A White Paper

Googleopoly III*

Dependency: The Crux of the Google-Yahoo Ad Agreement Problem.

Would Yahoo Compete as Vigorously with Google Post-Agreement?

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Abstract: The crux of the decision of whether the DOJ blocks or blesses the Google-Yahoo ad partnership is the DOJ's best assessment of whether Yahoo would compete as vigorously with Google after the agreement as before it. **At core, the proposed Google-Yahoo ad agreement would transform Google from being just Yahoo's primary competitor, to also being Yahoo's single most important business relationship: financially, operationally and strategically.** The purpose of this white paper is to analytically "stress test" the credibility of Google and Yahoo's assertions that Yahoo would have the same incentive to compete as vigorously with Google -- post-agreement. This white paper will:

- Present Yahoo/Google's specific claims about enhancing competition.
- Spotlight the fundamental asymmetry of the Google-Yahoo relationship.
  - It's not a relationship between equals, but a Yahoo dependency on Google.
  - Yahoo needs Google much more that Google needs Yahoo.
- Explain why it's not credible Yahoo would compete as vigorously post-agreement.
  - The agreement creates a slippery slope of more Yahoo dependence.
  - The agreement creates a slippery slope need for more antitrust regulatory oversight.
  - Google/Yahoo's largest customers believe Yahoo will compete less.
  - This is a "Hotel California" agreement; Yahoo can check out, but never leave.

DOJ has to determine if Yahoo has effectively succumbed to the old adage: "if you can't beat them, join them." Yahoo and Google's claims that the financial transaction between the #1 and #2 primary competitors in a highly-concentrated industry are: entirely benign, involve no quid pro quo outside the agreement, and create no opportunity or incentive for anti-competitive collusion – are simply not credible. The value, depth and breadth of this ad agreement would make Yahoo too dependent on Google financially, operationally and strategically to credibly believe Yahoo would compete as vigorously with Google post agreement as before. Thus, it is more likely than not, that the DOJ will attempt to block this ad agreement between Google and Yahoo as anti-competitive.

* *Googleopoly II: Google's Predatory Playbook to Thwart Competition*; 9-23-08
Googleopoly: The Google-DoubleClick Anti-Competitive Case; 9-17-07
See www.Googleopoly.net

** NetCompetition.org is a free market e-forum funded by broadband interests.

I. Introduction

The crux of the decision of whether the DOJ blocks or blesses the Google-Yahoo ad partnership is the DOJ's best assessment of whether Yahoo would compete as vigorously with Google after the agreement as before it. **At core, the proposed Google-Yahoo ad agreement would transform Google from being just Yahoo's primary competitor, to also being Yahoo's single most important business relationship: financially, operationally and strategically**. The purpose of this white paper is to analytically "stress test" the credibility of Google and Yahoo's assertions that Yahoo would have the same incentive to compete as vigorously with Google -- post-agreement.

The structure of this white paper is:

- Yahoo/Google's assertions about search competition – are they credible?
- The fundamental asymmetry of the Google-Yahoo relationship.
- Why it's <u>not</u> credible Yahoo would compete as vigorously after the agreement.
- Conclusion: Yahoo would be <u>too dependent</u> on Google to compete as vigorously.

II. Yahoo/Google's assertions about search competition – are they credible?

- Yahoo:
    - "*…since our plan and intent is to increase our search advertising share over time – not cede any of it to Google – this deal will make us a stronger competitor in search and display advertising*." David Hantman, Yahoo Vice President for Global Public Policy, in "*Justice Talks with Rivals, Clients of Yahoo, Google*" Wall Street Journal, 9-26-08.
        - (Note the claim of becoming a "stronger competitor" than they are now.)
    - *"Yahoo! will use this agreement to help us become a stronger competitor in all aspects of online advertising; and Yahoo! is not exiting the sponsored search business. We plan to remain a strong player in sponsored search."* Yahoo President Susan Decker, on Yahoo's website post 9-26-08.
        - (Note Ms. Decker said "strong player," not "strong competitor" in search.)
- Google:
    - "*Ultimately, we believe that the efficiencies of this agreement will help preserve and enhance competition*." Google website: www.YahooGoogleFacts.com
        - (Note: Efficiencies for whom? Google and Yahoo? Or customers?)

