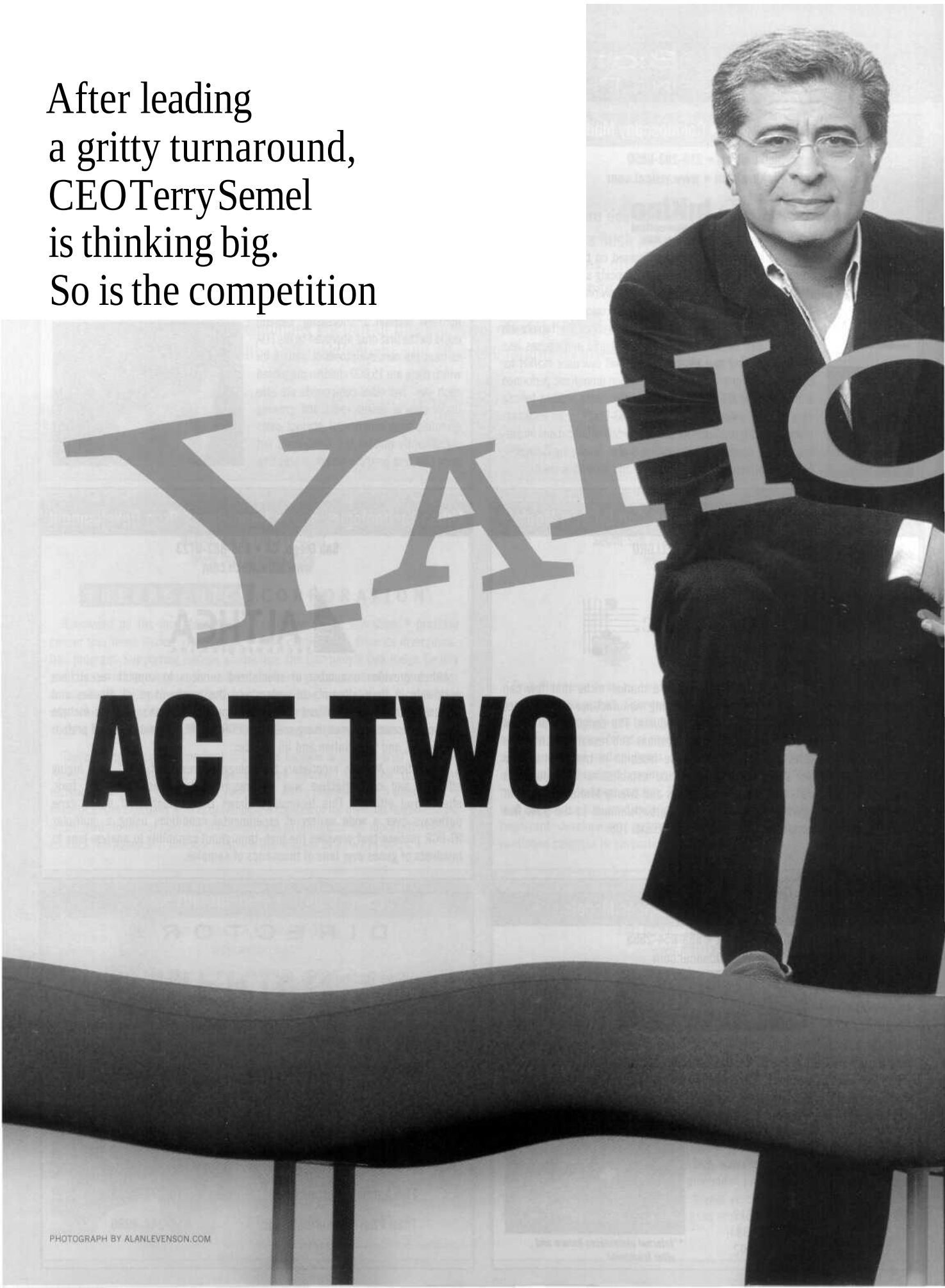
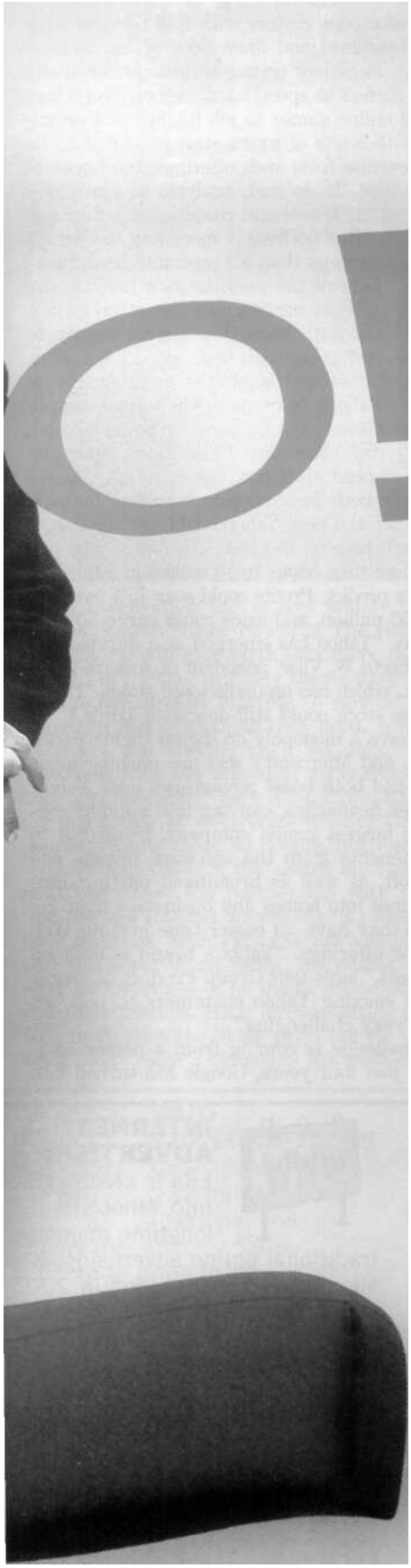
After leading
a gritty turnaround,
CEO Terry Semel
is thinking big.
So is the competition



