case 1 Steve Case, America Online, and Time Warner

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Every day, millions of people across the world log on to America Online to check their e-mail, track their stock portfolios, visit their favorite spots on the Internet, and send instant messages to friends on their buddy lists. In early 2000 AOL had 22 million subscribers and handled 110 million e-mails, 200 million stock quotes, and 562 million instant messages daily. Many subscribers used AOL features to create online photo albums, online calendars, and electronic jukeboxes. The company's members could also use AOL to purchase an airline ticket, reserve a car or hotel, or get a map from the airport to the hotel. They could purchase an unlimited variety of merchandise and services through Shop@AOL and pay their bills with an AOL Visa or through electronic banking provided by AOL and Intuit.

Other AOL brands brought the company millions more sets of eyeballs each day. Netscape Netcenter had 27.5 million registrants; Digital City, the number one local online network, had more than 6 million visitors each month from 60 U.S. cities; and ICQ, the number one communication community, had 53.1 million registrants and averaged 8 million daily users. Over 150 million movie tickets were purchased from AOL's MovieFone Web site each year. This combined traffic made AOL the leading interactive Internet medium, with more than $4.7 billion in 1999 revenues, nearly $400 million in net earnings, and a market capitalization of nearly $200 billion at year-end 1999. Exhibit 1 presents selected financial and operating highlights for America Online during the 1992–99 period. The performance of the company's stock price is shown in Exhibit 2.

Much of the company's success through 1999 was attributable to CEO and chairman Stephen Case's visionary leadership and his efforts to make AOL an essential and ubiquitous component of everyday life. During the last half of the 1990s, Case's entrepreneurship, his strategic vision for AOL, and AOL's undeniably significant market impact had made him one of the most prominent and influential top executives in the United States. His views on the Internet economy were paid close attention in industry

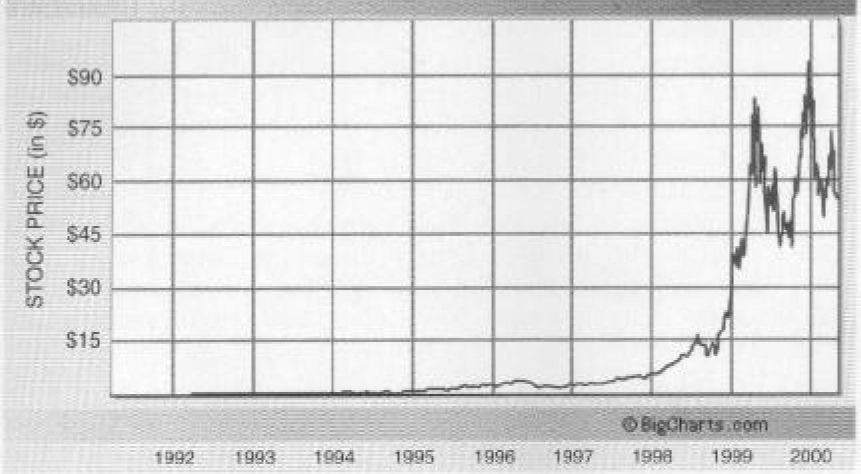
exhibit 1 Selected Financial and Operating Highlights, America Online, Inc., 1992–99

	Year Ended June 30				
	1999	1998	1997	1996	1995
Statement of operations data					
Subscription services	$3,321	$2,183	$1,478	$1,024	$ 352
Advertising, commerce, and other	1,000	543	308	111	50
Enterprise solutions	456	365	411	188	23
Total revenues	4,777	3,091	2,197	1,323	425
Income (loss) from operations	458	(120)	(485)	64	(41)
Net income (loss)	$ 762	$ (74)	$ (485)	$ 35	$ (55)
Income (loss) per common share					
Net income (loss) per share—diluted	$ 0.60	($ 0.08)	($ 0.58)	$ 0.04	($0.09)
Net income (loss) per share—basic	$ 0.73	($ 0.08)	($ 0.58)	$ 0.05	($0.09)
Weighted average shares outstanding					
Diluted	1,277	925	838	944	587
Basic	1,041	925	838	751	587
Net cash provided by operating activities	$1,099	$ 437	$ 131	$ 2	$ 18
Earnings before interest, taxes, depreciation and amortization (EBITDA)	968	302	111	138	11
Balance sheet data					
Working capital (deficiency)	$ 254	$ 108	($ 40)	$ 72	$ 18
Total assets	5,348	2,874	1,501	1,271	459
Total debt	364	372	52	25	24
Stockholders' equity	3,033	996	610	707	242

Source: America Online 1999 annual report.

circles and by the news media. Then on January 10, 2000, AOL stunned the business world with an announcement of potentially far-reaching consequences for business. Steve Case, Time Warner co-chairmen Gerald Levin and Ted Turner, and other America Online and Time Warner executives held a joint press conference describing plans to merge the two companies. The new company, to be named AOL Time Warner, would combine one of the largest "old-economy" media companies with the world's largest "new-economy" media company to create a company positioned, they said, to lead the second Internet revolution and capitalize on the convergence of entertainment, information, communications, and online services. Combined sales of the two companies would approach $33 billion.

America Online's brands included AOL, AOL.com, AOL MovieFone, ICQ, CompuServe, Netscape, Digital City, iPlanet, Spinner, Winamp, and AOL Instant Messenger. Time Warner's brands included *Time, Fortune, Sports Illustrated, People, Money, Southern Living, Parenting, Entertainment Weekly,* Book-of-the-Month Club, Warner Bros., CNN, TBS, TNT, Turner Classic Movies, World Championship Wrestling, Cartoon Network, HBO, Cinemax, Warner Music Group (five studios and over 70 artists), and Looney Tunes; in addition, Time Warner was the second largest provider of cable TV services, serving 12.4 million homes in over 34 areas of the country. Top executives at the *exhibit 2* Monthly Performance of America Online, Inc.'s Stock Price, 1992 to March 2000



two companies believed the merger would allow Time Warner to bring its entertainment brands to consumers in a digital environment, in addition to traditional formats, while AOL could use Time Warner's broadband cable resources and satellite television capabilities to deliver online content to consumers at speeds much greater than possible over telephone lines. If approved by shareholders and regulators, the merger would convert each company's shares to AOL Time Warner shares at a fixed ratio. Each Time Warner share was to be exchanged for 1.5 shares of the new company's shares, and each AOL share was to be exchanged for 1 share of the new company's stock. The new stock would be traded under the symbol AOL on the New York Stock Exchange.

