

# Causes and Effects of Online Industry M&A between International Internet Giants and Local Companies—Evidence from China

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**Abstract:** This paper aims at identifying the inside reasons of M&A(Merger and Acquisition) of online industry in China between international Internet giants and local companies and exploring the basis on which online industry can develop steadily and thus have a successful and sustainable business model. In the meanwhile, a case study will be made by analyzing the causes of the merger of Yahoo China into Alibaba from the perspectives of both parties. Then, this paper points out the possible effects of this merger on China's online industry. In the end, some conclusions will be made on how to build up core competence in online industry in a unique business circumstance in China.

US Internet giant Yahoo ended its six years of independent operations in China since August 2005 and joined forces with Chinese leading e-commerce company Alibaba.com. Yahoo China will transfer all operations in China including an Internet portal, e-mail services, instant messaging, Internet search services and its keyword services to Alibaba as well as paying US\$1 billion for a 40 per cent stake in Alibaba. This Merger is not only a single commercial buying case but also a symbol for creation of new revenue model in China. [2]

**Keywords:** Case Study in E-Business; M&A; Online Industry; China.

## I. Characteristics of Online Business in China and Stages in M&A of Online Industry over the Past 5 Years

### I.1 Characteristics of Online Business in China

With an online population of nearly 100 million, China's internet infrastructure is developing very fast, and China has surpassed Japan and become the second largest country in its Netizen number next to US [1]. However, due to its unique cultural and political environment, the development of online business in China seems to have had no breakthroughs since 2000 after the Dot-coms gradually lost their wizards. For example, because of the lack of credit system and strict regulations in China, the online business is

still at an early stage according to the turnover of online transactions.

However, the potential in online business in China can NOT be overlooked. According to a recent survey by IDC, the online population of China will surpass U.S. in 2010, and new killer applications including search engine, online games, instant messaging and internet phone calls will develop very fast in China due to its large scale of online population. Thus, a smart company can easily find the expanding potential in China and the cooperation between Yahoo and Alibaba is the best evidence showing the confidence in Chinese online business market.

### I. 2 Stages in M&A of Online Industry over the Past Years

Looking back to the M&A cases in China in the past 7-8 years, it is not difficult to find that the merger and acquisition has experienced the following three stages:

#### ● Stage 1(1998-2000)

Since it is the inception of development of online business in China, the business model was very simple at that time and the Internet portal dominated in online industry and the ad revenue is the main source of the income for most of the online companies. With the demonstration effect of the case that AOL.com merged Time-Warner, one of the characteristics of M&A at that time is that the merger occurred between an online company and a company dealing with traditional businesses, and the buyer in most cases was an online company especially an Internet portal.

#### ● Stage 2(2001-2003)

After the Internet bubbles got broken in 2000, overnight wealth was no longer the dream of most online companies. They began to search for the business model that can be really materialized. During this period of time, the M&A was technology-oriented and online companies hope that they can earn money with the help of new technologies like search technology, instant messaging, online gaming, and so on. A good example is that Yahoo China acquired 3721 for US\$ 120 million with 3721 founder Zhou Hongyi becoming President of Yahoo China.

#### ● Stage 3(2004-present)

In real operations, the international companies including Yahoo have no obvious advantages over the local competitors like Sohu, Sina and Netease. It is partially due to the fact that even a local company in China can easily copy the business model of a U.S. company let alone its advantages in knowing local factors well. For example, Yahoo China never won in its competition with its Chinese competitors in traditional businesses like e-mail services, online advertisement, etc. The merger between Yahoo China and Alibaba is a trial of cooperation other than a zero sum game.

## II. Causes of Current M&A Between International Internet Giants and Chinese Companies

(1) Good Economic Outlook and Improvements in Internet Infrastructure in China

China's rapid growth in Internet users, rising disposable income, low Internet penetration, a huge population of mobile phone users and growing e-commerce has put the country front and center on the radar of most of the world's Internet companies. Western Internet businesses' eager to tap its growth has been expanding their investments.