ACT TWO

PHOTOGRAPH BY ALANLEVENSON.COM



TWO YEARS AFTER TAKING THE HELM, FORMER HOLLYWOOD EXEC SEMEL HAS SILENCED THE DOUBTERS

WHEN TERRY S. SEMEL WALKED INTO the Sunnyvale (Calif.) headquarters of Yahoo! Inc. for his first day as chief executive on May 1, 2001, he faced an unenviable task. Ad sales at the Internet icon were plummeting, and the new CEO was replacing the well-liked Timothy Koogle, who had been pushed aside by the company's board. Worse, leery employees quickly saw that Semel, a retired Hollywood exec, didn't know Internet technology and looked stiffly out of place at Yahoo's playful, egalitarian headquarters. Would this guy tour the Valley in the purple Yahoo car, as Koogle did, or play a Yahoo kazoo? Fat chance. And instead of bunking in nearby Atherton or Palo Alto, like other Silicon Valley execs, he rode off every evening in a chauffeured suv to a luxury suite at San Francisco's Four Seasons Hotel.

Two years after taking control as chairman and CEO, Semel has silenced the doubters. By imposing his buttoned-down management approach on Yahoo, the 60-year-old has engineered one of the most remarkable revivals of a beleaguered dot-com. Once paralyzed by management gridlock and written off as another overhyped has-been, Yahoo is roaring back. The company earned $43 million on revenues of $953 million in 2002, compared with a $93 million loss in 2001 on $717 million in sales. And Yahoo's momentum is growing. Net income hit $47 million in this year's first quarter as revenues powered ahead 47%. Analysts predict that this year's profits will quadruple, to more than $200 million, while sales climb 33%, to $1.3 billion. "What he has done is just phenomenal," says Hollywood pal Barry Diller, CEO of USA Interactive Inc., a Yahoo competitor.

Cover Story

Semel has done nothing less than remake the culture of the quintessential Internet company. The new Yahoo is grounded by a host of Old Economy principles that Semel lugged up the coast from Los Angeles. The contrast with Yahoo's go-go days is stark. At Terry Semel's Yahoo, spontaneity is out. Order is in. New initiatives used to roll ahead following free-form brainstorming and a gut check. Now, they wind their way through a rugged gauntlet of tests and analysis. Only a few make the grade. It's

a wrenching change. But Semel's self-effacing style, honed over years of navigating through the towering egos of Hollywood, helps soften the shock.

