services and fees and is outperforming the industry in nearly every financial category. Financially-speaking Yahoo! is a solid performer with few worries. Yahoo! isn’t in danger of failing financially; rather, the Company is facing imminent threats from Google and a comparison of Yahoo!’s financials with those of Google (and other competitors) will show just how severe a threat Google poses.

**SWOT Analysis**

Outlined below are the main strengths, weaknesses, opportunities, and threats facing Yahoo! as seen by Gotham Global. The bolded items are of particular note: these are issues which we find to be most pressing for Yahoo! and are the topics we cover in detail in the following sections.

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7 Prior to 2004 Yahoo! counted revenues from Listings separate from Fees and Market Services. For the ease of comparison I combined Listings revenues with Fees revenues. We should also note that Yahoo!’s 2005 net income was greatly inflated due to a sale of over $500 million as part of an acquisition made during the year.
**STRENGTHS**

- Strong market position
- Comprehensive range of products and services
- Strong brand recognition
- Robust long-term financial performance
- International business presence
- Low cost of introducing/updating products and services
- Anticipation of introduction of new search engine technology (Panama)

**WEAKNESSES**

- **Slow rate of technological and intellectual innovation**
- Poor short-term financial performance
- Lack of proprietary content
- Lack of differentiation from competition
- **Decreasing demand for paid premium services**
- **High levels of uncertainty about future of advertisement-based revenues**
  - Difficulty of completing strategic acquisitions
  - Difficulty of obtaining user information to target advertisements

**OPPORTUNITIES**

- International expansion
- Increase online retail spending
- Strategic partnerships and launches
- Growing search engine advertising
- **Movement into mobile technologies**
- Improved search engine technology and advertisement targeting
- **Internet sector is constantly changing**
THREATS

• Intense competition from market search firms (Google, MSN, Ask.com)
• Competition from free social networking sites (MySpace, Facebook)
• Growing privacy regulations
• Barriers to entry practically nonexistent
• International, culture-specific competition
• Online advertisement blocking technology
• Competition from traditional media companies
• Vulnerability to economic conditions which cause a decrease in advertising
COMPETITIVE ANALYSIS

THE INDUSTRY

Yahoo! operates in a large industry defined as Internet Service Providers and Web Search Portals (NAICS code 5181). This industry definition is particularly broad and acts as an umbrella under which a large variety of firms operate. While many different firms fall into this industry, for the purpose of analyzing the competitive forces impacting Yahoo!’s market position we will restrict the list of interested firms to web search portals. These firms include Yahoo!’s primary competition Google, Microsoft, and AOL, as well a handful of other smaller Internet search engines such as Ask.com. The firms we have included in our rather limited industry definition all provide Internet users with access to an online search engine, the defining characteristic of a web portal.

INTERNAL RIVALRY

The Internet Service Providers and Web Search Portals industry is characterized by intense competition and a constant quest for preserving and increasing market share. Since most revenues are directly proportional to the size of a firm’s user base, companies such as Yahoo! are constantly trying to lure users from their competitors by offering new and improved Internet services. Brand loyalty in this industry is minimal at best given that consumers incur (almost) zero switching costs for using one search engine over another. It is therefore imperative for firms in this industry to develop new products and services to attract users. Such products and services can be developed through internal innovation or through merger and acquisition activity. As a result, the big players in this high-tech industry are often simultaneously competing to acquire the most popular Internet websites (such as online video and social networking sites), introduce a novel (or improved) Internet service in attempt to broaden user bases, and anticipate the next big thing to hit the web and get into it first.

Clearly Yahoo!’s primary competitors within the industry are Google, Microsoft, and AOL. Over the past two years Yahoo! has been slowly but steadily losing
market share to Google and now finds itself ranked second to Google for Internet searches and most visited website. Google’s gain in market share and user base is due in large part to a combination of superior search engine technology, strategic acquisitions of highly popular Internet site YouTube, and highly profitable relationships with online service providers like eBay and MySpace.

