Chapter Ten

Yahoo's Billion-Dollar Bet

Nobody knows the future. You can only create the future.
—Jack Ma

Alibaba put paid to eBay's ambitions in China. But eBay was not the first Silicon Valley company to run into problems there, nor would it be the last. Despite being one of the most popular sites in China when people first logged on to the Internet, Yahoo would quickly fall behind—until a billion-dollar deal with Alibaba changed everything.

Jerry Yang

Yahoo's early success in the United States and Jerry Yang's ethnicity set up high expectations for the company in China. Known in mainland China as Yang Zhiyuan (Yang Chih-yuan in his native Taiwan), Jerry and the company he cofounded[1] served as an inspiration for the founders of Sohu, Sina, and NetEase. His appeal went far beyond the tech community. People in China were fascinated with how a young software engineer born in Taiwan came to found such an iconic American company and become so wealthy at such a young age.

Born in Taiwan in 1968, Yang took the name Jerry after he moved to the United States in 1978 with his mother, Lily, and younger brother, Ken. His father, born in mainland China, had died from a pulmonary disease when Jerry was just two years old. In Taiwan his mother had been a teacher, of English and drama, and in California she took a job teaching English to other immigrants. The family settled in a modest one-story home off

Hostetter Road in a suburb of San Jose. Jerry's longtime neighbor Bill Otto remembers him as a "very congenial" young boy, playing with his husky dog Bodie in the front yard and lugging a large backpack off to Sierramont Middle School.

Jerry came to the United States with just one word of English—"shoe": "We got made fun of a lot at first. I didn't even know who the faces were on the paper money."

Struggling at first with English, he spent his first two years in the United States in remedial classes. But Jerry excelled in math and science. At Piedmont Hills High School he played on the Pirates tennis team and was elected student council president, finishing his senior year as valedictorian and winning a full scholarship to Stanford. A member of the class of 1990, Jerry completed both his bachelor's and master's degrees in electrical engineering, and between rounds of golf continued his studies in pursuit of a Ph.D. For one of his classes, Jerry's teaching assistant at Stanford was David Filo, two years his elder. David, known for his shyness and reserve, had come to Stanford after an undergraduate degree in computer engineering at Tulane University in New Orleans. Born in Wisconsin, his family moved to Louisiana when he was six and he grew up on a commune in Moss Bluff. Jerry and David had worked in the same design automation software research group, and while teaching at the Stanford campus in Kyoto, Japan, had become close friends, sharing an interest in watching sumo wrestling.

Returning to Stanford, they took adjacent cubicles in a Stanford trailer, where they launched what would become Yahoo on two servers: "Akebono" and "Konishiki," both names of Hawaii-born sumo wrestlers who had excelled in Japan.

Like the messy Lakeside apartment in Hangzhou where Jack launched Alibaba five years later, the trailer where Jerry and David launched Yahoo was not a pretty site. The company's first investor, Michael Moritz of Sequoia Capital, recalled, "With the shades drawn tight, the Sun servers generating a ferocious amount of heat, the answering machine going on and off every couple of minutes, golf clubs stashed against the walls, pizza cartons on the floor, and unwashed clothes strewn around . . . it was every mother's idea of the bedroom she wished her sons never had."

Yahoo began as a list of other sites that Jerry and David had bookmarked using Marc Andreessen's recently launched Mosaic browser.

Known initially as Jerry's Guide to the World Wide Web, then Jerry and David's Guide to the World Wide Web, the list consisted at first of a hundred sites categorized manually into relevant headings. At first, traffic on the site was a thousand or so visitors each week. But by early 1995, traffic had grown to millions of hits a day. Stanford told them to move the site to their own servers. Jerry and David needed to raise funds to pay for them. Registered as Yahoo.com in January 1995, the company was incorporated in March 1995, and the following month, Sequoia invested $2 million, taking a 25 percent share of the company. The two engineers never finished their Ph.D.s. Jerry recalled, "When I first told my mom what we were doing, the best way I could talk about it was like a librarian. And she said you know you went through nine years of school to become a librarian. She was kind of shocked to say the least."

In the fall of 1995, Jerry, David, and Yahoo CEO Tim Koogle initiated discussions with new investors, including Eric Hippeau, the CEO of Ziff-Davis Publishing Company, a large publisher of PC and technology magazines. In November, SoftBank acquired Ziff-Davis, and Hippeau introduced Masayoshi Son to Jerry and David. Son and a colleague flew to meet Yahoo's founders, in their small office in Mountain View, California, just south of Palo Alto. Meeting over a lunch of takeout pizza and sodas, Son and the two founders hit it off. Son agreed to invest $2 million for a 5 percent stake in Yahoo. In March, Son doubled down. In a gutsy move, Son agreed to pay more than $100 million to top up his stake, ending up with over 41 percent of Yahoo, more than Jerry and David, who together held just under 35 percent.

Jerry recalled, "Most of us thought he was crazy. . . . Putting $100 million into a start-up in March 1996 was very aggressive, but I don't think it was luck."

SoftBank saw the potential for Yahoo in Japan, and the two companies launched their joint venture. Jerry flew to Japan in January 1996 to oversee preparations. The site, run by Son's deputy, Masahiro Inoue, launched three months later and was an instant success, racking up five million page views per day in January 1997, and hitting 100 million by July 2000.