Yahoo's newfound success does, too. Semel has used the dealmaking skills that made him a legend in the movie business to land crucial acquisitions and partnerships that are producing rich new revenues for Yahoo. A deal with phone giant SBC Communications Inc. launched Yahoo into the business of selling broadband access to millions of American homes—which should add $70 million in revenue this year. The buyout of HoUobs.com last year put Yahoo into the online job-huntin; business, adding $80 million in revenue. Most important, a partnership with Overture Services Inc. to carry ads on Yahoo's search-results pages is gushing some $230 million in revenue this year. The upshot? Semel's new businesses should make up half of Yahoo's top line in 2003. "We planted a lot of seeds a year and a half ago, and some are beginning to grow," he says.

Broadband is key, since most services Semel wants to sell are data hogs

Semel's strategy is gaining fans on Wall Street—and stoking new fears of a mini-Internet bubble. The company's shares have soared 200% in the past eight months, to $26. Sure, Yahoo's market capitalization is a mere 13% of its giddy all-time high of $127 billion in early 2000. But today's price-earnings ratio of 79 is triple that of heavyweight Microsoft Corp. and more than eBay Inc.'s 67, despite the online auctioneer's heftier revenues, profits, and growth projections. "Yahoo's valuation is a tough case to make," concedes Firsthand Funds Chief Investment Officer Kevin Landis, who nonetheless has bought 50,000 Yahoo shares in the past eight months based on the portal's turnaround and brighter industry trends.

Investors are betting on Semel to follow up his bold debut with a sizzling encore. Call it Act Two. For this next stage of growth, Semel envisions building Yahoo into a digital Disneyland, a souped-up theme park for the Internet Age. The idea is that Web surfers logging on to Yahoo's site, like customers squeezing through the turnstiles in Anaheim, will find themselves in a self-contained world full of irresistible offerings.

In the past, Yahoo attracted visitors with free services such as stock quotes and headlines and drew 90% of its revenue from online ads. Now, Semel is trying to charge for many services, coaxing Web surfers to spend hard cash on everything from digital music and online games to job listings and premium e-mail accounts with loads of extra storage. Already, he pulls in one-third of revenue from such offerings and hopes to drive it up to 50% by 2004. To do that, analysts say, he's likely to cut deals to add online travel and classified ads for cars.

But nothing is more key to Semel's strategy than his push into broadband. Lots of the services he's banking on, such as music and interactive games, are data hogs that appeal mostly to customers with high-speed links. Plus, broadband is always on, so many of Yahoo's customers will be lingering in Semel's theme park for hours on end, day after day. "The more time you spend on Yahoo, the more apt you are to sample both free and paid services," he says.

If Semel can pull it off, the new Yahoo could become one of the few enduring powerhouses on the Net. Customers who pay for its services could more than triple, to 10 million in 2005 from 2.9 million now, analysts predict. Profits could soar 75% over the next two years, to $350 million, and sales could surge 30%, to $1.7 billion, analysts say. "Yahoo has emerged as a durable digital franchise," says Alberto W. War, president of Amerindo Investment Advisors Inc., which has an undisclosed stake. "If you take the long view, this stock could still double or triple."

But Semel doesn't have a monopoly on digital theme parks. AOL Time Warner Inc. and Microsoft's MSN are pushing nearly identical agendas—and both boast advantages over Yahoo. AOL, despite its merger headaches, can tap into popular content from the world's largest media company, from CNN to Warner Music. MSN benefits from the software muscle and cash hoard of Microsoft, as well as broadband partnerships that cover 27% more lines into homes and businesses than Yahoo's SBC deal. It also may have an easier time getting Web surfers to pay for new offerings. "Yahoo's brand is built on free information services," says MSN Group Product Manager Lisa Gurry. She says coaxing Yahoo customers to pull out their wallets will be "very challenging."