Steve Case would become chairman of AOL Time Warner, and Gerald Levin would serve as CEO. Case believed the merger was so important to securing AOL's future that he was willing for Levin to function as AOL Time Warner's CEO in order to win the support of Time Warner management for the merger. The impetus for the merger had come from Steve Case and AOL—it was Case's vision for the merged company that had prompted him to initiate merger discussions, and he was the person most responsible for sparking the excitement of Time Warner executives and leading the effort to pull the deal together.

STEPHEN M. CASE: CHAIRMAN, PRESIDENT, AND CEO OF AMERICA ONLINE

Steve Case was born and raised in Honolulu, Hawaii, where his father was a lawyer and his mother a teacher. Case's entrepreneurial spirit surfaced at an early age. When Case was six, he and his brother opened a juice stand and charged 2 cents a cup, but many of their customers gave them a nickel and let them keep the change—an experience that taught the boys the value of high margins. A few years later, the two brothers started a business selling a variety of products door-to-door and by mail. Then they began selling ad circulars and, in addition, shared a newspaper route.

Case attended Williams College, in Williamstown, Massachusetts, where he majored in political science and was the lead singer in two rock groups. After graduating in 1980, he accepted a marketing position at Procter & Gamble and worked to promote Lilt, a home permanent kit, after unsuccessfully attempting to obtain a position with Time, Inc.'s HBO. Unhappy with managing a mature business, Case left after two years to join Pizza Hut as manager of pizza development. The job involved a lot of travel, and he often spent evenings exploring his new laptop computer. He joined an early online service called The Source, and even though the service provided only text messages at a painfully slow rate, Steve Case became fascinated by the possibilities.

In 1983, Case's brother, then an investment banker, introduced him to the founders of Control Video; they offered him a job as a marketing assistant on the spot, and he accepted. When the company's video game business soured, the board of directors brought in entrepreneur Jim Kimsey as CEO, who proceeded to groom Case to take over the top spot. Kimsey and Case convinced venture capitalists to put up $5 million to back their idea of forming an online service for users of Commodore computers, and Control Video became Quantum Computer Services. It was Case who engineered Quantum's deals with Apple Computer and Tandy (although he used up much of the $5 million in capital in the process and had some of the venture capital board members calling on Kimsey to fire him). And it was Case who, when the Apple deal fell through, helped turn the basis for it into America Online.

When he was made CEO of America Online in 1992, Case quickly fashioned a growth-at-any-cost strategy and charged ahead. Despite industry observers' numerous predictions over the years that AOL would stumble or that its membership growth would soon slow to a crawl, Steve Case kept making new acquisitions, forging new alliances, adjusting the company's marketing strategies, and adapting AOL's services and content to fast-paced changes in the marketplace.

When Microsoft announced that it would bundle its new Microsoft Network software in with its Windows 95 operating system software, Steve Case was a leader in urging the Justice Department to block the move as an unfair advantage. Microsoft, however, was allowed to proceed. Later, in March 1996, Case negotiated a head-turning pact with Microsoft whereby AOL would integrate Microsoft's Internet Explorer (a Web browser) into its online software; Microsoft, in return, would include AOL software in every copy of its Windows 95 operating system. Case explained the reasons for choosing Microsoft's Internet Explorer over Netscape's Navigator, the market share leader in Web browsers:

> . . . there were a number of reasons we went with Microsoft. We think the Internet Explorer technology is evolving at a rapid rate and its modular design will enable us to plug it in to AOL quickly. Strategically, we thought it would be smart for us to make sure there were two strong providers of Web technology in the marketplace. We didn't want anyone, whether Microsoft or Netscape, to have the kind of monopoly in Web technology that Microsoft has in operating systems.[1]

Within four years as CEO, Case had led AOL in becoming the largest online service, with more than 5 million users. In 1998, Case stated that the mission of AOL was

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[1]As quoted in "AOL CEO Steve Case," *Forbes*, October 7, 1996, p. 95.

"to build a global medium as central to people's lives as the telephone or television . . . and even more valuable."[2] In 2000, AOL's 22 million subscribers easily made it the world's largest online service.

Because of his success in transforming AOL into what many observers believed was the most potent force in cyberspace, Case was often asked to speak at PC-related conventions, usually drawing packed audiences. His views were widely sought by business reporters, industry analysts, and executives from Internet-related companies. He discussed the growth of AOL's subscriber base and the Internet revolution at one such event during the fall of 1999 as follows:

> Today, the Internet is becoming as central to everyday life as the phone and the TV. Right now, 53 percent of U.S. households own a PC—up from 39 percent in 1995. Already, 37 percent of households have online access—when just eight or nine years ago, most Americans didn't know what online access was. At AOL, it took us about a decade to get our first 1 million members. Now we add an additional million members every few months. When we started, 90 percent of AOL users were men. Today, more than half are women—about the same proportion as the overall U.S. population. The Internet is becoming a mass medium. I knew this for sure a few years ago when my parents finally understood what I did for a living.[3]

Even before AOL's success was evident, those who knew Steve Case were impressed by his vision and his ability to forge success in an emerging industry. Although Case functioned as an ardent and visible spokesman for AOL and had fashioned a hard-charging image for the company, he displayed a low-key, non-egotistical management style in his relationships with AOL executives and employees. Case was also a hands-on manager who stayed on top of how things were going. In 1996, former U.S. general Alexander Haig, an AOL board member, said that Case "borders on genius. If you look at how this young fella has positioned this company, he has ventures with every big player in the business. Instead of being beaten to death by Microsoft, as everyone predicted, they came courting him."[4] "When I met Steve," recalled another AOL board member, "he was 30 years old, and he already had a messianic vision of a connected world where the Internet was going to be part of daily life in every way imaginable. AOL is about being the leader in making this medium all that it has the potential to be."[5] Another close observer of Case and AOL said, "Every time people ask 'How is he going to survive?' he makes the right moves."[6]

Nonetheless, Case had taken a number of potshots from critics. Ned Brainard of *HotWired*, for example, labeled Case a "shameless self-promoter." Disgruntled AOL members had, from time to time, posted messages on AOL bulletin boards "flaming" Steve Case and AOL for policies and practices they disagreed with, long wait times for customer support, excessive busy signals at peak hours (which spurred such labels as America On Hold), and assorted other grievances.

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[2]As stated in America Online's 1998 annual report.

[3]Speech given to the National School Boards Association, 13th Annual Technology and Learning Conference, Dallas, Texas, November 11, 1999.