On April 12, 1996, Yahoo went public on the Nasdaq, raising $33 million. After a healthy first-day 154 percent gain, investors valued the company at almost $850 million. Yahoo had just $1.4 million in revenues[2] and losses of over $600,000. Only a year after incorporating the company, Jerry Yang and David Filo were each worth more than $165 million on paper. Within three years they were billionaires. Their success propelled SoftBank to list in January 1998 on the primary board of the Tokyo Stock Exchange, making Son a billionaire, too.

Yahoo's popularity spread quickly around the world. The company rolled out localized sites where the business case was strongest. China was not a high priority, as Jerry indicated on a visit to Hong Kong in 1997: "China is probably the last market we want to address right now. It may be the most important one, but the last sequentially. There's not enough people using the Internet for us to be spending money over there."

Instead, Yahoo started to reach out to other parts of Asia, launching a regional site in Singapore in 1997 targeting Internet users in Southeast Asia. The following year it launched regional sites targeting overseas Chinese users and then users in China itself.[3] Consisting of links to ten thousand sites, the Chinese Yahoo was the thirteenth of its "mirror" sites around the world, hosted on servers in the United States and run from its headquarters in Santa Clara, California. Visitors could download free Chinese software to help with different character sets. The site was instantly popular on the mainland. Several hundred thousand visitors a day came to the site, impressive given that China then had less than a million Internet users.

As the Internet gained in popularity in China, Yahoo started to look at getting more deeply involved in the country. Jerry, who spoke fluent Mandarin, had yet to visit mainland China. In a fateful meeting, in 1997, Jack was his tour guide, assigned to the task while working for the government trade ministry in Beijing. In addition to the business meetings with MOFTEC and others, the trip was an opportunity for Jerry to see the sights. Jack's skills as a self-appointed tour guide on the shores of West Lake in Hangzhou came in handy when he and Cathy took Jerry, his younger brother Ken, and Yahoo vice president Heather Killen on a trip outside Beijing to see the Great Wall.

The image of Jerry sitting on the Great Wall is an appropriate metaphor for Yahoo's China dilemma. The market was growing rapidly, now home to millions and soon tens of millions of Internet users. Yahoo had already managed to become a dominant player in Japan, so why not in China, too? But China presented a quandary: how to deal with a government intent on control at all costs.

In 1996, speaking in Singapore, Jerry had shared his views: “Why the Internet has grown so fast is because it is not regulated.” There were limits to how much Jerry’s Chinese ethnicity would translate into an inside track for Yahoo in China: “The First Amendment safeguards freedom of speech. I’m more American in terms of my upbringing now.”

Yahoo from the outset was about content, and that would be tricky in China, where all forms of media were tightly controlled. When Yahoo opened its office in Hong Kong, Jerry was asked about the issue of censorship. He replied that Yahoo would “stay within the boundaries of the law and try to stay as free as possible.” He disclosed that Yahoo was in touch with the authorities in China but “to be honest, the policy is not very clear as to what is politically sensitive,” adding that they had been informed that “as long as we’re just listing content and not hosting it then we can just go right ahead.”

Although Yahoo was initially just a directory of links to websites run by third parties, even the choice of which links to present to the public was a sensitive matter. Furthermore, Yahoo was no longer just about links. Following an early partnership with Reuters the company added news content to its site, then chat rooms and, following an acquisition, Yahoo Mail.

The expanding scope of Yahoo’s business invited growing scrutiny from regulators on the mainland, who also harbored reservations about the company’s links to Taiwan. On a visit to the island in 1997, Jerry had been treated as a conquering hero, mobbed by the media and received by Vice President Lien Chan. His trip came just after Taiwan’s relations with Beijing had hit a new low. How could Yahoo comfortably serve users both in Taiwan and the mainland? Jerry Yang admitted it was a challenge: “We may or may not be able to get around it, because they [the Chinese government] can shut us off. . . . The point there is to take a very neutral stand. I don’t know if we can get away with it. We are already running into problems.”

Could Yahoo go it alone in China? Or would it be better to pick a local partner, perhaps buying out one of the portal pioneers, such as Charles Zhang’s Sohu, the original name of which, Sohoo, left no doubt as to its plans to become the “Yahoo of China”?

Build or buy? Either course had its complications. There were simply no precedents for Yahoo to look to. AOL opted in the summer of 1999 to invest in Hong Kong–based China.com. Even after it returned to Chinese sovereignty in 1997, Hong Kong was exempted[4] from the draconian media restrictions that made investing in China so fraught with risk for foreign companies. But China.com was a bit player in China, and even AOL's Steve Case admitted that Hong Kong was just "a logical staging area for China. We want to launch Hong Kong, and then we'll see what happens." (AOL's subsequent partnership in mainland China, with the computer manufacturer Legend Holdings, never gained traction.)