An even greater challenge is coming from a newer competitor, Google Inc. In just four years, Google has turned into

Yahoo's Game Plan

Can CEO Semel lift Yahoo to greatness? The nine-year-old company is poised to notch its best-ever sales and profits in 2003. But Semel must accomplish even more to justify Yahoo's nosebleed market valuation, including a p-e of 79. Here are his biggest bets:

PAID SEARCH

Revenues for selling links on its search-results pages rocketed from zilch to $130 million in 2002. With the overall paid-search market expected to grow 40% to 50% annually, paid search may be Yahoo!'s jet fuel in coming years.

2003 PROJECTED REVENUE

$230 million ▲77%

OUTLOOK

EXCELLENT This is the Internet's growth market, and few are positioned as well as Yahoo. Possible spoiler: Google.

INTERNET ADVERTISING

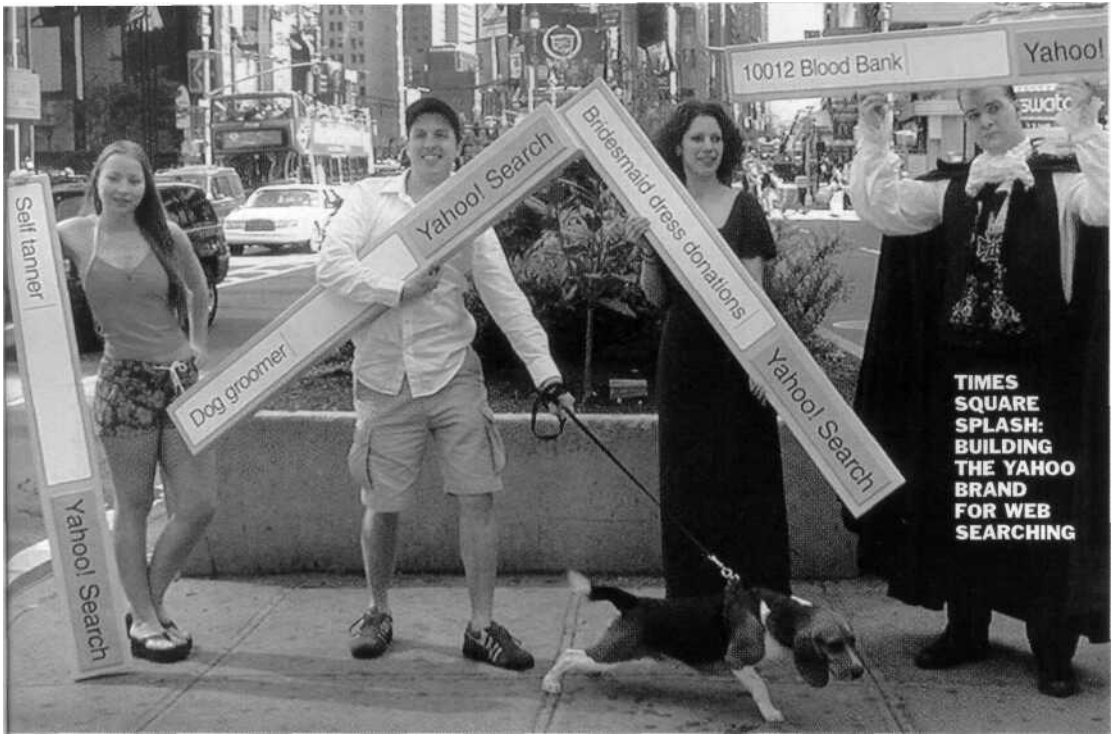
Life is creeping back into Yahoo's longtime mainstay, traditional online advertising, which should top $600 million in 2003 sales. Yahoo expects to double the industry growth rate, with annual growth of at least 5% to 10% for the next several years.

2003 PROJECTED REVENUE

$615 million ▲18%

OUTLOOK

GOOD The market is coming back, and Yahoo! has learned the hard way what works.



TIMES SQUARE SPLASH: BUILDING THE YAHOO BRAND FOR WEB SEARCHING

a global sensation and is now widely regarded as the preeminent search engine on earth. The risk to Yahoo is that the search king will give birth to a more potent business model. Instead of flocking to flashy theme parks such as Yahoo's, consumers are already starting to rely on Google's uncluttered search to find everything they need. Already, some online advertisers are moving their ad dollars to search engines. "We're shifting our emphasis away from portals [such as Yahoo, AOL, and MSN]," says Alan Rimm-Kaufman, vice-president for marketing at electronics retailer Crutchfield Corp. "The people stealing these ad dollars are [companies] like Google."