(2) Cultural Differences and Complex Regulations on Internet Industry

As mentioned above, though China has the second largest online population in the world, the online transactions are still very limited due to its lack of credit system and its unique consumer behavior features. For example, online payment system is not easy to put into use because most consumers are unwilling to pay online and thus select a COD (Cash on Delivery) model. Another reason is that the Chinese Government has lots of regulations on Internet industry and are reluctant to let a foreign company control the country's top Internet portals and other kinds of Internet companies. Under these circumstances, it is the best way for the international Internet giants to get quick access to local market by forming strategic partnership instead of acquiring top Chinese portals directly.

(3) Getting Complementary Advantages for Both Parties

The international Internet giants and the local Chinese companies have their respective advantages and disadvantages. The international Internet giants have advantages in their capital assets, experience in going public on stock market and state-of-the-art technologies in Internet. While in the meantime, the local Chinese companies are better in their connections with governments at all levels, marketing channels and first-mover advantages as well as their inherent cultural similarities.

## III. Case Study –The Strategic Partnership Between Yahoo! and Alibaba

### III.1 Corporate Overview of Alibaba.com

Alibaba was founded in 1999 and is based in Hangzhou, eastern China. It has over 2,000 employees, 13 regional sales offices across China and other offices in Hong Kong, Silicon Valley, Europe, and Beijing. Alibaba.com is China's leading e-commerce company, operating the world's largest online marketplaces for both international and domestic trade, as well as China's most popular online payment system, AliPay. The Alibaba websites have more than 15 million registered users in 200 countries and territories. In 2004, over US\$4 billion in trade is estimated to have come from buyers and sellers connecting at Alibaba sites. [4]

### III.2 Causes of Forming Strategic Partnership from the Perspective of Yahoo

(1) Yahoo has NOT been so successful in Mainland China

The US giant, which set up its Chinese operation in 1999, has been dogged by frequent personnel changes and twists in company strategies. Its first China general manager stayed at the post for only one year. Operations on the Chinese mainland were then overseen by executives in Hong Kong and Taiwan and the focus was still on online advertising which makes them face cooling ad revenue. Compared to other famous local Big Three portals, Yahoo's ad revenue in China in the year 2004 is very limited see Figure 1, amounting to only 50 million RMB Yuan. [5]

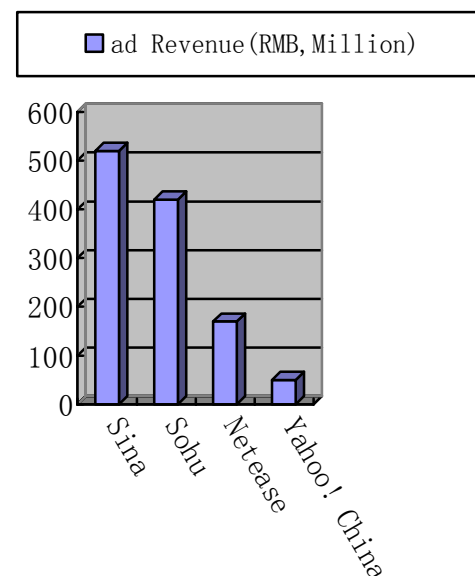


Figure 1. Ad Revenue Comparisons Between Yahoo! China and Big Three Local Portals

(2) Yahoo May Obtain Complementary Advantages from Alibaba

Since Alibaba is the most comprehensive website with its areas in e-commerce, business to business, customer to customer, payment system and an auction site, Yahoo may obtain the above-mentioned complementarities by forming strategic partnership with Alibaba very easily.

### (3) Yahoo China Can Fulfill Its Strategic Shift from an Operator to an Investor

The merger of Yahoo China into Alibaba has made it become a local company instead of the branch of a U.S. company. The shift from an operator to an investor has greatly simplified its business in China.

### III. 3 Causes of Forming Strategic Partnership from the Perspective of Alibaba

#### (1) Alibaba May Obtain Search Engine and E-mail Service Technology

As the biggest business-to-business website in the world, Alibaba is in urgent need of mature search technology and e-mail services for its 8 million customers all over the world. Yahoo's such expertise will greatly facilitate the searching efficiency for Alibaba customers.