If the word of the targets of a DOJ investigation were all it took to determine if a law was broken, then there would be no need for law enforcement or the DOJ. Moreover, if the DOJ accepted the parties' assertions at face value -- that competition would increase or be enhanced by the deal – the DOJ would not be conducting a serious and detailed investigation, including the use of subpoenas.

III. The Fundamental Asymmetry of the Google-Yahoo Relationship:

Upon close examination, the evidence will show overwhelmingly that the Google-Yahoo ad agreement is far from an agreement between equals; it is a situation where Yahoo needs Google more than Google needs Yahoo. The logical conclusion is that the fundamental asymmetry in the Google-Yahoo relationship practically means Yahoo would be dependent on Google under the agreement.

A. Google-Yahoo is not a relationship of equals: (Source: Yahoo Finance)

- Financially, Google is 3-5 times stronger that Yahoo.
    - Google's market cap valuation is >5 times Yahoo's;
    - Google's annual revenues are ~3 times Yahoo's;
    - Google's annual revenue growth is >6 times Yahoo's;
    - Google's annual operating free cash flow is ~3 times Yahoo's;
    - Google's current cash position is >4 times Yahoo's; and
    - Google's annual capital investment is >3 times Yahoo's.

- Competitively, Google is ~3-4 times stronger than Yahoo. (Hitwise, companies)
    - Google's retail search market share is ~3.5 times Yahoo's;
    - Google wholesale search market share is ~4 times Yahoo's; and
    - Google has >3 times more advertisers than Yahoo.

B. Yahoo needs Google much more that Google needs Yahoo.

- The agreement would increase annual *revenues* for:
    - Yahoo by ~$800m or ~11% of Yahoo's $7.72b in annual revenues;
    - Google by ~$900m or ~4.6% of Google's $19.61b in annual revenues.
        - (assumes deal represents ~10% industry standard deal)
- The agreement would increase the annual revenue *growth rate* for:
    - Yahoo by ~180% from ~6% to ~17%;
    - Google by ~12% from ~39% to 43.6%.
        - (assumes base revenue growth rates are constant for comparison)
- The agreement would increase the *operating cash flow* for:
    - Yahoo by ~15% from $2.29b to $2.64;
    - Google by ~5% from $6.87b to $7.22b.
        - (assumes $350m incremental operating cash flow per Yahoo estimate)

C. Most all the publicly announced benefits of the agreement go to Yahoo not Google.

Google' June 12th press release on the deal is telling in that it describes in great detail the benefits of Yahoo using "*Google's search and contextual advertising technology*" and how the agreement provides Yahoo with "*better advertising technology to help them succeed in their own businesses*." In a stunning and telling omission, Google claimed no benefit from the agreement

other than Yahoo-Google IM interoperability – begging the question why did they agree to provide benefits to a competitor with no counter-balancing benefits to Google and Google shareholders -- other than interoperability in a free service that generates no revenues? It suggests that the agreement is really about Google increasing market share/market power and/or thwarting the possibility of a stronger competitor focused on Google.

Yahoo's June 12th press release was even more telling in that it describes in even greater detail than Google's press release -- the benefits of the agreement to Yahoo:

- *"This agreement provides a source of funds to both deliver financial value to stockholders from search monetization and to invest in our broader strategy to transform display advertising…"*
- *"…this agreement will enable the Company to better monetize Yahoo!'s search inventory in the United States and Canada."*
- *"The agreement will enhance Yahoo!'s ability to achieve its goal to grow operating cash flow significantly…"*
- *"The financial benefits will enable Yahoo! to broaden the scope of its investments and initiatives, enhancing Yahoo!'s ability to offer attractive career opportunities to its employees."*

Moreover, Yahoo claims additional benefits from the agreement: it puts Yahoo in control in selecting which search queries are used and it requires no exclusives. What does Yahoo claim Google gets?

- Yahoo says that "*Google will share a percentage of such revenues with Yahoo*."
- Yahoo mentions the new IM interoperability for this free service.
- Probably the biggest benefit Google gets is a $250m poison pill payment if Yahoo were to experience a change in control (i.e. be bought by Microsoft) within 24 months.

In short, if this agreement is in fact pro-competitive as the parties claim, why is there such a stark asymmetry between the publicly disclosed benefits of the agreement for Yahoo and Google? If this was indeed a pro-competitive agreement, wouldn't it be logical to expect more a more balanced discussion of the agreement's benefits for both parties, and much more openness about what exactly Google gets out of the agreement? The asymmetry combined with the lack of public disclosure prompts suspicion that the agreement has substantial hidden collusive benefits to Google to make it worth its while, i.e. Yahoo is effectively subordinating itself to Google.