Hot competition in the search business could force Semel's next big move. His partnership with Overture, a company that delivers Internet advertising, is producing some 20% of Yahoo's revenues. Microsoft's MSN has a similar deal with Overture that also is paying off richly. Analysts say Semel could make an offer for Overture—if he thinks it's necessary to preempt a Microsoft acquisition. He is already sitting on $2.2 billion in cash, 50% more than the likely price tag for Overture. Still, Semel likely won't make a bid unless he's pushed into it because of the distractions of such a large merger. Yahoo and Overture declined comment on a possible deal.

Distraction is something Yahoo can ill afford as it adapts to the changes ahead. To date, Semel has honed the company's execution—cutting costs, filtering out iffy ideas, pursuing sure things, and making money. It's the perfect model for today's sickly market. But when the slump ends, new ideas will likely make a dramatic comeback. These could define the next generation of the Internet. The question is whether Yahoo, with its careful and laborious vetting process for new projects, risks losing out to Google or getting blindsided by a nimble newcomer.

Can Semel innovate, beat back the rising tide of competition, and live up to the latest round of great expectations for Yahoo? If he plays his cards right, yes. Despite the advantages of AOL and MSN, Yahoo has kept its position as the most popular site on the Web, according to Nielsen/Net Ratings. Yahoo claims 232 million monthly visitors. Semel is demonstrating the skills to turn this large chunk of humanity into paying customers, boosting the customer count eightfold, from 375,000 when he arrived two years ago. To combat Google, Semel is hurrying to beef up Yahoo's search capabilities. He closed a $290 million deal for search company Inktomi in March, and the marketing campaign to promote it blasted off in New York's Times Square on May 19. "Yahoo has reemerged as a potent force," says Derek Brown, an analyst at Pacific Growth Equities. "It's well-positioned to leverage its massive global user base and dominant brand."

The CEO'S low-key approach has worked quiet magic through a 40-year career. When Brooklyn-born Semel arrived as a sales trainee at Warner Bros, in 1965, the 22-year-old accountant had little relevant experience but an understated con-

PAID SUBSCRIPTIONS

Only 1% of Yahoo's 232 million online users pay the company for services. Yahoo is working to bring in more cash outlays by offering a host of premium services, including online personals and supersize e-mail accounts.

2003 PROJECTED REVENUE

$251 million ▲25%

OUTLOOK

FAIR This is Yahoo's Achilles' heel. The potential is rich, but turning free Web surfers into paying subscribers is proving tough.

BROADBAND ACCESS

A partnership with SBC Communications makes Yahoo a broadband player, generating fees and establishing Yahoo as a high-speed home page. But its failure to link up with other telecoms limits the offering, for now, to SBC's region.

2003 PROJECTED REVENUE

$70 million ▲900%

OUTLOOK

GOOD Yahoo can grow with broadband, which is gaining 30% annually. The risk: It hinges on partnerships that could prove fragile.

ONLINE CAREERS

Yahoo acquired HotJobs.com in late 2001, which contributed $80 million to Yahoo's top line in 2002. But growth is slow in the stagnant U.S. employment market, and Yahoo trails job-search leader Monster.com.

2003 PROJECTED REVENUE

$80 million ▲0%

OUTLOOK

GOOD Online recruiting is expected to grow 18% a year for the next five years. Yahoo should grab a growing share.

fidence in himself. In an industry brimming with ego, Semel stayed offstage and worked to shine the light on others. It paid dividends. As he moved from Warner Bros, to Buena Vista and back again, Semel rose to the top on a vast network of friends and allies. He used these, along with his formidable negotiating skills, to create a giant. In a two-decade partnership as co-CEO with Bob Daly, Semel turned Warner Bros, from a $1 billion studio to an $11 billion behemoth, producing megahits such as *The Matrix*.

Through his retirement in 1999, Semel kept up the winning formula, making friends and minting millions. He says that in their two decades together, he and Daly never fought. If such a smooth track record is rare in high tech, it's even more uncommon in Hollywood. "When you're releasing 20 or 25 movies a year, you're navigating a minefield every weekend," says Barry M. Meyer, chairman and CEO of Warner Bros. Entertainment Inc. and a longtime Semel colleague. "His success at Yahoo does not surprise me at all."