In September 1999, Jerry announced in Beijing that Yahoo was going into the mainland in a joint venture with Founder, a Chinese manufacturer of personal computers and software. The choice of partner was uninspiring but safe: The company was a spin-off from Peking University and retained strong ties to the Chinese government. Yahoo was finally in China itself, adding the coveted ".cn" suffix to become www.yahoo.com.cn. The site started as a directory of links to twenty thousand Chinese websites, plus additional content translated from its U.S. website, and Yahoo Mail and instant messenger. COO Jeffrey Mallett acknowledged that China wouldn't be easy: "We are walking into this with our eyes wide open. The site significantly expands the existing features of a Chinese Yahoo website already online, and it is being hosted in China by government-owned Beijing Telecom."

Yahoo's launch in China came just as the country's own portal pioneers had been dealt a blow in their efforts to launch an IPO. The announcement from Wu Jichuan, the powerful minister of information industry, appeared to ban all foreign investment in the Internet: "Whether or not it is an ICP [Internet content provider] or ISP [Internet service provider], it is about value-added services. In China, the service area is not open."

Yet, in an illustration of the gray area in which the Internet was operating, Minister Wu's own deputy[5] was onstage with Jerry Yang at the launch of Yahoo China, her presence as good a sign as any that Wu had given his tacit blessing to the venture. But an MII official described Yahoo's business as still being offshore, with Founder merely acting as a trustee: "No company was set up inside China's border." This admission revealed that, as with many deals in China, the negotiations only began once an agreement had been signed.

After the launch ceremony in Beijing, Jerry flew down to Shanghai to attend the Fortune Global Forum. He was one of sixty Fortune 500 CEOs—

including AOL's Steve Case, GE's Jack Welch, and Viacom's Sumner Redstone—along with other dignitaries, including Henry Kissinger, who gathered at the new, $100 million international convention center built in the city's Pudong district, on the right bank of the Huangpu River, directly opposite the city's iconic Bund. China's president Jiang Zemin inaugurated the Global Forum: "Set your eyes on China. China welcomes you. China's modernization needs your participation, and China's economic development will offer you tremendous opportunities."

The American host for the event was Gerald M. "Jerry" Levin, CEO of Time Warner, the publisher of *Fortune* magazine. Burnishing his credentials as an insider in China, Levin introduced the president of China onstage as "my good friend Jiang Zemin." The forum was a frenzy of China and Internet-infused deal making that soon swept up Jerry Levin himself. Soon afterward he inked Time Warner's $165 billion merger with AOL, a deal that became notorious as "the worst merger in history."

Unlike that deal, Yahoo's partnership with Founder in China ended up having little consequence. Founder was not the gatekeeper to China that Jerry Yang had hoped. The company's links to the Chinese government, which Yahoo had looked to as a shield from regulatory uncertainty, also prevented an entrepreneurial culture from ever taking root. Yahoo China's content was boring, and Chinese Internet users noticed, being drawn instead to the more compelling offerings of Sina, NetEase, and Sohu. Yahoo was losing the battle to stay relevant in China just as the country's Internet population was taking off.

Victor Koo, then COO of Sohu,[6] recalled that "Yahoo China could not match us in scale, localization, or investment. That was why it lost the China market." Their IPOs in 2000, facilitated by the VIE investment structure, allowed the three portals to survive the dot-com crash. Within a few years they had become profitable companies for the first time.

But, unbeknownst to them, the era of the China Internet portals was coming to an end, replaced by a new era of the "Three Kingdoms" of the "BAT": Baidu, Alibaba, and Tencent.

Yahoo's struggles, and backing, were to provide Alibaba its entry ticket to this exclusive club. Here's how.

Tencent

Tencent harnessed two trends that would transform the Chinese Internet sector: content delivered to cell phones, and online games played on PCs. Founded a few months before Alibaba, Tencent (*tengxun* in Chinese) was launched in late 1998 by two twenty-seven-year-old computer scientists who had met at Shenzhen University. Pony Ma (Ma Huateng) later became chairman and CEO of the company and is today one of China's richest men. Although no relation to Jack, Pony's last name, Ma, is the same as Jack's, his English name chosen as a joke since "Ma" means horse in Chinese.

Like Jack, Pony came from a modest background, and although he is much shyer than Jack he could also claim to be "one hundred percent Made in China." He was born in the coastal city of Shantou, Guangdong Province. His father worked as a port manager in Shenzhen, adjacent to Hong Kong.

After graduation, Pony took a job developing software for mobile pagers, a key entry point to the exploding market for cellular communications that would make his fortune. *Time* magazine anointed him as "China's Mobile Mogul." Pony named his company Tencent because the cost of sending a mobile text message at the time was ten Chinese cents (about 1.2 U.S. cents). Tencent's breakthrough product was its OICQ instant messaging client, installed on desktop computers, which was essentially a clone of the ICQ ("I seek you") product developed by Israeli company Mirabilis.[7] Facing the threat of a lawsuit, Tencent rebranded its service as "QQ," the letters chosen to approximate "cute" in Chinese. With a cuddly penguin in a red scarf for a mascot, the service became a big hit with young Chinese Internet users, initially on PCs, then on cell phones. When China's telecom operators began offering revenue-sharing partnerships with Internet players, Tencent's mobile business really took off. The partnerships, modeled on NTT DoCoMo's iMode in Japan, offered up to 85 percent of the new revenues generated. As mentioned earlier, when SARS hit the country many Chinese turned to mobile text messaging to gather or spread information about the outbreak.