Maybe the benefits of the Google-Yahoo agreement are so obvious that Google and Yahoo believe that they are better left unsaid:

- Increase Google's overall market share and market power;
- Ensure Google's primary competitor, Yahoo, is financially, operationally, and strategically dependent on Google; and
- Ensure that Google's biggest potential competitor long term, Microsoft, is thwarted from becoming a stronger competitor in search.

D. What is the most accurate characterization of the Google-Yahoo relationship?

Given that **the agreement in one fell swoop would transform Google from being just Yahoo's primary competitor, to being the single most important business relationship for Yahoo financially, operationally and strategically** -- more than any other single vendor or client relationship, – what is the most appropriate and accurate way to characterize this new relationship between Google and Yahoo?

- White Knight rescuing a damsel in distress from a proprietary takeover dragon?
- Gracious market winner allowing a market loser a way to publicly save face?
- Wealthy philanthropist showing compassion for their new needy ward?
- Big brother protecting a little brother from a perceived bully?
- Senior ad partner subsidizing a fledgling junior partner to maintain appearances?
- Center of the Internet universe adding a sixth company satellite to its orbit?
- #1 competitor redirecting a #2 competitor's attentions and focus northward?
- Boss/subordinate? Master/apprentice? Headquarters/subsidiary?

At core, this agreement is about dependency and subordination. Simply, does DOJ believe that Yahoo would competitively bite the hand that feeds them -- Google?

IV. Why it's <u>not</u> credible that Yahoo would compete as vigorously after the agreement.

A. The agreement creates a slippery slope of more Yahoo dependence.

Creates a profit spigot: As an open-ended revenue-sharing deal that Yahoo admits will: "*grow operating cash flow significantly;*" *"better monetize Yahoo!'s search inventor;"* and *"deliver financial value to stockholders;"* the deal functions like a revenue/profitability spigot that Yahoo could turn up or down. If the agreement proves successful, like the companies have represented it will be, why would Yahoo not add even more search queries to the agreement, at its discretion, beyond the initial estimates and plans of the agreement -- if the deal is so profitable for Yahoo?

- The Association of National Advertisers (ANA) affirms this concern in its letter to the DOJ opposing the agreement*: "Over the long term, Yahoo would be expected to source an increasing share of its ads via Google to optimize revenue."*

Google gets Yahoo a 'little pregnant.' The notion that this agreement is a slippery slope actually comes from Yahoo's investors. Since before Yahoo launched its 'Panama project' to better compete with Google, investors and analysts have strongly advised/pressured Yahoo to fully outsource its search business to Google, because it would dramatically increase Yahoo's profitability. Outsourcing would increase revenues from Google's better monetization while also eliminating the huge overhead costs of an "unnecessary" or "redundant" search engine. Investors point to the Google deals with AOL and Ask.com as examples of what Yahoo should do. In investor's and analyst's minds, this agreement is like Yahoo "getting a little bit pregnant." To continue the metaphor, an approved agreement would allow the outsourcing of Yahoo's search

business to grow and grow until it births into a full outsourcing of Yahoo's search business to Google – creating a permanent tie between "Mom" and "Dad."

What would cross the line? By voluntarily agreeing to submit this deal to regulators for approval, Google and Yahoo are implicitly admitting that the agreement at least approaches the antitrust "line" of acceptability or illegality. If the current agreement has prompted Google's customers to come out en masse to oppose it (ANA, WAN etc.) where exactly is the antitrust line? What amount of "competitive cooperation" between Google and Yahoo is OK and what amount would constitute illegal collusion? Wouldn't it be instructive for the parties to explain where they view the antitrust line is between legal and illegal "competitive cooperation," so the DOJ could determine if it is comfortable with how the overall dynamic and incentives built into the proposed agreement would affect that antitrust line – over time?