It was Yahoo co-founder Jerry Yang who nudged Semel toward Yahoo in 2001. The two had met two years earlier at a media conference and had hit it off. By the spring of 2001, Yahoo was reeling from the falloff in Net advertising and needed a major overhaul. The question was whether the wealthy Semel, who was already dabbling in online entertainment companies, would dive into one of the biggest of them all at a time of crisis. Semel signed on with the proviso that Koogle step down as chairman.

When the new chief arrived, he ran into a few troubling surprises. Semel was shocked early on to learn that Yahoo did not have the technology in place to handle surging demand for services such as online personals, say two former executives. That spelled months of delay before Semel could push premium offerings.

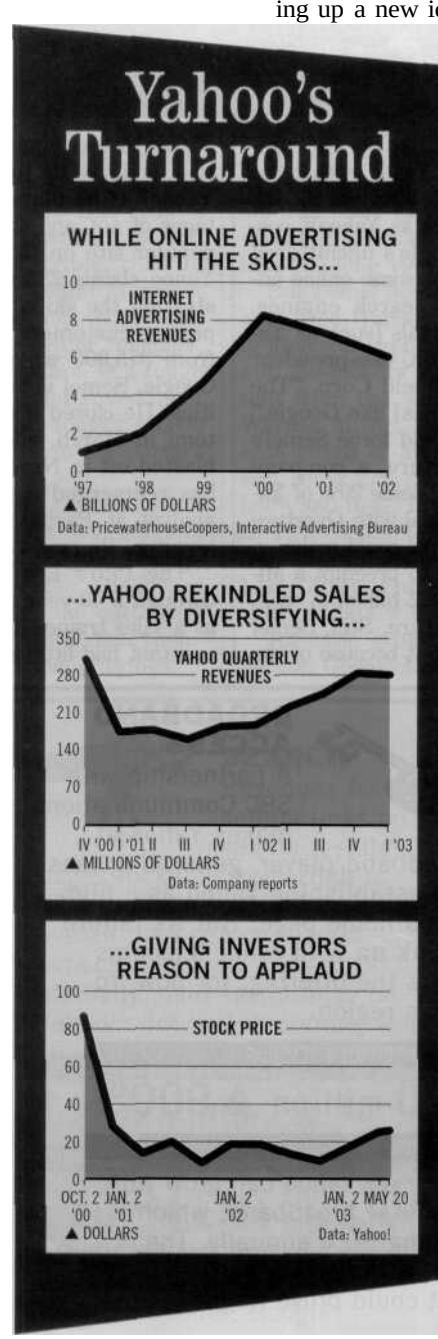
Then there were the cultural challenges. Initially, Semel balked at the company's "cubicles only" policy, finally settling into a cube adjacent to a conference room so he could make phone calls in private. He stayed free of the Valley social scene, spending weeknights at the hotel in San Francisco and flying his private jet home to his swanky Los Angeles neighborhood of Bel Air on weekends.

Morale was also an issue. Compared with his predecessor, the relaxed and chatty Koogle, known by the troops as T. K., Semel came off at first as cold and rough. He chopped down the 44 business units he inherited to 5, stripping many execs of pet projects. Veteran Yahoo execs prodded Semel to mingle more with the rank and file and pushed him into grabbing lunch more often at the campus cafeteria. Still, such forays often fell flat. "T. K. was just one of the guys," says a former Yahoo manager. "When Semel talked to you, it felt like he was consciously making an effort to talk to employees."

Soon, Semel's strengths started to shine through. With his focus and deal-making savvy, he appeared to have the tools to rescue Yahoo. Employees, with loads of underwater stock options, increasingly cheered him on. "People don't always agree with the direction they're getting, but they're happy the direction is there," says a current Yahoo manager who requested anonymity.

Walk through Yahoo's headquarters, past the purple cow in the lobby, the acres of cubicles, the workers in jeans, and you might think T. K. was still running the place. But sitting across from Semel, the change is evident. His voice quiet and steady, his language cordial yet deliberate, Semel seems incapable of the hype that once vaulted companies such as Yahoo into the stratosphere. This is the voice of the post-dot-com era. He steers attention to his colleagues. "I love [my managers] to do their homework," he says. "I love them to help make decisions, and they do. Somewhere in that process, I'll include myself—or they'll include me."