The following chart8 demonstrates Google’s stronghold on the industry. Google’s sites perform 1.7 times as many searches as Yahoo!, who is a distant second (yet far ahead of third place MSN) in the Internet sector.

**Substitutes & Complements**

Within in the Internet Service Providers and Web Search Portals industry, almost all firms are very strong substitutes for one another. There is little differentiation between the services offered by all web portals – the search, e-mail, and maps services, for example, are almost identical and most users cannot tell the difference between them and just use the search engine most convenient for them (e.g. by using a pre-installed toolbar search). Since product differentiation is

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8 Source: comSource qSearch
nearly impossible to accomplish at any noticeable level, Internet firms like Yahoo! shouldn’t even focus on making their products different from their competition; instead, they should concentrate on the issue of getting their products in as many places as possible so consumers see, and therefore use, them. This can be accomplished, for example, by completing deals to get their products incorporated exclusively into more websites (such as Google’s recent deal with Clear Channel) or having them preloaded on personal computers (such as Google’s deal with Hewlett Packard to install its Google Toolbar in all new computers for $1 apiece).

The other component of the user base for firms in this industry is made up of other businesses who advertise on sites like Yahoo!. For these companies, advertising online on Yahoo! and other web portals comes at the expense of television, radio, newsprint, and billboard advertising. Thus should a firm in the industry lose market share, business who once advertised with this firm will take their advertising business to a more popular provider of marketing services.

**Barriers to Entry**

The Internet Service Providers and Web Search Portals industry is hardly a mature market, having only been in existence for 15-20 years. In this high-tech industry barriers to entry are severely limited, if not nonexistent. Many technology and Internet companies were founded without more than a roof and a computer. For example, Yahoo! was started in a trailer on the Stanford campus, Apple was conceived in a northern-California garage, and Microsoft was created by a college dropout. Thus with the extremely high level of technological sophistication exhibited by today’s youth and the low level of capital required to start a website a technological genius could easily enter the industry. Just as Yahoo! entered the market as a small tech startup and, using its superior technology, quickly stole market share from AltaVista – the most popular web portal of the late-1990s – another similar startup could come along at any time and supplant Yahoo! or Google atop the industry.
This industry is, however, clearly dominated by a few “big-named” firms such as Yahoo!, Google, and Microsoft. As a result, establishing a product name in such an industry is particularly difficult. The technology required to create a search engine or web portal, while relatively inexpensive, is highly sophisticated. Hence there are only a select handful of people in the world are technologically savvy enough to write a code that could rival that of Yahoo! and Google’s slew of engineers.

**BUYER & SUPPLIER POWER**

In the Internet Service Providers and Web Search Portals industry some buyers exhibit high levels of power while others exhibit none. Since most firms in the industry rely on advertisement-based revenue streams nearly the entire industry is highly susceptible to having business clients leave for other web portals. If a company that advertises on Yahoo! sees that Google or another Internet firm offers lower rates for advertisements, this company can take its business to Google without incurring high switching costs. On the other hand, individual search engine users do not pay Yahoo! directly and therefore carry no power over Yahoo!.

Supplier power is almost a non-issue in the Internet Service Providers and Web Search Portals industry. Just about all of the firms in this industry link to the exact same online content and websites and because their revenues are based on advertising, most are almost forced to accept an industry norm for their advertising revenues.

**YAHOO! VS. GOOGLE**

While Yahoo! competes with dozens of various Internet information providers, its main competition is undoubtedly Google. The Company isn’t in danger of failing financially, but is clearly at risk of having Google take away market share the same exact way Yahoo! did to AltaVista a few years ago. Since its introduction to the market, Google has taken considerable market share from Yahoo! and outperformed the once-dominant Company in nearly every financial category.
Despite the fact that Google’s stock price has slipped recently on news of various lawsuits related to its recent acquisition of YouTube and Yahoo!’s impending introduction of its Panama technology, Google’s stock has exhibited considerable growth over the past few years and shows few signs of slowing. The following chart demonstrates how Yahoo! and Google’s stock prices have diverged in recent years.