Tencent has been the leading player in China's mobile social networking market ever since. But mobile messaging alone doesn't explain its meteoric rise. The company's biggest business today is online games.[8] Tencent's success in offering MMORPG (massively multiplayer online role playing games) titles such as The Legend of Mir 2 and Lineage, pioneered in South Korea, unlocked the largest revenue streams in China's Internet sector.[9] Tencent's success in QQ, games, and later with WeChat would propel its market capitalization in 2015 to exceed $200 billion, surpassing at times Alibaba, and generating a gold mine of tens of billions of dollars for the South African media company Naspers. In 2001, Naspers made one of the best investments in China, in any sector, ever—acquiring a 46.5 percent stake, three times that of founder Pony Ma, in the company for a mere $32 million from investors, including Richard Li, the son of Hong Kong tycoon Li Ka-shing.

Baidu

Baidu was founded in Beijing in 2000 by Robin Li (Li Yanhong) and his friend Dr. Eric Xu (Xu Yong). Born in November 1968, Robin was one of five children of factory workers in Shanxi, a gritty province in central China. His smarts won him entry to Peking University to study information science. After June 4, 1989, he was keen to head overseas: "China was a depressing place. . . . I thought there was no hope."

Rejected from the top three U.S. schools he had applied to, Robin won a full scholarship in 1991 for a master's degree in computer science at the State University of New York (SUNY) at Buffalo. There he joined a computer lab focused on designing automation technologies, funded by a grant from the U.S. Postal Service. His professor, Sargur N. Srihari, recalled that "he started doing information retrieval here at Buffalo, and we were well ahead of the game in terms of the importance of search engines."

After SUNY, Robin worked for a subsidiary of Dow Jones in New York. Visitors today to Baidu's one-million-square-foot campus in Beijing are shown a copy of Robin's patent filing from February 5, 1997—when he still worked for Dow Jones—for a search mechanism he called "hypertext document retrieval" that determined the popularity of a website based on the number of other websites that had linked to it. Robin then moved to California to work for the search company Infoseek, before raising $1.2 million in start-up funding and returning to China in January 2000 to found Baidu. The company first operated out of a hotel room near his alma mater, Peking University, its business starting as a third-party supplier of Chinese language search engines to other websites.[10] Although it quickly gained the bulk of the market, Baidu wasn't profitable.

Robin Li, CEO, recalled, "I wanted to continue to improve the search experience, but the portals didn't want to pay for it. . . . That's when I knew we needed our own branded service." Baidu's stand-alone search website was launched in October 2001.

Robin Li has remained closely involved in Baidu's technology development. To ensure that its search engine was cutting-edge, in late 2001, Li temporarily set aside his role as CEO to drive a new development project called "Project Blitzen," recalled by the company's engineering team as a "Great Leap Forward" effort. Li would often sleep in the office, and meetings doubled in frequency until the project was completed.

Looking back, Li said, "Once you find out what you should do, then you need to stay focused. That's what we did during the difficult times back in year 2000, 2001, 2002. Many people think search was a done deal. It's boring. Everyone has figured that out in terms of technology and product, but we thought we could do a better job. We resisted all kinds of temptations from being a portal, being an SMS player, online games, developing all kinds of things that could make money in the short term. We really, really focused on Chinese search. That's how we got here."

In 2002, Baidu's Chinese index of searchable sites was 50 percent greater than its nearest rival's. By 2003 it had become the number one search engine in China. Prior to Baidu's August 2005 IPO on Nasdaq, even Google invested $5 million in it. Baidu's shares rose more than 350 percent on the first day of trading. As it became apparent that Baidu was now its chief rival in China, Google sold its stake the following summer for $60 million.

Baidu would emerge as China's largest search engine.[11] Although worth around $70 billion, it remains a much smaller company than Alibaba and Tencent, two companies that, interestingly, enjoy a better relationship with each other than they do with Baidu.

Yahoo and "AK47"

But back in 2003, there was little sign of the emergence of the "BAT." Yahoo thought it still had a shot at cracking the China market. In search, Yahoo partnered with Baidu. To take on eBay, Yahoo launched an online auction venture with Sina. But, like the Founder partnership, neither deal made a difference.

Becoming increasingly desperate for a fix for its China business, in November 2003, Yahoo announced a deal it hoped would transform its fortunes, buying a company called 3721 Network Software.

Founded five years earlier by a feisty entrepreneur called Zhou Hongyi, 3721 had spotted a niche in the market. Domain names in the Internet were available only in alphanumeric characters (one reason it had chosen numbers rather than a name in the Roman alphabet, for its own website, since “3721” was a saying for something easy, as “easy as 3 times 7 equals 21”).

The company 3721 allowed the millions of new users coming online in China to search using Chinese characters thanks to a special toolbar that would then link the Chinese characters input to the corresponding website. The software was downloaded, although not always with the user’s knowledge, and was hard to remove. Competitors criticized 3721’s technology, arguing it supplanted existing browsers. In 2002, Baidu took 3721 to court, one of many Internet companies to tussle with Zhou Hongyi; 3721 raised several rounds of venture capital and by 2001 had broken even. By assembling a large sales force to market the most valuable Chinese names in the tool bar, 3721 started to make a lot of money, generating $17 million in revenues in 2002.