Semel's not kidding about the homework. In the old days, Yahoo execs would brainstorm for hours, often following hunches with new initiatives. Those days are long gone. Under Semel, managers must prepare exhaustively before bringing up a new idea if it's to have a chance to survive.



It's a Darwinian drama that takes place in near-weekly meetings of a group called the Product Council. Dreamed up by a couple of vice-presidents and championed by Semel and his chief operating officer, Daniel Rosensweig, a former president of CNET Networks Inc., the group typically includes nine managers from all corners of the company. It's chaired by Geoff Ralston and often includes key lieutenants such as Jeff Weiner and Jim Brock, all senior vice-presidents. The group sizes up business plans to make sure all new projects bring benefits to Yahoo's existing businesses. "We need to work within a framework," says Semel. "If it's a free-for-all... we won't take advantage of the strengths of our company."

For years, managers built up their own niches around the main Yahoo site. No one, say former and current execs, appeared to be thinking about the portal as a whole, much less how the various bits and pieces could work together. "Managers would beg, borrow, and steal from the network to help their own properties," says Greg Coleman, Yahoo's executive vice-president for media and sales.

Semel wants to stitch it all together. He calls the concept "network optimization" and says it's a key goal for 2003. The idea is that every initiative should not only make money but also feed Yahoo's other businesses. It's the painstaking job of establishing these interconnections that eats up much of the time at council meetings. And the winnowing process is brutal. Of the 79 current ideas for premium services at some stage of planning inside Yahoo, only a few will launch in 2003, predicts Rosensweig.

Although some critics worry that innovative ideas may never see the light of day under Semel's tight control, he dismisses the prospect. Semel stresses instead the potential payoff: less clutter and a handful of high-performance services that feed each other. For a success story,

he points to the company's recently relaunched search capabilities. Search for "pizza" and type in your area code, and Yahoo culls its Yellow Pages site to return addresses and driving maps to nearby pizza joints. Yahoo is the only heavyweight portal that integrates content this deeply with its search features.

Such smart execution was in dangerously short supply at Yahoo in the past. At the height of the Net bubble, Yahoo came off as arrogant. Its attitude, recalls Jeff Bell, a marketing vice-president at DaimlerChrysler Corp., was "Buy our stuff, and shut up." Semel has turned that around, hiring traditional media sales veterans and introducing more flexibility. The payoff: As the online ad market has recovered, advertisers are flocking back to Yahoo. Daimler's Bell says his Yahoo ad budget has doubled over the past two years.

Entertainment companies are joining the rush to buy key Yahoo ad space. Some 42 movies advertised on Yahoo in the first quarter, up from zilch in the first quarter of 2001. "Getting a presence on Yahoo's home page is huge," says Sarah Beatty, a senior marketing vice-president at USA Network, which is running seven ad campaigns on Yahoo in 2003.

Semel has supplemented Yahoo's ad revenues with dealmaking in other businesses. Consider the SBC pact to market broadband Net access. SBC pays Yahoo about $5 out of the $40 to $60 customers pay each month for service. Revenues from the deal should jump from $70 million this year to $125 million in 2004.

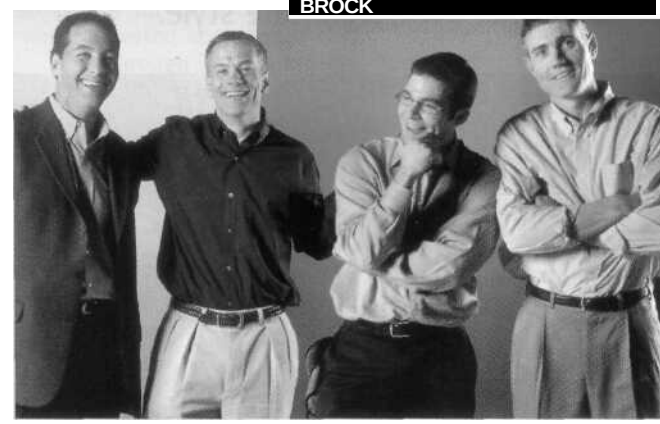
Still, Yahoo remains vulnerable in broadband. MSN has cut similar deals with Verizon Communications and Qwest Communications International Inc., which have 75 million lines to homes and businesses, vs. SBC'S 59 million. Semel's efforts to land other broadband deals have come up short. More worrisome is the fragile nature of these partnerships. If SBC concludes that the Yahoo brand isn't a big draw, it could cut Yahoo out and save itself millions. An SBC spokesman says it is "happy" with Yahoo.