[4]As quoted in "The Online World of Steve Case," *Business Week*, April 15, 1996, p. 80.

[5]"These Guys Want It All," *Fortune*, February 7, 2000, p. 72.

[6]Ibid.

COMPANY HISTORY AND BACKGROUND

Control Video Corporation was founded in the early 1980s with the business purpose of creating an online service that specialized in video games for users of Atari computer-game machines. At the time, two brands of home computers, the Apple II and the Commodore 64, dominated the market for playing online computer games. But because of maddeningly slow modems and modest processing power, playing video games online was not popular, and thus Control Video soon failed. The company was reorganized by James Kimsey and Steve Case as Quantum Computer Services in 1985; the new company focused its energies on developing customized online services for other companies. Quantum created a service for Commodore, then a leading computer company, called Q-Link. Commodore ended up selling millions of its home computers, and Q-Link was a hit with Commodore users. Quantum generated enough revenues to keep the company going. During the next several years, Quantum expanded to serve other computer users. Steve Case made a deal with Apple Computer in 1987 to create software packages for its Apple II and Macintosh models, and in 1988 he convinced Tandy Corporation to support a new online service, PC-Link, for purchasers of its DOS-based Radio Shack computers. Then in 1989 Apple withdrew from its deal at the last minute. Frustrated by the turn of events with Apple, Quantum decided to introduce the software service it designed for Apple under the name America Online.

Quantum's promotional strategy for its online service was to blanket home computer users with diskettes containing the America Online software. It gave the disks away at trade shows, got them included in magazine subscription mail-outs, had them attached to magazine covers at newsstands, and mailed them to selected households. By 1990, management had decided to bring all of its segmented online services together under one overall service. Quantum changed its name to America Online in 1991 and went public in 1992, raising $66 million to fund its expansion. Steve Case was named CEO shortly thereafter.

When Case took over as CEO, America Online, with only 200,000 subscribers and 250 employees, was well behind CompuServe and Prodigy, the two leading online services. In early 1993, AOL cut its monthly fee well below what CompuServe and Prodigy were charging and began mailing out massive numbers of diskettes with free trial offers. The company also made its start-up disks available to United Airlines passengers with their meals, inserted AOL CDs in boxes of cereal, and even included AOL disks with deliveries of Omaha Steaks. AOL's membership growth accelerated to the point where it had trouble handling the influx of new subscribers. Users would get abruptly disconnected, and logging on in peak periods sometimes took over an hour. Numerous complaints led Case to issue a letter of apology and to promise network improvements. Case proceeded to initiate agreements with NBC, the *New York Times*, CNN, *Time*, and others to provide AOL with content for its service. AOL made investments to handle a bigger volume of users; acquired new companies to boost its network and multimedia expertise and its software development capabilities; and continued to solicit new members with aggressive marketing.

By early 1995, America Online had 1 million subscribers but still trailed Prodigy (which had 1.5 million subscribers) and industry leader CompuServe (which had over 2 million subscribers). The company then began offering members Internet and World Wide Web access and kept flooding the market with diskettes, running arresting ads and come-ons, and offering consumers first 10 then 15 free hours to try the service, all the while improving the breadth and quality of the content of its services. AOL launched AOL Germany in 1995 through a joint venture with Bertelsmann AG, the world's third largest publisher. AOL UK, AOL Canada, and AOL France were all launched in early 1996. By mid-1996 the company's enhanced services, international expansion, and aggressive marketing built its membership to more than 6 million subscribers.

AOL's Setbacks during 1996

In July 1996 AOL, pressured by inquiries from the Federal Trade Commission and several state attorneys general, settled a class-action lawsuit concerning its billing practices by agreeing to give members free time online. The agreement cost AOL about $8 million. On August 7, AOL's system crashed during an equipment upgrade and the network went dead for 19 hours; the failure made headlines in newspapers and on TV and users complained about being deprived of e-mail and World Wide Web connections. In an apology to subscribers, Steve Case wrote, "I would like to be able to tell you this sort of thing will never happen again, but frankly, I can't make that commitment."

AOL encountered additional problems in August 1996, when the National Basketball Association sued the company in federal court, charging it with misappropriating proprietary data and violating intellectual property laws by providing real-time updates on NBA games in progress, not only giving the scores as each point was made but also providing summaries of player performance. AOL claimed that it was exercising its constitutional right to free speech and that the NBA didn't own the underlying facts about its basketball games. The three other major professional sports leagues (for baseball, football, and ice hockey) filed briefs supporting the NBA's lawsuit. AOL subsequently altered its practice of reporting on games in progress by delaying its updates.

In October 1996, the company's shares fell 10 percent the day following its 10-K filing with the Securities and Exchange Commission that noted its difficulties in retaining subscribers. AOL management attributed its problems with customer retention (referred to as "customer churn") to an increased number of lower-priced competitors and to the flat-rate monthly service pricing of many Internet service providers. In the October–December 1995 quarter, AOL signed up 1.8 million new subscribers but 950,000 members canceled, for a net gain of 850,000. Analysts estimated that in the January–March 1996 quarter AOL signed up 2.3 million new users and 1.4 million users quit. One analyst estimated that up to 45 percent of AOL's subscriber base canceled service each year; the same analyst observed that AOL spent more than $300 million in marketing in 1996 to add a net of 3.2 million subscribers to its membership base.[7] Steve Case indicated in the fall of 1996 that AOL's cost to acquire a subscriber averaged about $45 and that the company's customer churn was running under 40 percent.

Later in October, reacting to mounting criticism that the manner in which it accounted for its marketing expenses resulted in greatly overstated profits, America Online announced that it was changing its accounting practice of amortizing its marketing expenditures for acquiring new subscribers. Whereas the typical company charged marketing expenses against earnings as the expenses were incurred, it was AOL's practice

[7] *The Wall Street Journal,* October 2, 1996, p. B5.

to spread those costs over a 24-month period; AOL's accounting methods (agreed to by its auditors, Ernst & Young) had the effect of increasing the company's reported short-term profits—an outcome that critics said was misleading to investors. AOL's decision to switch to a practice of charging subscriber acquisition costs as a current operating expense resulted in an immediate charge against prior earnings of $350 million—an amount over 50 times greater than the company's total profits in the five preceding years combined (see again Exhibit 1).

