

Yahoo Tie-Up Is Latest Sign Tide Turning for Microsoft's Ballmer

By Nick Wingfield

REDMOND, Wash. -- [Microsoft](#) Corp.'s deal to join forces with [Yahoo](#) Inc. in the Internet search and advertising businesses could create a counterweight to the online muscle of [Google](#) Inc. It may also help Steve Ballmer end the worst slump in his career at the helm of Microsoft.

For the past several years, Microsoft has been stung by missteps, including a clumsy defeat last year in Mr. Ballmer's unsolicited bid to acquire all of Yahoo. Microsoft's Windows Vista operating system was pilloried for technical problems, and its videogame ambitions were nearly thwarted by widespread malfunctions of its Xbox 360 console.



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Steve Ballmer: Focus on Windows

Ballmer on Leadership

In a series of earlier video interviews, Mr. Ballmer spoke about how he manages his time, makes decisions, runs meeting and more. Watch the clips from the Journal's [Lessons in Leadership](#) series here:

- [Ballmer on Time Management](#)
- [Ballmer on Making Decisions](#)
- [Ballmer on Running Meetings](#)
- [Ballmer on Micromanaging](#)
- [Ballmer on Hiring](#)

Yet amid the bad news, there are signs that things may be finally starting to look up for Microsoft.

Reviewers are praising the test version of its Windows 7, which will go on sale in final form Oct. 22. Microsoft's Xbox business is getting buzz for innovation. Its new search engine, called Bing, has earned plaudits and market share since it launched last month.

"Suddenly you don't feel like a moron for saying you use a Microsoft product," says Keith Richman, chief executive of Internet video site Break.com and a fan of Bing.

And now Mr. Ballmer, Microsoft's CEO, has reached a deal with Yahoo that, if successful, could give him a big boost in his company's rivalry with Google. Under their 10-year agreement, Microsoft's Bing will become the Internet search service on Yahoo, while Yahoo will sell advertisements that run next to the search results to large companies on behalf of both Microsoft and Yahoo. The agreement could catapult Microsoft's share of online searches conducted by U.S. consumers to nearly 30% from just over 8.4%, compared with Google's 65% of the market, based on market estimates by Comscore Inc.

While the deal is likely to face scrutiny from regulators concerned about its effects on competition, Microsoft and Yahoo argue the pact is the only way to create a viable alternative to Google, a company that harvests the bulk of the lucrative online advertising market. They say the deal will help advertisers reach a bigger audience than they can if Yahoo and Microsoft search efforts remain separate.

For Mr. Ballmer, the agreement provides some redemption in an area he has stressed is critical to Microsoft's future. In an interview, he says the Yahoo deal received "more of my personal attention over the last 18 months than anything else we're involved with," including focusing on its most important new product in years, Windows 7. "It's a big deal," he says.

Microsoft has big challenges. Mr. Ballmer, 53 years old, runs a company of nearly 100,000 employees across an often unwieldy array of businesses, including a mobile-phone group that has fallen far behind Apple Inc.'s iPhone. Microsoft's Windows and Office businesses still face long-term threats such as Google's recently announced Chrome OS for powering inexpensive laptops and a shift to online versions of applications that could jeopardize many of Microsoft's software businesses.

Ballmer, Bartz on Buzz, Impact, History

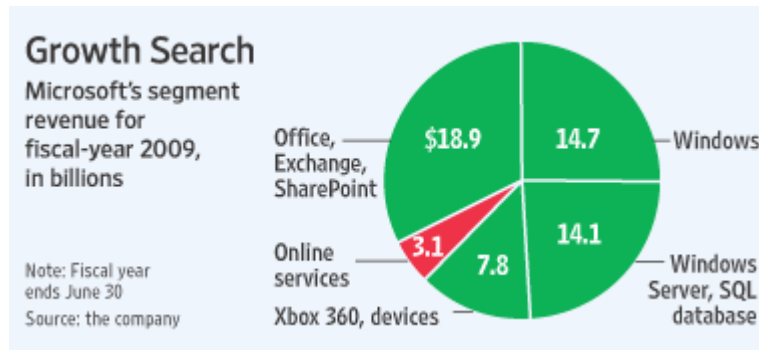
A slowdown in technology spending prompted the company to eliminate 5,000 jobs earlier this year -- the first significant layoffs in its history. That slowdown also caused the company to report its first-ever decline in annual revenue last week. Investors had bid the company's stock up on anticipation of new products coming, but slammed the shares after last week's disappointing earnings.

Still, there are glimpses of a sentiment shift about the world's biggest software company. One of the most telling came earlier this month, on Mini-Microsoft, a blog written by an anonymous Microsoft employee in product management that is popular with company employees. For the past five years, the author has slammed Microsoft as a flabby, inefficient bureaucracy losing ground, but Windows 7, Bing and other recent efforts changed his mind. "I've got to say: in my opinion, Microsoft has turned The Corner," he wrote.

