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Internet Search Giants Hurry Into Chinese Market

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PALO ALTO, Calif. -- An Internet boom is coming to China, and the U.S.'s big search companies don't want to miss out.

Online giants Yahoo Inc. (YHOO), Google Inc. (GOOG) and Microsoft Corp. (MSFT) have been jockeying for position in a market expected to have more Internet users than the U.S by the end of the decade.

To compete, the companies are building Web sites for Chinese consumers, who have cultural norms quite a bit different than American consumers. Their efforts will probably take longer and prove more complex than the companies would like.

To some analysts, China is like the U.S. of the late 1990s when an explosion of interest in the Internet brought millions of consumers online and attracted billions of investment dollars. Online revenue today is small in this diverse Asian nation, but the opportunity to make money is anticipated to grow quickly.

China's Internet search market revenue of \$154 million in 2004 is expected to expand 81% this year and another 60% next year, according market researchers at iResearch Inc. of Shanghai. By 2007, the market should top \$690 million.

Even with its present 19.1% share of the Chinese search market, Google sees the opportunity selling search advertising as exciting. "Google's growth heavily depends on the quality of the product," says James Mi, head of Asian products for the company. "We're very much focused on the product and the user experience."

While it is early, companies need to act now or the "market share may get locked up," says Piper Jaffray analyst Safa Rachtchy. Sales and earnings

from search advertising may not have a significant impact on a company as large as Google or Yahoo for three to five years, says Rachtchy, who doesn't own stock in either firm and Piper Jaffray performs no banking business for them.

But the search engines can't wait.

With dominant positions in many Western markets, the companies are accelerating their overseas efforts, especially in markets where the growth in online audiences is generally faster. At the top is China with its 103 million Internet users, second to the 203 million in the U.S. With growth beginning to slow in the West, emerging markets represent the future.

That means fighting for brand recognition and market awareness today.

Already in China there's been a bustle of activity. Recently, Yahoo decided to spend \$1 billion to buy a 40% share of online auction company Alibaba.com. Under the terms of the deal, Alibaba will take control of Yahoo's China operations, which includes its 2003 acquisition of search engine 3721 Network Software.

Google, which opened an office in Shanghai in May, plans to start a research and development center in China in the third quarter. It also said earlier this month that three Chinese firms - China Enterprise, China Source and Hotsales - will distribute Google's ads in the country.

Google also made a splash in July when it hired Kai-Fu Lee from Microsoft. Lee founded Microsoft's Chinese research lab.

Microsoft quickly filed a lawsuit to enforce a non-compete agreement and won a court ruling that keeps Lee from working on search technologies at Google until at least September.

Representatives of Yahoo and Microsoft declined to discuss their Chinese strategies.

Thinking Local

The challenge facing U.S. search engines is how to localize and publicize their products for the Chinese market. Chinese consumers have no aversion to using foreign-made products and services; however, to be successful, foreign companies need name recognition across China's 23 provinces.

"In China the brand is very important," says Joe Wang, chief executive of LANDesk Software, a company with operations in the country. While

"everybody knows Google," it doesn't yet appear to have the cachet of Coca-Cola, Mercedes or BMW, all of which are widely known in China, Wang says.

Building a brand in China is a long process involving lots of leg work. There are hundreds of cities with populations of more than a million people and 19 million small and medium-sized businesses to reach, says Adrian Koch, senior vice president at Hewlett-Packard Co. (HPQ), which started doing business in China 20 years ago.

"You need to build brand province by province," says Koch.

Companies also need to shape their products for local tastes and requirements. H-P has done that by renaming computers sold in China and developing products that are sold only in that country, including a desktop PC with a monitor that sells for about \$350.

Bending to local interests is one reason why public search engine Baidu.com Inc. (BIBU), which recently went public, has a lead over Yahoo and Google. As of the first quarter, Baidu had a 37.4% search market share in China compared with 32.2% for Yahoo and 19.1% for Google, according to iResearch.

A local focus for Baidu has been online music. With young people accounting for more than 80% of the Chinese Internet population, Baidu has become a popular site for finding MP3 files. About 20% of searches on its site seek a service that lets people find unlicensed music and video files.

A recent test of search engines shows Baidu also has a strong focus on Chinese news. A search for news printed in Chinese on the China National Offshore Oil Corp. (CEO) turned up 1,100 responses on Baidu, but only 554 on Google and 155 on Yahoo.

When asked about the results, Google's Mi said a special Chinese "interface" available to Chinese searchers returns additional news on a particular topic.

But generating useful results also requires a detailed knowledge of the Chinese language and online habits. Because a Chinese character might mean one thing when printed by itself and another when combined with another character, search engines must understand the context of a search query. At the same time, Chinese Internet users are uncomfortable with buying and selling online. Internet commerce needs to accommodate their preferences.

"People like to meet face to face and develop relationships," says George

Haley, a University of New Haven marketing professor and expert in Chinese business. They aren't used to the anonymous exchange of goods online. That is why online auction site eBay Inc. (EBAY) provides physical meeting rooms to allow buyers and sellers to carry out transactions, Haley says.

Finding a seasoned local executive who understands the Chinese market is important for these foreign companies. Observers say Google's decision to hire Lee was motivated by this need.

"This is a very daring move for them," says Joseph Tzeng, managing director at Crystal Ventures, a venture capitalist with a focus on China. "It's fundamentally different from the other companies."

Yahoo's investment in Alibaba also reflects this "grow-it-in-China" strategy.

Still, for all the effort, Google sales out of China last year were probably less than Baidu's \$14 million, says Rashtchy. Yahoo's may have been a little larger.

In other words, finding a payback in China will take some time.

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