AOL's Move to Flat-Rate Pricing

In November 1996, AOL announced that starting in December it would give members the option to switch to unlimited usage for $19.95 per month instead of paying $9.95 for basic service of five hours per month and $2.95 for each additional online hour. It also offered several other pricing plans, including advance renewal rates of $14.95 per month for customers paying two years in advance, advance renewal rates of $17.95 for customers paying one year in advance, and a light usage program of 3 hours per month for $4.95 (with additional time at $2.95 per hour). In addition to its new pricing options, America Online sought to further spur new subscriber sign-ups in November by boosting its trial offer from 15 free hours to 50 free hours.

The response to these marketing initiatives was overwhelming, greatly exceeding what AOL had expected and prepared for. Over 1.2 million new members signed on in the last quarter of 1996, and an estimated 75 percent of existing members switched to the new flat-rate, unlimited-use pricing plan. Virtually overnight, usage of AOL's service jumped dramatically (especially during the peak hours of 8 PM until midnight), straining existing capacity and causing members to get busy signals when they tried to sign on. In November 1996, the month before the unlimited use pricing plan went into effect, AOL members spent 66 million hours collectively online, more than double the 30 million hours they averaged during the summer months of 1996 and 50 percent more than the 44 million hours logged in September. In December 1996, the total soared to more than 100 million hours and rose further to about 125 million hours in January 1997. The number of daily sessions rose from 6.2 million in October to more than 10 million in January 1997 and over 11 million in February. AOL users averaged more than 32 minutes per day in January 1997, compared to 14 minutes per day in September 1996. And the number of simultaneous users increased from 185,000 in November 1996 to more than 260,000 in January 1997. Member complaints about busy signals and congested network traffic escalated, even though AOL had added about 20,000 modems to its network to accommodate increased call-ins and was adding thousands more weekly. One member's experience was typical: "It's literally impossible to get on AOL at night. I do business on the Internet and this has really hurt me."

In January 1997, five AOL members filed a class-action lawsuit in a state court in Los Angeles, alleging they were not getting the promised services due to repeated busy signals; similar suits were filed in three other states as well. State attorneys general from 36 states quickly joined in, reacting to a chorus of customer complaints. AOL responded by announcing it would spend $350 million to upgrade its network over the next five months by adding 150,000 modems, building new data centers, hiring 600 additional customer service representatives, adding 1-800 access numbers, and cutting back on the recruitment of new members. In an open letter to members, Steve Case said:

> Last fall, you told us you wanted an unlimited use plan, and we delivered. Naturally, we anticipated more usage, and prepared for it, but we seriously underestimated the surge in

demand that actually occurred. We know that you are having problems getting online and we are working day and night to improve the situation . . .

The events of the past few weeks have vividly reminded us of the responsibilities we have, as the service that 8 million members rely on each day. We take these responsibilities seriously, and I can assure you we will do everything in our power to meet them.

AOL'S EVOLVING STRATEGY, 1997–99

In early 1997 America Online, under mounting pressure of legal action, formally agreed to issue refunds or credit toward future service to cover network access and service problems during December 1996 and January 1997. Under terms of the agreement, customers could choose whether to receive credit for a free month of service or qualify for cash rebates up to $39.90. By March 1997, AOL had a total of 250,000 modems in place, was handling more than 11 million connections per day, and was distributing 10.5 million e-mail messages daily. On an average day, AOL members were, collectively, spending just over 4 million hours online and accounting for 225 million Web hits daily.

Steve Case saw the move to flat-rate pricing and the ensuing system overloads as hard evidence that Internet users were adopting his vision of the future and AOL's role in their lives: "What was happening, for really the first time, was that we impacted people's daily lives in a significant way. Suddenly, almost overnight, we became part of their everyday life. That's why there was this national outrage and tremendous passion and frustration, because people needed us, and many of them loved us, and we had disappointed them. It was a coming of age for the medium."[8]

AOL's Use of Alliances and Acquisitions to Enhance the Online Experience

America Online began making acquisitions to build its capabilities to deliver interesting online content in 1994. The company's acquisitions added expertise in creating multimedia experiences, improving the performance of its software, bringing new functionality to AOL's service, and improving the performance of AOL's network. Exhibit 3 presents AOL's acquisitions from August 1994 through December 1999. Through the company's acquisitions and its own internal product development efforts, it was able to offer a richer interactive experience than most of its online and Internet rivals.

In 1997 AOL launched its version 4.0 software that built on the resources gained through the company's numerous acquisitions and alliances and was faster, more responsive, and more interactive than its 3.0 predecessor. AOL 4.0 allowed members to send other members e-mail with embedded color photographs, custom backgrounds, multiple attachments, and different fonts. On the chat side, members could display a photograph, graphic image, or live video camera footage while they were chatting. Users could also click on a button and request an AOL phone conversation with the person they were chatting with. Another new feature was Driveway, an automated offline information option that could be customized by members to retrieve particular content from e-mail, newsgroups, the Web, and other places. Other new features included e-mail spelling and grammar checking, greeting card creation, address book enhancements,

[8]"The Internet Is Mr. Case's Neighborhood," *Fortune,* March 30, 1998, p. 72.

exhibit 3 America Online's Acquisitions, August 1994–December 1999

Date	Price in Stock	Company Acquired
August 1994	$34 million	Redgate Communications, Ted Leonis's company, which made multimedia CD-ROMs with online links
November 1994	$6 million	Navisoft, a maker of software for creating Web sites
December 1994	$41 million	BookLink Technologies, which provided AOL's first browser
February 1995	$35 million	ANS, creator of the Internet network
May 1995	$30 million	Medior, interactive media developer
May 1995	$15 million	WAS, developer of Web server software
June 1995	$11 million	Global Network Navigator, which provided the foundation for AOL's new Internet browser
September 1995	$15 million	Ubique, maker of software for 3-D worlds
February 1996	$59 million	Johnson-Grace, provider of data compression
August 1996	Not disclosed	ImagiNation Network, producer of online multiplayer games
March 1997	Not disclosed	Lightspeed Media, online program developer
January 1998	Not disclosed	PLS, developer of information indexing and search technologies
February 1998	$1.3 billion deal involving AOL's ANS, H&R Block, and WorldCom	CompuServe
June 1998	$29 million	NetChannnel, a Web-enhanced television company
June 1998	$287 million	Mirabilis, producer of ICQ instant communications technology
November 1998	Not disclosed	PersonaLogic, maker of online decision tree software
March 1999	$10.2 billion	Netscape
April 1999	Not disclosed	When, Inc., an Internet calendar developer
May 1999	Not disclosed	MovieFone, Inc.
June 1999	$400 million	Winamp, Spinner.com, and SHOUTcast music brands
June 1999	$15 million	Digital Marketing Services, online marketing research and online incentive marketing

Source: America Online press releases and *Business Week,* April 15, 1996, p. 82.