Born in 1970 in southern China’s Hubei Province, Zhou Hongyi grew up in the agricultural province of Henan before attending Xi’an Jiaotong University. He tried his hand as an entrepreneur twice, but both ventures failed before Zhou signed on as an employee of Founder, China’s largest university-run enterprise. Three years later, he launched 3721 in partnership with his wife, Helen Hu (Hu Huan), and four others.

Zhou felt his earlier failures cost him his rightful place as a true pioneer of the Internet industry, and he was constantly spoiling for a fight with his rivals. He relished the publicity of the lawsuits or public spats he engaged in with Jack, Robin Li, Pony Ma, William Ding, and Lei Jun (Kingsoft and Xiaomi), among others.

Jerry Yang was known for his affable and approachable manner, but Zhou was the polar opposite: a self-styled bad boy of the Internet in China. He had a passion for guns. After 3721 was acquired by Yahoo, Zhou’s new colleagues in Sunnyvale, California, were aghast when they saw his photo in the Yahoo internal directory, in which he toted an AK-47. The team immediately adopted it as his nickname. Zhou even liked to adorn the walls of his office with bullet-hole ridden sheets from target practice. His main investor, Wang Gongquan from IDG, described Zhou as a “frenzied idealist,” an “aggressive and wild child.”

Whatever their differences in personality, Jerry Yang saw in Zhou Hongyi’s firm the opportunity to boost Yahoo China’s revenues. In 2003, Yahoo China made only a few million dollars in revenue, but 3721 raked in an estimated $25 million from its clients. It was the fourth-most-visited Chinese website after Sina, Sohu, and NetEase.

In November 2003, Yahoo acquired 3721 for $120 million (with $50 million paid up front, and $70 million to follow based on performance in the following two years). The deal boosted Yahoo’s China team, from 100 to nearly 300. But just as eBay botched its acquisition of local partner EachNet, Yahoo’s efforts to integrate 3721 rapidly fell apart.

The culture clash was immediate. Former Yahoo CFO Sue Decker recalls, “Zhou reportedly felt that the original Yahoos were overpaid and lazy, whereas the Yahoo team felt bullied and believed Zhou wasn’t focused on the Yahoo operations.” Yahoo had carefully courted relations with the Chinese government. But just a couple of months after Yahoo acquired his company 3721, Zhou Hongyi was sued by none other than the Chinese government, whose Internet domain name agency, the China Internet Network Information Center (CNNIC) accused 3721 of damaging its reputation.[12]

Next, Zhou dumped Baidu, which he was in the process of suing, as Yahoo’s search partner in China, and launched a new search offering instead.[13] But Zhou hadn’t consulted first with Yahoo executives in Sunnyvale. Zhou recalled, “I believed that with an annual investment of only several millions of dollars, it would be entirely possible for us to overtake Baidu.” Zhou became frustrated by the managers at Yahoo headquarters: “They were unwilling to invest in the company’s future. It is like farming. If you only care about harvesting, but not fertilizing or cultivating, eventually the land will lose its vitality.”

China was the least of Yahoo’s worries. In the United States, the company was being eclipsed by Google, whose algorithmic search engine was outgunning Yahoo’s directory-based design. Yahoo was slow to recognize the threat posed by Google, a company like Yahoo founded by two Stanford Ph.D. candidates. Yahoo had missed an opportunity in 1997 to buy Google from Larry Page and Sergey Brin, but its biggest mistake of all was the June 2000 decision to make Google its search partner. With

Google’s logo featured on its home page, millions of customers discovered a superior search product and gateway to the broader Internet that made Yahoo increasingly irrelevant.[14]

In July 2005, six months before the end of his two-year earn-out, Zhou announced he was quitting Yahoo China. Within two months he had set up his own company, Qihoo 360 Technology. Here he would adopt the same aggressive tactics[15] that he’d used at 3721.

It wasn’t long before Zhou took to the media to criticize Yahoo, telling journalists that selling 3721 to Yahoo was his biggest regret, that Yahoo’s corporate culture stifled innovation, and that the firm was poorly managed: “Yahoo’s leaders have unshakable responsibility for its decline. Whether it is spiritual leader Jerry Yang or former CEO [Terry] Semel, they are good people, but [they] are not geniuses. They lack true leadership qualities. When facing competition from Google and Microsoft, they didn’t know what to do, and had no sense of direction.”

Yahoo had struck out twice in China: first Founder, then 3721. After years of frustration, Jerry Yang made a bold decision. He handed Jack $1 billion, and the keys to Yahoo China’s business, in exchange for a 40 percent stake in Alibaba.

Project Pebble

Although it took some time for them to realize it, the deal was transformative for Alibaba and Yahoo. Alibaba gained the ammunition to finish off eBay in China, and to build Taobao and Alipay into the behemoths that they are today. The rising value of its stake[16] gave Yahoo leverage in dealing with its increasingly frustrated investors, concerned about its deteriorating market position versus Google and its subsequent controversial decision to rebuff Microsoft’s offer to buy the company.