Even before the Yahoo deal, Mr. Ballmer was starting to get some respect in search, the business that turned Google into a powerhouse. Last year, the Microsoft group that runs its search business was a shambles, with a brand name -- Live Search -- that few consumers could remember and an eroding share of searches. Its top executives were distracted by the bungled bid for Yahoo, putting on hold improvements -- picking a more memorable name, for instance.

In the ultimate insult, even most of Microsoft's employees used Google to conduct Internet searches from computers on the company's internal network. "I don't think they felt like they could be evangelists about the product that we had," says Yusuf Mehdi, senior vice president for the

online audience business group at Microsoft. Now, he says, most Microsoft employees are using Bing.



With its Bing search engine, the company has focused on making results more consumer friendly -- for example, by using software formulas to tell searchers for flights from a local airport whether ticket prices are likely to rise in the coming days. The Bing name is, in the words of Mr. Mehdi, "vervable" in the same way Google is.

The new site was launched in June and backed up with a \$100 million advertising campaign. According to Comscore, Microsoft's share of U.S. online searches in June increased to 8.4% from 8% the prior month, growth that appears to have come at the expense of Yahoo, which declined to 19.6% in June from 20.1% the prior month.

Robert Murray, CEO of search marketing firm iProspect.com, say his clients are seeing significant improvements in results from ads on Microsoft's search engine since Bing launched; they are beginning to invest more money with Microsoft, he says.

Even with the growth of Bing, Mr. Ballmer held out for a Yahoo deal, seeing it as the only way to create a serious competitor to Google. In a joint interview, Mr. Ballmer and Ms. Bartz said the conversations between the two companies began to pick up about a search deal after January, when Ms. Bartz took over as CEO of Yahoo. Mr. Ballmer said the broad concept of the current deal began to take shape about a month ago.

Under their agreement, the cost of investing the hefty sums of money required to constantly improve the search technology used by both companies will be Microsoft's burden, while Yahoo will receive from Microsoft 88% of the revenue generated from searches conducted on Yahoo's site.

While its Internet efforts have nabbed most of the attention lately, Mr. Ballmer's greatest challenge is in reviving its biggest cash-cow business -- Windows, which delivered more than half of its \$20.4 billion in operating profit during its last fiscal year, ended June 30. It is unclear yet whether the company can again energize PC sales as it has in the past with new versions of its operating system, as the economy dampens spending and more consumers rely on cheaper devices like mobile phones for computing chores.

Windows Vista became a symbol of all that was wrong with Mr. Ballmer's Microsoft: When it came out nearly three years ago, the much-delayed software suffered from sluggish performance; it was slow to start up and shut down, especially on less powerful computers. It also had problems working with common devices like printers and digital cameras.

The problems created an opening that Microsoft's rival Apple relentlessly exploited in its Mac versus PC advertising campaign that depicted Windows in the guise of a bumbling nerd.

According to Gartner Inc., Apple increased its share of new computer shipments in the U.S. to 7.2% in the first quarter from 4.2% in the same period three years earlier, though the vast majority of computers still run on some form of Windows.

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Microsoft hopes its new Project Natal, demonstrated in Los Angeles in June, will help kick up X-box sales.



Microsoft executives insist Vista got a bum rap based on early problems that were fixed through software updates. Still, Mr. Ballmer says "there's more negative noise on Vista than I would have liked."

Complaints about Vista were dispiriting to Microsoft employees, adding to a sense of malaise. At a company sales meeting in early 2008, Eugenio Beaufrand, a veteran Microsoft executive in

China, grabbed a microphone during a question-and-answer session with executives. In an emotional speech, he demanded to know why the company wasn't doing more to combat the troubles of Windows Vista.

"He was fired up," says Bill Veghte, senior vice president of Microsoft's Windows business, one of the executives there.