16-character screen names, additional security and control, and streaming video and multimedia enhancements for the World Wide Web.

In 1997, AOL began an alliance with Tel-Save, a small long-distance company, that allowed the company to offer its customers long-distance service at 9 cents per minute. AOL furthered its global reach in 1997 with the launch of AOL Japan and AOL Australia to gain more than 1 million international subscribers by the end of the year. AOL also announced an "AOL Anywhere" initiative in December 1997 that would ultimately make the company's services available beyond PCs through alliances and investments in interactive television, handheld connected devices, and broadband technology.

In 1998 AOL expanded its paying membership to 14.5 million through its continued aggressive marketing and the acquisition of CompuServe. Steve Case saw the interactive experience not as separate online and Internet markets but as a seamless product; he therefore made acquisitions to ensure that AOL would become a notable Internet destination. The company expanded its content available to AOL.com non-subscribers and acquired both instant communication provider ICQ and Web community Digital City. AOL's combined brands were visited by tens of millions of different people in 1998.

AOL also acquired a Web-enhanced television company called NetChannel and PLS, the leading developer of information indexing and search technologies, to improve the functionality of upcoming versions of AOL's software. AOL entered into an alliance with Sun Microsystems in November 1998 to build end-to-end electronic solutions and to help other companies put their businesses on the Internet. The company created a number of other alliances in 1998 with companies such as eBay to improve the diversity of its content, and added a mixture of e-commerce sites through alliances with 1-800-FLOWERS, J. Crew, Barnes & Noble, Preview Travel, DLJ Direct, E*Trade, Intuit, and others. AOL also created an investment unit in 1998 to examine interactive investment opportunities related to the Internet. The company expanded its international presence in 1998 with the launch of AOL Austria with the help of Bertelsmann AG.

AOL's Acquisition of Netscape

During 1999 AOL acquired Netscape for $10.2 billion in AOL stock. The Netscape acquisition provided AOL with the browser technology necessary to enhance its product development resources and provided the company with a West Coast location for job candidates unwilling to move to Virginia, but more importantly it gave AOL the resources necessary to provide electronic commerce services to business customers. Even though AOL customers could buy goods and services through the company's online service, prior to the Netscape acquisition AOL's e-commerce capabilities were primarily restricted to its efforts to offer an online shopping mall to Internet retailers.

In 1996, AOL attempted to develop the computer software and services necessary for companies to put their business online, but firms were hesitant to contract with AOL for their e-commerce requirements. AOL's senior vice president of its enterprise solutions group said that the company's failure in landing commercial accounts was largely attributable to the "psychic clash" encountered by business executives considering purchasing software from a consumer online service—many companies thought that it "bordered on a joke" that AOL's technology could reliably handle their mission-critical operations.[9]

The Netscape acquisition, along with AOL's existing agreement with Sun Microsystems, allowed the company to offer e-commerce solutions under a brand that would appeal to the business customer. Furthermore, the addition of Netscape to AOL's brands brought more daytime visitors to AOL sites and added a highly talented pool of workers needed to develop newer generations of AOL's software and browser capabilities. Steve Case commented on the importance of the addition of Netscape to AOL's portfolio of brands shortly after the company had been reorganized to fully capture the strategic fit benefits of the acquisition:

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[9] "AOL's New State: Firm Faces Challenge Selling Software, Services to Business," *Washington Post*, November 29, 1998, p. H01.

> This acquisition will greatly accelerate our business momentum by advancing our multiple-brand, multiple-product strategy and helping us take e-commerce to a new level. We are especially excited about adding Netscape's talented-people—highly regarded in Silicon Valley and elsewhere—to our team. We will continue to build Netscape's successful businesses, including expanding the audience for popular Netscape NetCenter and extending both the Navigator and Communicator browsers to the emerging market of next-generation Internet devices.[10]

Some industry analysts suggested that America Online should integrate the Netscape Navigator and Communicator browsers into the upcoming versions of its online software in lieu of using Microsoft's Internet Explorer.

Other Recent Acquisitions and Alliances

In 1999 AOL acquired When.com and PersonaLogic, the developers of Web-based calendar services; online music brands Spinner.com, Winamp, and SHOUTcast; and MovieFone, the premier movie information and ticketing brand. Also in 1999, the company acquired online incentive marketing and marketing research firm Digital Marketing Services, Inc.

AOL signed an alliance with CBS to become its exclusive provider of broadcast news, formed alliances with Bell Atlantic, SBC, Ameritech, and GTE to provide high-speed digital subscriber line (DSL) access to AOL customers, forged an advertising partnership with First USA, and formed alliances with Gemstar DIRECTV, Hughes Network Systems, Philips Electronics, and Liberate Technologies to create a television-based online service. In addition, AOL and 3Com Corporation created an alliance that would allow AOL subscribers to access their e-mail with their PalmPilots; AOL and Motorola began to develop wireless applications for AOL's Instant Messenger; and the company partnered with Gateway to introduce a family of specialized Internet appliances that would automatically launch AOL when the device was switched on. The new appliances would be a low-cost alternative to PCs and would come in countertop, desktop, or wireless handheld models.

Many of America Online's alliances were accompanied by equity investments in the company's partners. AOL had made investments in more than 70 publicly and closely held companies that were valued at more than $2 billion in early 2000. In addition, America Online had invested $1.5 billion in Hughes Electronics and $800 million in Gateway. A list of AOL's content and e-commerce partners is presented in Exhibit 4.

America Online's Strategy to Finance Its Growth

The company's rapid growth had been financed largely through new issues of common stock. The company had raised nearly $1.5 billion from the issue of new shares of common and preferred stock in fiscal years 1993–99 to pay for the costs of attracting new subscribers; new product development; and investments in modems, servers, and other equipment needed to operate and expand its online network capability. America Online had also generated the more than $12 billion needed for its many acquisitions through the issuance of new shares. The company's cash flows from operations had remained

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[10]"America Online Announces New Organization to Integrate Netscape and Extend Industry Leadership," *Business Wire*, March 24, 1999.

exhibit 4 America Online's Content and E-Commerce Partners

Auto, Travel
American Airlines
Norwegian Cruise Line
Budget Rent-a-Car
Preview Travel
The Hertz Corporation
AutoTrader.com

Babies, Children, and Toys
Gymboree.com
eToys
Healthtex
BabyCenter
iBaby
Sesame Street
Toysrus.com
KBKids.com
Americasbaby.com