![Graph showing stock price divergence between Yahoo! and Google](image)

As is evident from Table 2 below, Yahoo! is keeping pace with Google in some financial categories, but is lagging significantly behind Google in many key areas.

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Clearly at this point Google is just a more profitable firm than Yahoo!. Since Google is still a relatively young company we expect Google to exhibit very high levels of growth – and it has over the past five years. However, its profitability and efficiency have far surpassed Yahoo!’s in a very short period of time, in much the same way Yahoo! overtook and far surpassed AltaVista. While we don’t anticipate Google enjoying the success and incredibly high growth rates we see now, Google has clearly set itself up well for a prosperous future. Taking full advantage of Yahoo!’s relative first-mover advantage in the industry, Google has established an advertisement-based revenue system which allows the firm to operate at much higher margins than its counterpart. Table 2 illustrates this point well: while the two firms exhibit nearly identical gross margins, Google’s profit margin, operating margin, return on assets, and return on equity are far superior to those of Yahoo!. The issue of Yahoo!’s relative inefficiency and the consequences thereof are further discussed in the Strategic Issues section.
STRATEGIC ISSUES & RECOMMENDATIONS

There are two main strategic issues facing Yahoo!: (1) a necessary improvement on its current revenue generation system, and (2) fierce competition for new users. These two issues, as we will see, are far from mutually exclusive. We will describe these issues separately, then offer our recommendations for both simultaneously due to their overlapping nature.

REVENUES: ADVERTISEMENT-BASED SYSTEM & PREMIUM SERVICES

As we saw in the financial analysis section, Yahoo! is lagging behind Google in terms of efficiency of income generation. When Google entered the market for Internet information providers in 1998 Yahoo! was already working its way to the top of the industry and was about to dethrone AltaVista. Over the next couple years Yahoo! created a solid two-part revenue generating mechanism which earned the Company money through online advertisements and paid premium services. Using this system as a benchmark, Google was able to create a modified system of its own – its AdWords and AdSense programs have proved more profitable over the past couple years than Yahoo!’s equivalent systems and show no signs of slowing down. As Yahoo! and Google currently trade off between the #1 and #2 most visited website in the world, Google is able to generate more revenue than Yahoo!...and of the revenues generated, Google is able to retain a higher proportion as net income.

When Yahoo! began operations in 1996 it focused heavily on both its paid premium services and marketing services. By offering online services such as high-storage e-mail accounts, personal and classified ads, job search, etc. Yahoo! was able to attract many new users as the Internet became a popular substitute for print media for both individual consumers and businesses looking to advertise. The increase in user base brought in more and more business clients who realized that the Internet would provide them with cheap and efficient advertising opportunities. Until 2001 Yahoo! shaded more and more towards advertisement-based revenue streams, hardly improving or expanding its paid
premium services over this period. However, in the rebound of the 2000 Internet bubble crash, Yahoo! changed focus once again. Terry Semel, CEO of Yahoo!, pushed the Company more in the direction of the paid premium services and expanded operations to include relationships with telecommunications companies such as AT&T in order to provide co-branded Internet access. Interestingly, as the Company focused more and more on its premium services the share of revenues coming from marketing services increased significantly. Currently, Yahoo! is once again focusing primarily on advertisement-based revenue streams, which comprised roughly 88% of total revenues for the Company in 2006.

While Yahoo! was busy dividing its attention between its premium and marketing services after the bubble crash, Google was focusing solely on improving its advertisement-based revenue system and the results speak for themselves. It is evident that Yahoo! must now play catch-up and somehow revamp their system to compete with the efficiency and profitability of Google’s structure.