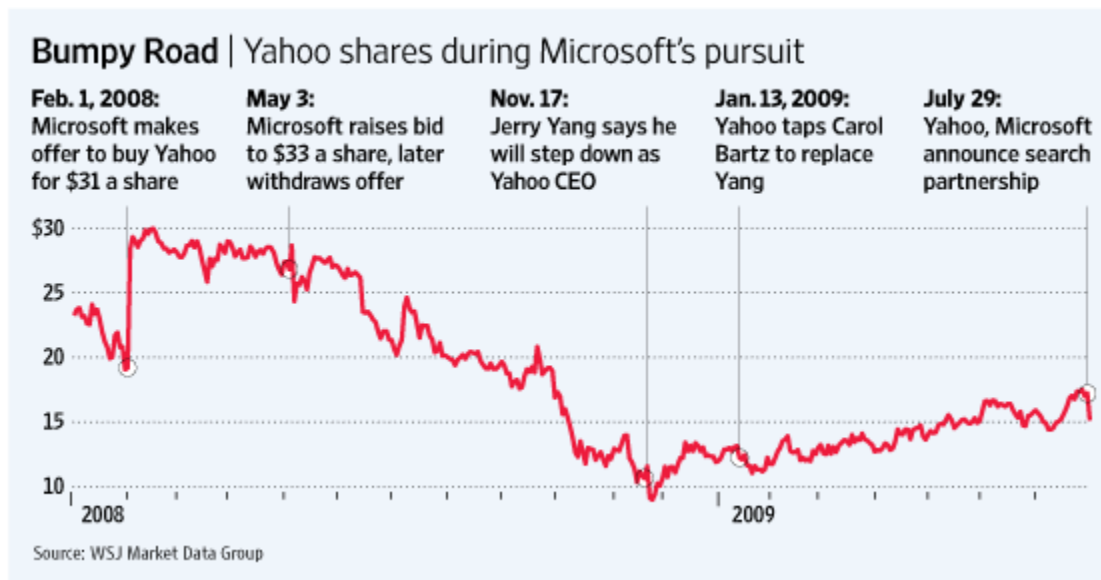
Frustrated with the delays in Vista, Mr. Ballmer in 2006 put Steven Sinofsky, a veteran Microsoft executive with a reputation for shipping regular updates to Microsoft's Office software on time, in charge of developing Windows 7. Among his marching orders: Work more closely with hardware partners to make sure it worked well with other devices.

Late last year, Microsoft released a test version of Windows 7 to the public. Early reviews have been positive; it starts up and runs quickly, even on inexpensive laptops called netbooks that are the strongest part of the PC business right now.

"It seems like what Vista should have been," says Michael Cusumano, a business professor at the Massachusetts Institute of Technology and author of several books on Microsoft's strategy. "They took a couple more years and got it right."

Retailers are hoping Windows 7 will give a lift to PC sales. "This new operating system isn't just a 'Vista that works,'" [Best Buy](#) Co. said in a recent internal message.

In a June survey of 100 information technology executives at large companies by Goldman Sachs, 76% of respondents said they eventually plan to upgrade their companies to Windows 7, indicating stronger demand for the software than for Windows Vista, which Goldman estimates is deployed on only 20% of business machines. Chris Dill, chief information officer of the Portland Trail Blazers, calls Windows Vista a "dud" and says the organization largely skipped it. Mr. Dill says he is enthusiastic enough about Windows 7 that he plans to upgrade most of the 300 PCs he is responsible for to the new software within six months.



Executives inside and outside Microsoft credit Mr. Ballmer with wresting the company out of its torpor. He shook up the company's Internet division, hiring Qi Lu, who used to lead Yahoo's search efforts and now is president of Microsoft's online services division. Larry Heck, a former

Yahoo vice president, chose a Microsoft job recently over opportunities at Google Inc. and other companies, he says.

"It's more fun, frankly, to make a bigger impact than being at a place that's already number one in the space," Mr. Heck says.

Some longtime Silicon Valley executives are happy about Microsoft's improvements in search because they see a need for a counterweight to Google. "People no longer perceive Microsoft as the enemy," says Jeff Bonforte, CEO of Internet startup Xobni Corp. and a former Yahoo executive. "On the Internet, Microsoft isn't that powerful."

Long a follower of the innovation of others, Microsoft is even getting credit for some technology breakthroughs. In June at the E3 games conference in Los Angeles, the company generated buzz with a new motion-sensing video camera called Project Natal Microsoft it is developing for the Xbox 360. The technology is designed to allow people to control on-screen action -- driving cars, boxing, kicking soccer balls -- by simply mimicking those movements with their bodies. Project Natal won't require users to hold a motion-sensing controller in their hands as Nintendo Co.'s Wii does.

That could give the Xbox 360 a boost in its push to further outpace [Sony Corp.](#)'s PlayStation 3 and to catch up to the Wii, the market leader in the console business. "Microsoft stole E3 and may have already won the motion-control wars with the announcement of Project Natal," the popular Gizmodo gadget blog declared in June. Such talk has helped Microsoft gain distance from a near calamity two years ago, in which it was forced to take a \$1.1 billion charge to cover the cost of repairing defective Xbox 360s.

Microsoft executives say they expect technology spending to improve next year and the company's sales should further get a lift from the release of Office 14, a new version of its well-known package of application software that has become a big money-maker for the company.

Microsoft employees say they've noticed a change at get-togethers with people outside the company. Over the past few years Tim O'Brien, director of the platform strategy group at Microsoft, said he often experienced an attitude from friends that he described as: "You're Microsoft, let me pound you."

When Mr. O'Brien went to his 25-year college reunion in Indianapolis recently, in contrast, he was congratulated about Windows 7 and Bing. "It was a completely different vibe," he says.