Books, Videos, Movies, Music, Electronics and Computers
DIRECTV
barnesandnoble.com
Amazon.com
CDNow
DVD Express
New Line Cinema
Beyond.com
800.COM
Onsale

Cards, Office Supplies, Gifts, Art, and Collectibles
americangreetings.com
eBay
1-800-FLOWERS.com
Godiva Chocolatier
Art.com
Sharper Image
Office Max
Red Envelope.com

Clothing, Apparel, Fashion, and Accessories
J. Crew
Fossil
JCPenney
bluefly.com
eBags
Brooks Brothers
Guess
Steve Madden
Levi Strauss

Educational Programming
Nickelodeon
MamaMedia
New York Times Learning Network
Cartoon Network
Time for Kids

Food, Cooking, and Consumer Products
OmahaSteaks.com
Procter & Gamble
Cooking.com
Hickory Farms
Tavolo

Health, Pharmacy, Beauty, and Fitness
PlanetRx.com
Drugstore.com
Healthquick
HealthAxis.com
AmericasDoctor.com
Avon

News, Sports, Entertainment, and General Interest
CBS News
CBS SportsLine
The Weather Channel
iVillage
Oxygen Media Inc.
People Online
E! Online
MTV
Bloomberg

Insurance, Real Estate, Banking, and Financial Services
E*Trade
TD Waterhouse
The Motley Fool
Ameritrade
Century 21 Real Estate Corporation
Realtor.com
First USA
Intuit
DLJdirect
iOwn.com
Bank of America
BankOne
Citibank
Scudder Investments
The Kaufmann Fund
Union Bank of California

Pets, Hobbies, and Outdoors
Chipshot.com
PetSmart
Eastman Kodak Company
L. L. Bean
Mammoth Golf

Source: AOL Web site.

negative until 1997, when America Online generated $131 million from its operating activities. AOL began to record investment gains from many capital investments in strategic allies after those companies had later gone public. At year-end 1999 the company had not yet paid a dividend to its shareholders. Exhibits 5, 6, and 7 show America Online's income statements, balance sheets, and cash flow statements for 1994–99.

The Costs of Marketing, Acquiring New Subscribers, and Developing New Products

Acquiring new subscribers absorbed a sizable fraction on America Online's financial resources. In 1999 AOL's current marketing expenses were $808 million, up from $77 million in 1995. The company's marketing expenditures had amounted to as much as 28 *exhibit 5* Consolidated Statements of Operations, America Online, Inc., 1994–99 (In Millions, Except Per Share Data)

	Year Ended June 30					
	1999	1998	1997	1996	1995	1994
Revenues						
Subscription services	$3,321	$2,183	$1,478	$ 992	$ 334	$ 98
Advertising, commerce and other	1000	543	308	102	50	17
Enterprise solutions	456	365	411	—	—	—
Total revenues	4,777	3,091	2,197	1,094	394	116
Costs and expenses						
Cost of revenues	2,657	1,811	1,162	627	230	69
Sales and marketing	808	623	608	213	77	24
Write-off of deferred subscriber acquisition costs	—	(385)	—	—	—	—
Product development	286	239	195	54	14	5
General and administrative	408	328	220	110	43	14
Amortization of goodwill and other intangible assets	65	24	6	7	2	—
Acquired in-process research and development	—	94	9	17	50	—
Merger, restructuring and contract termination charges	95	75	73	—	—	—
Settlement charges	—	17	24	—	—	—
Total costs and expenses	4,319	3,211	2,682	1,029	416	112
Income (loss) from operations	458	(120)	(485)	65	(21)	4
Other income, net	638	30	10	(2)	3	2
Income (loss) before provision for income taxes	1,096	(90)	(475)	62	(21)	6
(Provision) benefit for income taxes	(334)	16	(10)	(33)	(15)	(4)
Net income (loss)	$ 762	($ 74)	($ 485)	$ 30	($ 36)	$ 2
Earnings (loss) per share						
Earnings (loss) per share—diluted	$ 0.60	($ 0.08)	($ 0.58)	$ 0.28	($0.51)	$0.03
Earnings (loss) per share—basic	$ 0.73	($ 0.08)	($ 0.58)	$ 0.28	($0.51)	$0.03
Weighted average shares outstanding—diluted	1,277	925	838	108	70	69
Weighted average shares outstanding—basic	1,041	925	838	108	70	69

Source: America Online annual reports.

percent of revenues in prior years but totaled less than 20 percent in 1999. Prior to 1997, these expenses did not include all that the company actually spent in soliciting new members. As noted earlier, AOL employed an accounting practice whereby it treated a large portion of the solicitation costs of new subscribers (including the costs of printing, producing, and shipping starter kits; obtaining mailing lists of qualified prospects; and creating direct response advertising) as a capital investment rather than a current expense; it then depreciated these "capital investments" over the next 12 to 18 months. In 1996, AOL spent approximately $275 million on subscriber acquisition efforts that it classified as capital investment. Moreover, company accountants opted in 1996 to increase the time frame over which AOL amortized subscriber acquisition costs from 12 and 18 months to 24 months, a change that had the effect of increasing the company's reported 1996 earnings by $48 million (actions and outcomes that were described in the

exhibit 6 Consolidated Balance Sheets, America Online, Inc., 1998–99 (In Millions)

	June 30	
	1999	1998
Assets		
Current assets		
Cash and cash equivalents	$ 887	$ 677
Short-term investments	537	146
Trade accounts receivable, less allowances of $54 and $34, respectively	323	192
Other receivables	79	93
Prepaid expenses and other current assets	153	155
Total current assets	1,979	1,263
Property and equipment at cost, net	657	503
Other assets		
Investments including available-for-sale securities	2,151	531
Product development costs, net	100	88
Goodwill and other intangible assets, net	454	472
Other assets	7	17
Total assets	$5,348	$2,874
Liabilities and Stockholders' Equity		
Current liabilities		
Trade accounts payable	$ 74	$ 120
Other accrued expenses and liabilities	795	461
Deferred revenue	646	420
Accrued personnel costs	134	78
Deferred network services credit	76	76
Total current liabilities	1,725	1,155
Long-term liabilities		
Notes payable	348	372
Deferred revenue	30	71
Other liabilities	15	7
Deferred network services credit	197	273
Total liabilities	2,315	1,878
Stockholders' equity		
Preferred stock, $.01 par value; 5 million shares authorized, no shares issued and outstanding at June 30, 1999 and 1998, respectively	—	—
Common stock, $.01 par value, 1.8 billion shares authorized; 1,100,893,933 and 973,150,052 shares issued and outstanding at June 30, 1999 and 1998, respectively.	11	10
Additional paid-in capital	2,703	1,431
Accumulated comprehensive income—unrealized gain on available-for-sale securities, net	168	145
Retained earnings (accumulated deficit)	151	(590)
Total stockholders' equity	3,033	996
Total liabilities and stockholders' equity	$5,348	$2,874