As the following chart demonstrates, Google’s decision to focus on advertisement-based revenue was a wise one. As Credit Suisse shows, online advertising is likely to continue to grow rapidly and continuously over the next few years, thereby providing companies like Yahoo! and Google with strong and steady revenue streams. However, the firm that is able to command the biggest user base and utilize the most efficient advertising model will make out best, which is why it is vital for Yahoo! to revamp its revenue structure as soon and swiftly as possible.
COMPETITION FOR USERS

For an Internet information provider like Yahoo!, generating revenue isn’t merely an issue of the model used to extract as much revenue as possible from existing customers; rather, the number of users visiting Yahoo!’s various sites and utilizing its numerous products and services is the single largest determining factor in the Company’s revenue stream. The logic is painfully simple: the more users Yahoo! has, the more people see the advertisements and the more revenue the advertisements generate through views and click-throughs. Just how Yahoo! should increase its user base, however, is not a simple issue to tackle. When it comes to increasing user base, Yahoo! has several different options and an equally large number of challenges standing in its way.

To generate revenue, Yahoo! must simultaneously attract new users while preserving the user base it has already established. Offering an ever-increasing range of new products and services is not only helpful in this regard, but it is necessary if Yahoo! is to compete with the two-front threat it faces from Google and the emergence of free social networking sites. Over the past three years Yahoo! has significantly expanded its portfolio of both free and premium services
and the resulting increase in users is noticeable. For example, in 2006 alone the number of paying users subscribing to Yahoo!’s fee-based premium services increased 29% to over 16.3 million.

The problem, however, is that the market for Internet access in the United States has almost reached its saturation: at this point, just about every American who is capable of accessing the Internet can do so from his or her home or for free via public libraries or schools. Thus the total number of users in the United States market is a fixed quantity and Yahoo! must compete directly with Google and its other competitors to lure users away from them and to its own site. Google has taken several steps in the right direction by acquiring the frequently visited site YouTube.com and forming relationships with several popular websites such as online marketplace eBay and social networking site MySpace. Yahoo! is still ranked highly in the list of most frequented websites, but without that one killer deal Yahoo!’s control over the United States market becomes even more questionable.

**Recommendations**

The easiest way for Yahoo! to compete with Google’s advertisement-based revenue structure would be to benchmark Google’s system in much the same way Google used Yahoo!’s system as a basis for their revenue structure just a few years ago. By using Google’s current system as a starting point, Yahoo! could take advantage of Google’s relative first-mover advantage and reduce the costs of formulating a completely new revenue mechanism from scratch.

While Yahoo! has clearly formed strong connections with some very powerful companies over the years, one has to wonder what the future holds for fee-based premium online services. As the Internet continues to grow, more and more sites are being developed that offer similar services to what Yahoo! offers, only their services are free of charge. It is only a matter of time before Yahoo! and its main competitors are forced to either purchase these new free sites or offer their own

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services free of charge as well. One example of this phenomenon is the New York Times. At first, the Times only offered its online newspaper and other features to paid subscribers, but as news became more readily available via the Internet, the newspaper was forced to offer more and more of its content for free. Today, the Times charges only for selected columnists’ work and allows users to access all other news and features free of charge. In fact, Yahoo! has already recognized significant slowing in the rate of increase of its users for its premium services. From 2004 to 2005, the number of paying users for their fee-based services increased 50% from 8.4 million to 12.6 million. However, as previously noted, from 2005 to 2006 the number of users increased roughly 29% to 16.3 million. While this slowdown could be partially attributed to the Internet market in the United States reaching saturation, in 2006 Yahoo! noticed that “the increase in our number of paying users was offset by a reduction in the average monthly revenues per paying user”\(^{10}\). Partially responsible for this revenue reduction was the decrease in price for many of its services, and this trend is likely to continue as its offers more and more services for free. For example, Yahoo! has already announced that it will – in response to Google’s increase in the size of its free GMail e-mail accounts – offer unlimited storage on its Yahoo! Mail for free to all users. Doing so means a loss in revenue from the discontinuation of its fee-based premium e-mail accounts, but Yahoo! is betting that the new users they will attract will increase advertisement revenues to more than offset the loss of the paid premiums.