The deal originated in a May 2005 meeting[17] between Jack and Jerry at the Pebble Beach golf course in California. Before a steak-and-seafood dinner with other tech luminaries from the United States and China, the two founders, who had a common shareholder in Masayoshi Son, took a stroll[18] outside. Jack recalled, “It was extremely cold that day, and after ten minutes I couldn’t bear it anymore. I ran back indoors. [But] in those ten minutes we exchanged some ideas. I told him clearly that I wanted to enter the search business, and my opinion was that search engines would play a very important role in e-commerce in the future."

From this initial discussion, the outlines of a deal—which Yahoo called Project Pebble—started to take shape two weeks later when Jerry[19] held further meetings with Jack and Joe on the sidelines of the Fortune Global Forum, hosted that year in Beijing.

Yahoo had known for some time that 3721 was not going to be the silver bullet to solve its China woes. But after a thorough screening of which company might be the answer, Alibaba had not been Yahoo's first choice.

Sina was the most logical target. The company had started as an Internet portal and was positioning itself as the "undisputed online media leader in China." Guided by CEO Terry Semel,[20] Yahoo was increasingly trying to become a media and entertainment company. Yahoo and Sina had already signed a memorandum of understanding for Yahoo to invest in Sina, subject to Chinese government approval. Sina's executives and investors were ready to pop the champagne corks when Sina CEO Wang Yan went to meet China's propaganda chief, Li Changchun.[21] Li rejected the deal. Sina would not be allowed to align itself with a foreign strategic investor.

David Chao, a partner at the investment firm DCM, related a conversation in 2004 with Hurst Lin, then COO of Sina: "When their stock was about three dollars Hurst called me up and said, 'I just met Jerry and I think I can finally get rid of my stock. We have a deal.' He was really happy. But, of course, as you know 'the forces above' were uncomfortable."

Yahoo's second choice of partner was Shanda, the Shanghai-based online games specialist.[22] But Shanda's founder and CEO, the Zhejiang-born Timothy Chen (Chen Tianqiao), wasn't interested.[23] Baidu wasn't an option for Yahoo, either; it was already on its way to an IPO.

A deal with Alibaba was attractive on a number of levels. It was a private company, and this meant a deal could be struck quickly. Yahoo and Alibaba had a common shareholder. SoftBank owned 42 percent of Yahoo and 27 percent of Alibaba.[24]

Another positive was good chemistry. Jerry and Jack had known each other for seven years, since their first meeting in Beijing, when Jack played tour guide. The two men hadn't stayed in regular contact, but they had established a rapport.

For Jerry, dealing with Jack was a breath of fresh air after the cantankerous Zhou Hongyi. Jerry also got on well with Joe Tsai. Both were born in Taiwan and educated in the United States. Yahoo CFO Sue Decker recalled that the two companies "immediately felt a strong cultural alignment."

Yet the logic of the combination was not immediately obvious. Yahoo, a consumer content company, was to hand over its China assets to a company that was essentially a B2B business information company with two newer businesses, Taobao and Alipay, tacked on. Taobao was gaining traction in consumer e-commerce, but Alibaba had recently committed not to charge fees for the next three years. How do you value free? Sue Decker recalled Yahoo's concerns: "At the time this seemed like a big leap of faith: More than half the value of the venture—more than two billion dollars—was attributed to Taobao and Alipay, both of which were losing money." The decision to hand over Yahoo's China business was a gutsy move, as Decker recalled, "We realized we needed to be willing to give up all operating control. Practically speaking, this meant forgoing our previous desire to own more than fifty percent of the local operations. It also meant we would leave all employee issues to our partner and allow our code to be used by people with no previous connection to the company. Scary."

A decade later, Jerry Yang reflected[25] on the deal, pointing out that in 2005, when Yahoo made the investment: "The balance sheet at Yahoo was around $3 billion, so it wasn't as though there were huge amounts of cash at Yahoo." Putting a billion dollars into Alibaba, he added "probably raised a lot of eyebrows." Although Yahoo conducted extensive analysis on the underlying business, Jack's charisma and vision for Alibaba also played an important role, as Jerry recalled, "It was probably in retrospect a big bet, but if you met Jack, and having got to know him and seeing what his vision was, you certainly thought it was worth it. And he really had an inside track on being a very dominant commerce platform in China, so that really gave us a lot of comfort." Asked about which company got the better side of the deal, he answered, "If you look at that partnership over ten years, clearly Alibaba was a beneficiary of a very strong vote of confidence back in 2005, and now Yahoo as a company is a beneficiary of that investment."

For Alibaba, the deal immediately delivered the cash it needed to support Taobao, still unprofitable, in its fights with eBay. Yahoo and SoftBank already had a profitable relationship stretching back almost a decade. The Yahoo investment in Alibaba added a new dimension, creating a "Golden Triangle" that has linked Jack, Jerry, and Masayoshi Son for a decade more. With the deal, the *New York Times* crowned Jack as "China's New Internet King." Jack couldn't resist taking yet another shot at eBay: "Thank you, eBay. . . . You made all of this possible."

With the sale, Alibaba was also able to reward its employees, by allowing them to cash out a quarter of their shares, and its early investors, who sold about 40 percent of their stakes in the company to Yahoo at a valuation of about $4 billion. Although they had made an impressive return, the investors then saw Alibaba sell a stake in itself to Yahoo at a valuation some four times higher.[26]

Jack later emphasized that the impact of the transaction went beyond the funding and market recognition provided by Yahoo. Although Alibaba had demonstrated its ability to build start-ups—Alibaba.com, Taobao, and Alipay—the deal brought much-needed experience in mergers and acquisitions, something that would become increasingly important in the future.