Source: America Online annual reports.

exhibit 7 Consolidated Statements of Cash Flows, America Online, Inc., 1997–99 (In Millions)

	June 30		
	1999	1998	1997
Cash flows from operating activities			
Net income (loss)	$762	($74)	($485)
Adjustments to reconcile net income (loss) to net cash provided by operating activities			
Write-off of deferred subscriber acquisition costs	—	—	385
Non-cash restructuring charges	7	32	22
Depreciation and amortization	298	191	93
Amortization of deferred network services credit	(76)	(32)	—
Charge for acquired in-process research and development	—	94	9
Compensatory stock options	20	33	2
Deferred income taxes	334	(18)	(1)
Gain on sale of investments	(564)	(28)	—
Amortization of subscriber acquisition costs	—	—	59
Changes in assets and liabilities, net of the effects of acquisitions and dispositions			
Trade accounts receivable	(123)	78	(122)
Other receivables	12	(67)	2
Prepaid expenses and other current assets	(63)	28	(50)
Deferred subscriber acquisition costs	—	—	(130)
Other assets	4	(5)	(15)
Investments including available-for-sale securities	(16)	(40)	(30)
Accrued expenses and other current liabilities	319	141	130
Deferred revenue and other liabilities	185	104	262
Total adjustments	337	511	616
Net cash provided by operating activities	1,099	437	131
Cash flows from investing activities			
Purchase of property and equipment	(301)	(384)	(230)
Product development costs	(49)	(51)	(57)
Proceeds from sale of investments	769	87	26
Purchase of investments, including available-for-sale securities	(2,289)	(166)	(208)
Maturity of investments	133	103	83
Net (payments) proceeds for acquisitions/dispositions of subsidiaries	30	(98)	30
Other investing activities	(69)	(22)	(11)
Net cash used in investing activities	(1,776)	(531)	(367)
Cash flows from financing activities			
Proceeds from issuance of common and preferred stock, net	836	141	251
Proceeds from sale and leaseback of property and equipment	8	70	20
Principal and accrued interest payments on line of credit and debt	(22)	(2)	(22)
Proceeds from line of credit and issuance of debt	65	371	1
Net cash provided by financing activities	887	580	250
Net increase in cash and cash equivalents	210	486	14
Cash and cash equivalents at beginning of year	677	191	177
Cash and cash equivalents at end of year	$887	$677	$191
Supplemental cash flow information			
Cash paid during the year for interest	$17	$10	$2

Source: America Online annual reports.

notes to the company's financial statements in its 1996 annual report). This change came on the heels of AOL's having agreed a few months earlier, following a review by the Securities and Exchange Commission, to reduce the portion of member-acquisition expenses it capitalized. An article in *Business Week* indicated that the company's practice of treating subscriber acquisition expenses as a capital investment instead of as a current expense allowed the company to report a loss of only $35.8 million in 1995 instead of a loss of $84.5 million.[11]

In 1999, America Online's product development expenses were more than $400 million, up from $14.3 million in 1995. These costs included amortization charges for software development (e.g., for AOL 5.0), new content features, and other R&D activities relating to improving the content and functionality of the company's online services. AOL was endeavoring to position itself as a catalyst of innovation, not only investing in original content but also promoting new kinds of interactive programming and building previously unimagined services.

Even though AOL promoted innovation, its central focus in the development of new software was ease of use. AOL was very careful to design its service for people with modest computer skills rather than those who were technically oriented. In fact, most programmers and other computer professionals used a service other than AOL to connect to the Internet. Bob Pittman, the company's chief operating officer, commented on AOL's philosophy concerning innovation in its software: "Well, ours has never been a technology service. AOL always has been focused on the mass market. I think that was the genius of Steve Case. Very early on, when it was just computer users online, he said, 'You know what, we're going to build a service for the mass market.' Now that the mass market is coming, AOL is the obvious choice. It's easy to use, understandable, and things are there that real people are interested in, not just people interested in computers."[12]

AOL's Efforts to Become Profitable

Beginning in 1996, AOL investors began to call for the company to earn a profit. The company's revenues had grown at a dramatic rate, to more than $1 billion, but AOL was still recording significant losses. Steve Case saw that he was having difficulty reining in expenses (the company was adding about 200 new employees on average each month) while trying to increase the company's services and chose to bring in someone to help him keep AOL's daily operations under control. He recruited an executive from FedEx, William Razzouk, to become the company's president and chief operating officer (COO) in April 1996. However, Razzouk's command-and-control management style clashed with Case's style and with AOL's laid-back, collegial culture, and Razzouk abruptly resigned after four months on the job.

In October 1996, Case recruited Robert W. Pittman to pursue Wall Street's vision of a profitable AOL. Pittman had been a college dropout who, at age 24, helped develop The Movie Channel and co-founded MTV shortly after The Movie Channel merged with Showtime. Pittman later helped launch VH-1 and Nick at Nite before turning around Time Warner's Six Flags theme-park business. Pittman met Case in 1995, when as head of Century 21 Realty he began discussions with AOL to provide an online site for the company's real estate listings.

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[11]Ibid., p. 81.

[12]Interview with CNNfn, *In the Game*, March 31, 1998.

With Pittman as COO, the company scaled back its growth-at-any-price strategy and launched a reorganization that put Pittman in charge of AOL, CompuServe, and AOL Studios, the unit that developed AOL's proprietary content. With all three of AOL's operating units reporting to him, Pittman concentrated on improving efficiencies throughout the company while growing revenues beyond subscription fees. Pittman quickly cut costs by cutting back the company's mailings of sign-up disks and called for the sale of the company's data network to WorldCom. The result was a decrease in the cost to sign up a new customer from $375 in 1996 to $77 in 1998. The sale of AOL's data network reduced the cost of connecting a member from 90 cents per hour prior to the sale to 45 cents per hour in 1998.