It is at this point that Yahoo! finds itself at a decisive fork in the road: should it completely scrap the idea of improving its fee-based services in favor of some other potential revenue stream, or would it be better off continuing to focus on these premium services in hopes that the slowdown in demand is temporary? It is the recommendation of Gotham Global that Yahoo! slowly transition to a business strategy along the lines of the former: Yahoo! should devote the majority of its attention to both improving and broadening its marketing services and discovering a new source of revenue while maintaining focus on only is most

\(^{10}\) Yahoo! 2006 10-K
profitable fee-based services, such as broadband Internet access. To do so requires many large steps, the most important of which include increasing user base, forming strong relationships with other online marketing service providers, and performing extensive research and design to stay ahead of the market.

In recent weeks Yahoo! has already made significant progress on the advertisement relationship front. On April 10th Yahoo! announced that it had signed a deal with Viacom to serve as the exclusive provider of sponsored search and contextual ads to Viacom’s 33 entertainment sites, which include those of MTV Networks’ VH1 and Comedy Central. Such a move serves two purposes: it clearly increases Yahoo!’s user base and simultaneously provides the Company with more advertisements to sell to its business clients. The result should come in the form of an increase in gross revenues in the near future.

In another interesting move, Yahoo! recently finalized a deal with a group of U.S. newspaper companies that would establish a common online platform among a large group of newspaper websites and allow an advertiser to purchase advertising space across multiple newspaper sites. This group currently includes 12 newspaper publishing companies representing over 264 newspapers in 44 states. As part of the deal, the newspapers in the consortium are required to use Yahoo! searches on their websites. Yahoo! and the newspapers will sell advertisements on each others’ sites and the revenue will be shared among the partners. Content from the newspapers will also be featured on Yahoo!’s individual channels, such as news and technology.11 This deal is evidence of the newspaper companies’ recognition that consumers are beginning to prefer online news over the daily paper. This deal clearly benefits both sides and is an important step for Yahoo!. In a single move, Yahoo! concurrently increases the quality of the news found on its portal, the number of advertising opportunities available to its marketing services clients, and the number of individuals using its search engine.

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The aforementioned deals aimed at stabilizing Yahoo!’s precarious perch atop the industry’s advertisement-based revenue leaders represent a solid start to improving the Company’s market position. Yahoo! needs to continue to solidify the revenues derived from market services, but the Company simply cannot continue to follow the strategy of relying on advertisement revenue and following Google’s tactical moves. In its short history, Yahoo! has quickly gone from the premier web portal on the Internet to playing catch-up to a much younger and aggressive competitor. Yahoo! has been slow to react to the market and its lack of innovation is severely threatening its future success – and even survival – in the industry.

To this end, Yahoo! must begin taking steps to better position itself in the Internet sector to stay ahead of the curve. We’ve seen a recent focus of the Company to more of an Internet service provider role, laying infrastructure for high-speed DSL Internet connections through a deal with SBC/AT&T. While the potential exists for this to be a profitable venture, it’s relatively backward-looking in nature: firms that laid infrastructure and provided Internet access before the bubble crash in 2000 were highly profitable, but in today’s economy there is admittedly a limited market for high-speed Internet access. Providing high-speed DSL Internet access through AT&T provides Yahoo! with a steady income stream in the short run as the number of broadband subscribers continues to increase in the United States and abroad. In 2006, for example, the number of broadband subscribers increased over 14% and now one-in-five Americans are high-speed Internet subscribers12. As the following chart shows, most broadband subscribers worldwide use DSL in favor of cable and other forms of high-speed Internet (such as satellite). Yahoo! should continue to focus on its broadband access – which has become its most profitable fee-based service – because it provides them with not only strong branding, but also deals for exclusive search rights.