A Tacit Obligation for a Heads Up? Implicit in the agreement is that Yahoo and Google would be partners for a significant part of the search business – i.e. Yahoo's weaker monetized inventory. Implicit in any partnership is a certain level of communication and respect to ensure that the relationship works for both sides. The antitrust concern is that in any highly-concentrated industry, primary competitors are not supposed to be communicating about sensitive aspects of their business model, inventory, and business weaknesses, because it could easily slip into anti-competitive collusion of fixing prices or restricting supply. Simply, approving this agreement could blur the line of what is cooperation vs. collusion; it could also perversely encourage the parties to push the "cooperation" envelope under the 'cover' of an approved agreement.

B. The agreement creates a slippery slope need for antitrust regulatory oversight.

By "voluntarily" submitting this agreement for review and approval of the DOJ, Google and Yahoo are implicitly asking for DOJ to bless their 'cooperative' business model going forward. Google and Yahoo have done this because their antitrust counsel advised them that this deal at least approaches the antitrust line between legal and illegal cooperation among primary competitors. By proactively choosing to dance near the edge of legality, the parties are creating a need for two new sets of behaviors: one by Google and Yahoo, and the other by the Government.

- The new behavior by Google and Yahoo comes from establishing the precedent of a "Mother may I?" dynamic -- where every time Google or Yahoo contemplates a material change to their ad agreement -- they would be implicitly obligated to ask the DOJ if it crossed the line of illegality.
- The new behavior required of the DOJ, (if they were to bless the agreement) would be one of ongoing antitrust/regulatory oversight, where the DOJ staff would need to vigilantly monitor the agreement indefinitely to ensure it does not morph into illegal collusion.

In a word, Google and Yahoo have self-created a quasi-regulatory environment where they are proactively seeking Government guidance on how to legally conduct their businesses jointly. It is odd that Google and Yahoo have chosen to put themselves into such a "catch 22" situation.

C. Google/Yahoo's largest customers believe Yahoo will compete less.

Given that customers are the constituency that the DOJ gives most credence to in antitrust investigation and prosecutions, it is telling that Google and Yahoo's largest customers have publicly and emphatically declared they believe the agreement will diminish Yahoo's incentive to compete against Google.

The Association of National Advertisers (ANA), in their letter to the DOJ opposing the agreement, clearly believes that the agreement would weaken Yahoo's incentive to compete as vigorously with Google.

- *"Critically, the Google-Yahoo collaboration will likely lead to an increased concentration of market power that will adversely impact the marketing community. The impact of higher market concentration could result in reduced competition and leave advertisers with limited choices and alternatives to secure high-quality, affordable online advertising."*

The World Association of Newspapers (WAN) in their communiqué opposing the agreement, clearly believes the agreement would weaken Yahoo's incentive to compete as vigorously with Google.

- *"…W.A.N. strenuously opposes Google's attempt to take over a portion of Yahoo's content advertising and syndicated search businesses. Google already substantially dominates both businesses and its market dominance is growing by the day. Yahoo is (and should continue to be) Google's most significant competitor in the syndicated search business and is (and should continue to be) its only real competitor in content advertising."*

D. Agreement practically functions as cross-ownership of media companies:

Given that the agreement would increase Yahoo's: revenues $800m (~11% of Yahoo's $7.72b total revenues); growth rate by 180%; and operating cash flow by ~15% or $350M, -- investors and analysts would estimate that the agreement, if approved and successful, would be worth at a minimum, a 10% increase in Yahoo's valuation and most likely a much greater increase in Yahoo's valuation -- ~20-40%. As Yahoo's single largest and most important business relationship, Google would effectively "own" a significant piece of Yahoo because it would get a revenue-sharing flow from Yahoo in excess of 10% of Yahoo's business. For all practical purposes, Yahoo would view Google as more important than a shareholder that owns 10% of Yahoo. To date, Yahoo has shown more willingness to buck its own shareholders than its #1 competitor Google.

Why would practical and functional cross-ownership of Yahoo by Google be problematic? First, Yahoo and Google are leading online media companies, especially since Google's YouTube now constitutes ~44% of the Internet video streaming business -- per ComScore. Second, under FCC rules, a five percent stake in a company constitutes cross-ownership under the law for the purposes of limiting media concentration. FCC rules have limited cable cross-ownership to 30%

for cable companies and 39% for broadcast companies. The cross-ownership of search share between Google and Yahoo would be roughly 90% -- per Hitwise.