#### (2) Removing the Obstacles for Alibaba to be Listed on the Stock Market

The business-to-business model that Alibaba adopted is no longer fresh to investors in international stock market. And Alibaba's auction site Taobao.com still lacks of enough revenue that can attract the investment from Wall Street. The partnership between Yahoo and Alibaba at least made Alibaba the most comprehensive website consisting of almost all the business models including BtoB, BtoC and CtoC. In addition, with an international Internet giant as its shareholders, it will win the Chinese company a worldwide reputation. [3]

## IV. Effects of the Strategic Partnership Formed Between Yahoo! and Alibaba on China's Online Industry

### IV. 1 Creating a New Revenue Model

The Internet industry has been plunged into slump since the overnight rich dream broke 1998 through 1999, and China is no exception. The real reason for that is that no good business model has been developed. Although Yahoo! is a successful net company in the U.S., however, its performance in China is not as good as expected. This can be seen from the following several criterion. First, its ad revenue is far less than the Big Three portals; Second, its traffic can only rank 6<sup>th</sup> in China, next to some "small" companies; Last, Yahoo! China is a company whose business has no apparent differentiation advantages. While in the same time, Alibaba is a young company compared to Yahoo!, but it is the largest B2B website in China, especially deemed as the largest horizontal e-marketplace for importers

and exporters the world over. In an industry where searching technology is most important of all, Alibaba finds the strength of Yahoo! China's search engine at first glance, especially Yahoo! China has very powerful technology in searching for keywords in Chinese, and this helps a lot for a horizontal e-marketplace majoring in import and export business. Therefore, Alibaba is eager to enter into a strategic partnership with Yahoo! China because they have very strong complementary abilities. According to strategic alliance theory, the effect of strategic alliance will exist for a long time until the complementary abilities disappear (see Figure 2).

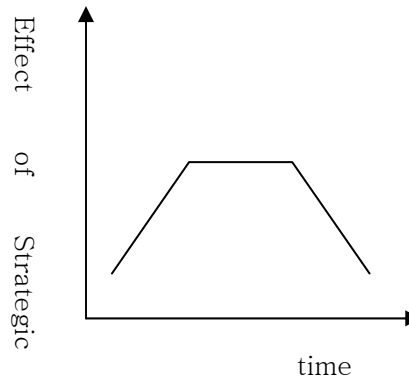


Figure 2 Effect of Strategic Alliance

### IV. 2 Setting a Good Example for International Cooperation in Online Industry

In the past, seldom did international internet giants see real cooperation between local companies and them. They attributed this to policy barriers or discrimination. However, the successful alliance between Yahoo! China and Alibaba could be a symbol for gaining support from the Chinese government for real partnership. This merger can greatly reinforce the confidence for international institutional investors in IT field and set a good example for international cooperation in online industry.

### IV. 3 Promoting Imports and Exports for Chinese Companies

After Yahoo! China was merged into Alibaba.com, Ma Yun, the CEO of Alibaba started to specialize the searching technology to support his customers in identifying both potential commodities and potential customers. In fact, since most of Alibaba's customers are dealing with import and export activities, the stronger searching technology will significantly strengthen the competitiveness of Alibaba and therefore promote the export activities for Chinese manufacturers and the procurement of international buyers.

## V. Conclusions

Even in online industry, the companies should abide by laws and principles that are frequently used in traditional

industries such as the power of strategic alliance, cost advantages and so on. In other words, the traditional economic rules can also be well embodied in online industry.

The partnership between Yahoo and Alibaba has announced the failure of traditional business model in online industry. The Internet portals can only realize its value through the combination with the “real” business like what Alibaba is dealing with.

The partnership between international Internet giants and local companies of China has also shown the strengths from both capital and market. The international Internet giants represent the power of capital while the local companies of China represent the power of the market. The partnership aiming at obtaining both strengths is a completely ideal combination and will probably result in a great success.

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