The final ownership of Alibaba would be Yahoo, 40 percent; SoftBank, 30 percent; and existing management, 30 percent. In 1999, Jack had sold a 50 percent stake in Alibaba to Goldman Sachs and other investors—something he had joked was the worst deal he ever made. Did he feel any seller's remorse about parting with this 40 percent stake? A decade later he again looked back on the deal: "I asked for one billion dollars, and they gave us one billion dollars. I thought the war between Taobao and eBay would last for a long time, so we needed enough cash to fight." In the end, $1 billion was enough to scare off eBay.[27] "We asked a lot. But we did not know when we got the money eBay would run away. So the money [wasn't used]." Jack said he would do the Yahoo deal again but "in a better, smarter way," adding, "Nobody knows the future. You can only create the future."

The deal left Jack and Joe in charge of Alibaba, although the agreement also included a little-noticed clause that gave Yahoo the right, in October 2010, to appoint an additional board member. If that board member aligned with SoftBank, then Yahoo could then enjoy a majority and the ability, in theory, to take control of Alibaba.

The key terms decided, Alibaba and Yahoo prepared to position the deal to the public. Jerry Yang told *BusinessWeek* that Alibaba was now "the only company in China that has commerce, search, communications, and a very,

very strong local management team. This is going to be a very valuable franchise going forward." The media reaction was mixed. Andreas Kluth at *The Economist* was unconvinced: "Yahoo can't keep on being all things to all people. It seems to me that Yahoo has to decide what it is, which means deciding what it's not. Does Yahoo think that it's a search and a media and an e-commerce company now? So why not manufacturing, retailing, banking, health care? So I'm confused."

Yahoo was keen to reassure the market, and its employees, that Alibaba was a safe pair of hands to manage its China business. Yahoo China staffers in particular were unhappy about the change in ownership. Former Yahoo China employee Liu Jie, who quit the company for Qihoo soon after, remembered the jarring change in management style under Alibaba: "At noon the sales-oriented departments at Alibaba would jog and sing. I felt a bit low at that time."

The reception in Yahoo's headquarters was more positive. Former executive vice president Rich Riley[28] recalled, "Markets like China had proven challenging for Western companies," adding that, "this seemed like a smart way to go."

But other than the financial return, did Yahoo achieve its other objectives?

When the deal was announced, Jerry Yang told the media that although Alibaba was taking over Yahoo in China, this didn't mean the end of the Yahoo brand in the country: "All of the consumer Internet products will be branded Yahoo—search, mail, and anything new they decide to come up with. They definitely feel that the Yahoo brand in China has not only global implications but a lot of resonance."

Yet under Alibaba's management the Yahoo brand would rapidly fade and indeed eventually disappear entirely from China. Within a year of the deal, local media started to refer to Yahoo China as the unwanted "orphaned child," with Alibaba more focused on nurturing its own baby, Taobao. In May 2007, Alibaba changed the name of the business from Yahoo China to China Yahoo, an apt reflection of who was in charge.

Alibaba did invest heavily in the Yahoo China brand at first, pouring in 30 million yuan (over $4 million) to make TV ads to promote Yahoo Search. Jack spared no expense for the ads, partnering with the Huayi Brothers film studios, in which he would later invest, and hiring three of China's most famous directors, Chen Kaige, Feng Xiaogang (who directed

Alibaba's Singles' Day TV special in 2015), and Zhang Jizhong. Zhang was known for his flamboyant, big-budget TV adaptations of Jack's favorite author Jin Yong.

But in the core area of search, the superior algorithmic search of Google and Baidu was winning out. China Yahoo was in trouble. After the deal, Jack became exasperated at how slow Yahoo was in delivering on the search and other technology it had committed to provide. The pressure was so great that in 2006 Jack made the decision to remodel Yahoo's home page in the uncluttered, clean style popularized by Google, which Baidu had already mimicked. But Jerry Yang was very unhappy with the move and asked Jack to change the China Yahoo site back to its original portal look and feel, which he did. Not surprisingly, Yahoo's users were confused by the changes, and the company's market share slid further. From a 21 percent share of search revenue in 2005, driven largely by the 3721 tool bar, Yahoo's share fell to only 6 percent in 2009 as Baidu's soared to take almost two-thirds of the market, leaving Google with just 29 percent.

Messy Exit

But had Yahoo soldiered on without selling its China business to Alibaba, the company would still have had to contend with two major challenges: 3721 founder Zhou Hongyi, and an ethical and public relations catastrophe involving Chinese journalist Shi Tao.

Zhou Hongyi, on learning of the Yahoo-Alibaba deal, immediately announced his resignation and became a disgruntled former employee. He began to brief journalists that he would be starting his own venture and started to hire people away from Yahoo. In the coming years Zhou and his new firm, Qihoo 360, caused a lot of headaches[29] for Alibaba, China Yahoo's new owner.