Why are media concentration limits relevant to this deal? They prove that Congress, on more than one occasion, passed laws limiting the potential concentration of industries involved in media. Given that Google and Yahoo are the leading online media companies in the world, given that people are increasingly getting their news online, and given that Google and Yahoo are leading online news aggregators, the restated will of Congress to limit media concentration is relevant to this deal. In addition, this deal underscores how much faster market share accumulates online than offline.

E. This is a "Hotel California" agreement; Yahoo can check out, but never leave.

The context of this agreement is that it was the end result of a major comprehensive strategic review by Yahoo prompted by the repeated attempts by Microsoft to buy or align with Yahoo. Yahoo told its shareholders that it reviewed all its strategic options: Microsoft, AOL, MySpace, Google, etc., and that it concluded the Google relationship was the best strategic option for Yahoo. With the agreement's two-year, $250m poison bill to discourage the reopening of talks with Microsoft, the agreement is a clear ploy by Google to make Yahoo dependent financially, operationally and strategically on Google going forward.

Google knows that once Yahoo and shareholders become accustomed to the superior monetization via the agreement, and the very substantial subsidization that would come with being Yahoo's #1 business relationship, that Yahoo and its shareholders would become as addicted to Google's business help, as an addict is addicted to heroin. The cold reality is that the longer the agreement was to continue, the harder it would be for Yahoo to go cold turkey and reestablish its competitive independence.

V. Conclusion: Yahoo would be <u>too dependent</u> on Google to compete as vigorously.

At core, DOJ has to determine if Yahoo has effectively adopted the old adage: **"if you can't beat them, join them."** On its face, is this agreement evidence of an increase in competition as the competitors allege? Or is it a partial competitive truce and collusion to divvy up the spoils of market power? As Norman Hawker, a Senior Fellow at the American Antitrust Institute, stated in his paper: The proposed Google-Yahoo Alliance: "*It strains credulity, however, to believe that Google would agree to an arrangement that gives its chief rival $800m to invest in effort that would, if successful, reduce Google's market power*."

Yahoo and Google's claims that this financial agreement between the #1 and #2 primary competitors in a highly concentrated industry are: entirely benign, involve no quid pro quo outside the agreement, and create no opportunity or incentive for anti-competitive collusion – are simply not credible. The question is not whether the proposed Google-Yahoo relationship behind

this agreement is anti-competitive. It is. The open question is whether the DOJ believes it can prove it is anti-competitive in a Federal court of law.

The bottom line is simple. **The value, depth and breadth of this ad agreement would make Yahoo too dependent on Google financially, operationally and strategically to credibly believe Yahoo would compete as vigorously with Google post agreement as before.** Thus, it is more likely than not, that the DOJ will attempt to block this ad agreement between Google and Yahoo as anti-competitive.

Bio for:

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- Scott Cleland is one of nation's foremost techcom analysts and experts *at the nexus of*: capital markets, public policy and techcom industry change. He is widely-respected in industry, government, media and capital markets as a forward thinker, free market proponent, and leading authority on the future of communications. Precursor LLC is an industry research and consulting firm, specializing in the techcom sector, whose mission is to help companies anticipate change for competitive advantage. He previously founded The Precursor Group Inc., which *Institutional Investor* magazine ranked as the #1 "Best Independent" research firm in communications for two years in a row. He is also Chairman of Netcompetition.org, a wholly-owned subsidiary of Precursor LLC and an e-forum on Net Neutrality funded by broadband telecom, cable, and wireless companies.

- Cleland has a high-profile track record of foreseeing big change before others. He coined the term "techcom" to define how information technology drives the communications future and to best name the new sector that converging communications technologies are creating. *Fortune* profiled Cleland as the first to call "WorldCom: Dead Model Walking" and to predict its bankruptcy. Then WorldCom CEO Bernie Ebbers tried to discredit Cleland's prescient and hard-hitting research on WorldCom by deriding him the "idiot Washington analyst." Cleland has testified before seven different Congressional subcommittees on a variety of forward-looking topics and was the first congressional expert witness asked to testify on what went wrong with Enron.

Scott Cleland's Congressional Testimony on Google:

- Before the Senate Judiciary Subcommittee on Antitrust on the Google-DoubleClick Merger, September 27, 2007.
  - http://googleopoly.net/cleland_testimony_092707.pdf
- Before the House Energy and Commerce Subcommittee on the Internet on Google Privacy issues, July 17, 2008.
  - http://www.netcompetition.org/Written_Testimony_House_Privacy_071707.pdf