Of all Semel's deals, none shines brighter than the partnership with Overture Services. The companies team up to sell ads near Yahoo's search results, a business known as "paid search." If a user searches for "cookware," for instance, advertisers from Macy's to Sur La Table can bid to showcase their links near the results. Overture delivers the advertisers and forks over roughly two-thirds of the revenue. While Yahoo had debated such a partnership for years under Koogle, Semel drove it through in a hurry.

Just in time for paid search to blossom into the latest Web sensation. The partnership notched Yahoo more than $130 million in revenues last year—14% of its business. Analysts expect revenues from the partnership to increase 75% in 2003, accounting for nearly 20% of Yahoo's revenues.

That assumes that Google won't spoil Yahoo's fun. The wildly popular search engine has emerged as the fourth-most-trafficked site on the Internet, with an estimated $700 million in 2003 revenues. And the world may be heading Google's way. Industry analysts say that as Web surfers gain expertise, they visit general-interest sites such as Yahoo less and instead cut to the chase by typing in keywords on a search engine. According to analytics firm WebSideStory, the percentage of Web site visitors arriving via search engines doubled in the past year, to 13%.

KEY PLAYERS IN THE NEW REGIME: COO ROSENSWEIG AND SVPs RALSTON, WEINER, AND BROCK



Google's strength puts Semel in a bind. He licenses Google's search engine, which is popular among Yahoo's users. Trouble is, by keeping Google on Yahoo, he publicly endorses a rival. His likely goal, say analysts, is to replace Google soon with Inktomi, the search engine he acquired in March. That would save $13 million a year in licensing and pull the plug on Yahoo's apparent backing of Google. The danger? If Yahoo's Google-loving customers balk at switching to Inktomi, they could ditch Yahoo and surf straight to the Google site.

His answer is a national marketing campaign to boost Yahoo as a search brand. It kicked off on May 19 in New York's Times Square with the unveiling of a huge computer-screen ad featuring live searches on the Yahoo site. At street level in New York, teams of Yahoo's costumed "searchers" paraded among the crowds waving five-foot-long search bars.

It's all part of the growing buzz at Yahoo. Using his mix of discipline, sales, and dealmaking, Terry Semel has pulled off a stunning revival. But can he pull off Act Two and build Yahoo into the digital theme park of his dreams? If he does, Semel will be one of the biggest winners: When he took the helm, he bought 1 million shares of Yahoo at $17 apiece. Those shares are up 60%. The fact that Yahoo shares are banging on the ceiling and not the floor is a vivid sign that Semel's turnaround may be just getting started.

By Ben Elgin in Sunnyvale, Calif., with Ronald Grover in Los Angeles

Terence Steven Semel

BORN Feb. 24, 1943.

EDUCATION Graduated in 1964 from Long Island University with a degree in accounting/finance.

CAREER Joined Warner Bros, as a sales trainee, selling movies to theaters, in 1965. Made stops at CBS and Walt Disney before returning to Warner Bros, in 1978. Promoted to COO in 1980 and co-CEO in '94. Over two decades, Semel and co-CEO Bob Daly built Warner Bros, from $1 billion in revenues to $11 billion. Joined Yahoo! in May, 2001.

FAMILY Married to wife, Jane, since 1977; three daughters, and a son from a previous marriage.

PALS Has walked the red carpet with Tom Cruise (right) and others. Still chums around with Hollywood royalty, including director Steven Spielberg, who recently stopped by Yahoo's offices and chatted with employees.

HOME Stays in San Francisco during the week and flies home to Los Angeles on weekends.

BusinessWeek online

For a look at Yahoo! Japan, go to www.businessweek.com/magazine/extra.htm