12 Source: OECD
However, high-speed Internet access is yet another example of an area in which Yahoo! is one step behind Google. While Yahoo! generates revenues from providing DSL connections to subscribers, Google gained much publicity for its announcement that it will be providing free Wi-Fi Internet access to entire cities, San Francisco being the first. Should Google succeed in expanding this venture to other cities, it will drive almost all competitors in its free-Wi-Fi areas out of business. DSL can still be profitable for Yahoo! for the time being, but Yahoo! must devote most of its attention to constantly searching for the next “big thing” to hit the Internet.

Yahoo! has tried closely following its competitors’ market maneuvers the past few years, and hasn’t been doing a very good job of it. Google purchased and YouTube and the rights to exclusive searches on MySpace and took heat from investors and analysts alike for the high prices it paid. Not only did Yahoo! completely miss out on the purchase of these two sites (which, incidentally, single-handedly launched Google into the lead for most visited website), but by the time Yahoo! reacted and attempted a purchase of social networking site Facebook, prices had risen astronomically and the deal fell through due to an undervaluation on the part of Yahoo!. Needham and Company notes that Yahoo!’s failure to acquire Facebook had some significant short- and long-term effects for the Company. They say that “Yahoo! must take steps to gain a more meaningful leadership position in social networking or risk not participating in
what could be one of the fastest growing segments in the consumer Internet sector over the next five-plus years.”

Social networking is an area that Yahoo! simply cannot afford to miss out on. Its networking site Yahoo! 360 failed to catch on with consumers, and while Yahoo! Answers, Flickr, and del.icio.us have thus far been successful online socially-oriented services they aren’t core destinations. Social networking is a prime example of a product that Yahoo! missed out on due to its inability to keep up with the constantly-changing Internet sector.

In a similar vein, Yahoo! recently introduced an MP3 player to compete with Apple’s highly popular iPod. Teaming up with Sandisk, Yahoo!’s Sansa Connect device combines Wi-Fi capabilities and 4GB of memory so that users can download songs directly from the Internet and even stream Internet radio. A telling sign of Yahoo!’s lag in the technology market comes in the form of an announcement made on the very same day as Yahoo!’s introduction of its Sansa Connect: Apple announced it had sold its 100 millionth iPod. Apple’s iPod has a stronghold on the MP3 player market and Yahoo!’s attempt at a portable music device is years too late. There is talk of Yahoo! adding e-mail and cellular phone capabilities to its Sansa Connect, which sounds like a profitable idea. However, Google announced months ago it was in the planning stages of its own cellular phone to compete with the highly anticipated iPhone, which Apple is set to debut later this year. The introduction of the iPhone and Google’s yet-unnamed Internet-ready (and Google portal-equipped) phone, coupled with the continuing popularity of devices such as the Blackberry signals a changing in the market: mobile devices are the future for Internet access. Yahoo! must not miss out on this opportunity to penetrate the market early by providing mobile device users access to the Internet and its services.

It is imperative that Yahoo! improve greatly on the lack of innovation it has shown over the past decade. While its new Panama search engine technology is promising, Yahoo! needs to branch out and take risks in uncovering the next big

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13 Needham & Company Yahoo! Report; April 4, 2007
product or service that will take the Internet market by storm. As it stands, Yahoo! is dangerously close to falling victim to the dreaded Microsoft Syndrome. Microsoft has allowed itself to become so large that its own size severely limits its efficiency, market mobility, and room for innovation. Take, for example, Microsoft’s new Vista software. It took Microsoft nearly a decade to design and introduce this software, an unacceptable timetable for a firm as powerful as Microsoft.

Yahoo! is still growing (and doing so rapidly), but it has to take measures to remain nimble in an industry characterized by quick changes in consumer taste. With the myriad resources available to it, a necessity for Yahoo! is the promotion of its Yahoo! Next program: employ young technicians who can keep the company up-to-date with, and hopefully ahead of, the market. We at Gotham Global aren’t in a position to suggest the next product that will redefine the Internet industry, and it is likely that engineers at Yahoo!, Google, or Microsoft aren’t either. Thus Yahoo! must keep its finger on the pulse of the market and not become too big and slow-moving to protect against the possibility of missing a potentially blockbuster acquisition or invention.