But even after it sold its China business to Alibaba, Yahoo's image would be tarnished in the United States by the case of imprisoned Chinese journalist Shi Tao. The source of intense personal anguish for Jerry Yang, the affair would illustrate the unpredictable risks that awaited any foreign company planning to build a business in China's Internet sector.

Shi Tao was an editor and reporter at a newspaper in Changsha, the capital of Hunan Province, called *Contemporary Trade News* (*Dangdai Shang Bao*). He was also a customer of Yahoo Mail. On April 20, 2004, Shi participated in an internal editorial meeting, convened by the newspaper's deputy general editor, to discuss a classified document sent from Beijing with instructions on how to avoid social unrest in the run-up to the fifteenth anniversary of the June 4 Tiananmen Square crackdown. Although copies of the document were not handed out, Shi Tao took notes during the meeting later that evening using a Yahoo China email account,[30] then emailed them to a Chinese, prodemocracy website based in New York. Two days later, Yahoo China was requested by the government to hand over details of the account owner,[31] which they provided that day.

On November 23, 2004, Shi was detained by the State Security Bureau in Changsha. On December 15 he was arrested and charged with revealing state secrets. After a trial lasting two hours in March 2005, Shi was found guilty and sentenced to ten years' imprisonment.

Shi's case was quickly taken up by activist groups[32] who accused Yahoo of being a "police informant." The publicity and appeals, launched by Shi's journalist friends and his mother, Gao Qinsheng, were unsuccessful in reversing the verdict. After what Amnesty International alleged was intense harassment from the Chinese government, Shi's wife divorced him.

It was a nightmare for Shi and his family. For Yahoo it was a black eye. For Alibaba, although it now ran the China business, the case had happened on Yahoo's watch. Jack was asked to comment on the case and said, "As a business, if you cannot change the law, follow the law. . . . Respect the local government. We're not interested in politics. We're just focused on e-commerce."

On September 10, 2005, I attended Alibaba's Alifest in Hangzhou. The partylike atmosphere was heightened that year by the newly minted $1 billion deal with Yahoo and the growing sense that Taobao would prevail over eBay. Jerry Yang was to appear onstage with Jack as part of the celebrations. The icing on the cake was Jack's invited keynote speaker that year: former U.S. president Bill Clinton.

Clinton had accepted the invitation to speak in July, but news of the Yahoo connection to Shi Tao's case emerged only days before the summit, putting Clinton[33] in an awkward position. Clinton did not refer to Shi's case but discussed more generally the economic cost of censorship and the need for China to develop greater tolerance for dissent.

After Clinton left the room with his Secret Service and Chinese government security detail, Jerry Yang took the stage for a Q&A session to talk about the deal with Alibaba. *Washington Post* reporter Peter S. Goodman asked Jerry Yang directly about Yahoo's role in handing over the information that led to Shi Tao's incarceration.

Yang answered, "To be doing business in China, or anywhere else in the world, we have to comply with local law. . . . We don't know what they want that information for, we're not told what they look for. If they give us the proper documentation and court orders, we give them things that satisfy both our privacy policy and the local rules." He added, "I do not like the outcome of what happens with these things. . . . But we have to follow the law."

The audience, made up mostly of Chinese Internet executives and investors, erupted into applause, what seemed like an inappropriate response given the seriousness of the case, but thanks to the Great Firewall few in the audience had even heard of Shi Tao. Things would get much worse for Jerry Yang after that, culminating in a public skewering in Washington, D.C., in 2007 when he was summoned to appear before Congress[34] to answer questions about the case. The committee chairman, California congressman Tom Lantos, opened the session by introducing Shi Tao's mother. Jerry Yang, wearing a dark suit and tie, bowed solemnly to her three times as she sat behind him sobbing. Lantos lambasted Yahoo for its "inexcusably negligent behavior at best and deliberately deceptive behavior at worst" and concluded, "While technologically and financially you are giants, morally you are pygmies."

Yahoo later settled out of court a lawsuit filed by Shi's family, paying an undisclosed amount. Shi Tao was released in September 2013 after serving eight and a half years in prison, his ten-year sentence having been earlier reduced by fifteen months.

Yahoo's travails proved that for companies dealing with Internet content, China was a highly risky market, as Google would later experience itself before it closed up most of its operations in 2010. Google had launched its search engine on servers hosted in China (as google.cn) in 2006, keeping servers for Gmail and other products that involved personal and confidential information offshore. But in early 2010, in response to an attempt to hack its servers and the cumulative pressure of growing need to censor its search results, Google announced its withdrawal from China. In March 2010, Google stopped censoring search results in China, rerouting traffic to its site in Hong Kong—the other side of the “Great Firewall of China”—and signaling its exit from the market.[35]

eBay, Yahoo, and Google had all recognized that China’s Internet market would become massive. But as the market grew, so did regulatory barriers and the competitive challenge from entrepreneurial and well-financed companies like Alibaba, Baidu, and Tencent.

Speaking in 2015, Jerry Yang took stock of the China Internet market: “Maybe in the next ten years some American or Western brands will be successful in China. But in that 2000–2010 time frame there just weren’t any.”

Western Internet companies trying to crack the China market came to experience firsthand the old adage that in China “it is better to be a merchant than a missionary.” And the biggest merchant of all was Alibaba.