Pittman also brought in substantial new revenues from e-commerce ventures and advertising. Much of AOL's e-commerce revenue came not from goods sold by AOL, but from fees charged to companies wanting to sell their merchandise or services to AOL subscribers. Tel-Save paid AOL a $100 million up-front fee plus ongoing commissions for the exclusive right to offer long-distance services to AOL customers, and eBay paid AOL a $75 million fee to link its online auctions to AOL's online service. Some companies offered AOL an equity stake in their company in lieu of up-front fees. Pittman was named as one of *Business Week*'s "25 Top Executives" in 1998.

AOL's Principles Regarding the Internet

Since the use of the Internet and online services was growing at dramatic rates and the interactive medium was growing in very unpredictable ways, AOL managers believed that it was important for the company to develop principles to guide public policy regarding the Internet. The company stated four basic principles: (1) Internet policy should foster individual choice and empowerment in the economic and social dimensions; (2) public policies should be led by the market and the industry rather than by a government gatekeeper; (3) where government involvement was determined to be necessary, policies should be technologically neutral and nondiscriminatory; and (4) policies should be designed to ensure that all segments of society and all countries of the world had access to the potential of the new medium.

AOL believed that adherence to these principles was essential if society was to realize the full benefit of the Internet. AOL believed too that there were sizable economic incentives to promote restrained public policy related to the Internet. In 2000, 200 million people were connected to the Internet and some estimates suggested that there might eventually be 1 billion Internet users worldwide. U.S. consumers purchased $13.6 billion in goods and services online in 1998, and the U.S. Commerce Department projected that the Internet would account for $300 billion worth of business-to-business commerce and that 500,000 small businesses would use the Internet by 2002. The U.S. Chamber of Commerce projected that by 2006 almost one-half of U.S. workers would be employed by industries that produce information technology or are intensive users of it. AOL also pointed to educational benefits of the Internet and its use to promote citizen involvement in the political process as reasons to support its principles guiding public policy concerning interactive services.

Steve Case believed that companies like AOL could police themselves and could shape the interactive medium to serve the public interest:

> Many of the policy issues are ultimately centered on creating a better environment for online consumers. Safeguarding children, protecting privacy, enforcing security and ensuring fair tax treatment of online purchases are just some of the issues on which America Online

> has led coalitions of industry representatives, consumer advocates, and government officials to build effective, mediumwide solutions.
>
> At the same time, we are working hard to maximize the medium's positive impact. For example, we will soon introduce exciting new tools that will enable people to donate their time or money online and connect to hundreds of thousands of nonprofit organizations and charities. We are also working to use this medium to reinvigorate the political process and help more people connect more easily with government services, and have invested significantly in learning achievement. Perhaps the most important is our work on bridging the "digital divide" between the information technology "haves" and "have-nots" so the interactive revolution does not leave behind the very populations who need the empowerment of these tools the most.[13]

In a speech to the National School Boards Association, Case discussed how the Internet presented a challenge to educators and how it could improve the delivery of education:

> Kids live in Internet time. They want to learn in Internet time. Which means we have to teach classes and run schools in Internet time. And that's not easy. In fact, it's exhausting. This new medium is pushing us faster and further than anything we've ever confronted.
>
> The good news is that we have time to respond, because we're only at the very beginning stages in the development of this interactive world. But even in its early days, this medium holds the promise of reforming education and giving our kids the tools to learn throughout their lives. It can help us make the transition from classroom-centered, location-specific, age-based schooling . . . to anytime, anywhere, any-age lifelong learning that's continuous, customized, and connected.
>
> Such a transition is a major break from the past. For most of this century, schools have run on the same principles that guided the Industrial Age—mass production, standardization, and one best way.
>
> That system worked well in its time, but it just won't do anymore. The world moves too fast. Along with passing on the substance of the lesson, we've got to sharpen the very skill of learning.
>
> The Internet can help us forge this broader reform in education. It can help us transition from childhood schooling that begins and ends . . . to lifelong learning that goes and goes.
>
> From an education system with the institution at the center . . . to a system where learning is flexible enough to be truly centered on the child. From the old regime of command and control . . . to a new interactive ethic of nurture and guide. We can use the Internet to do some amazing things, to stretch our kids' minds, expand their possibilities, and prepare them for life in a connected society.[14]

The AOL Foundation

America Online created the AOL Foundation in October 1997 with a $150 million endowment from Steve Case. The foundation's mission was to leverage the power of the emerging global medium to improve the lives of families and children and to empower the disadvantaged. In 1998 and 1999 the foundation addressed the "digital divide" through research initiatives, partnerships, and projects. The AOL Foundation saw that it was necessary to work with others in the industry, the policy community, and the nonprofit community to ensure that Americans of all backgrounds had the opportunity

[13] America Online, Inc., 1999 annual report.

[14] Speech given to the National School Boards Association, 13th Annual Technology and Learning Conference, Dallas, Texas, November 11, 1999.

to share in the economic and social benefits of the Internet. The foundation believed that such collaborative efforts could expand entrepreneurial opportunities in communities that lack access to capital; foster better understanding of cultural and religious differences; and provide rural citizens with greater access to goods, information, and medical services. The foundation also focused on using online services to foster civic engagement, educational applications, health care information, and philanthropy.

In an April 2000 speech to newspaper executives from around the country, Steve Case commented on the need for organizations like the AOL Foundation to address the digital divide:

> There has always been a gap between the "haves" and the "have-nots" in our society. The question we face today is whether the Internet is going to widen that gap or close it. As you know, there is a growing divide between people who have access to the new technology and those who don't—a divide that breaks along many fault lines, including education, income, race, and geography.
>
> Seventy-five percent of households with incomes over $75,000 own computers, yet only 10 percent of our poorest families do—an unacceptable situation when more than 60 percent of all new jobs will require high-tech skills by 2002.
>
> But we can do something about it. Giving young people the tools to reach their dreams is not a job any one person or entity can or should do alone—not parents, not teachers, not community leaders, not businesses, not government. It's something we have to do together—joining our resources and expertise, sharing the things we know can work and applying those ideas to existing programs—working from the top down and the bottom up.
>
> I am especially proud of the role we are playing at AOL to help launch PowerUp, a unique public-private partnership to create a network of community technology centers that teach young people the skills they need—and that give them the guidance they need—to make the most of their potential.
>
> We have to keep asking ourselves: What are the concrete steps we must take to ensure that the benefits of the Internet Revolution are equally shared, leaving no community or country behind in the Internet Century?[15]

STEVE CASE'S VISION FOR THE INTERNET AND INTERACTIVITY BEYOND 2000

Steve Case believed that the Internet and interactivity had already created a great deal of change in the way people communicated, conducted business, stayed abreast of the latest news around the world, and spent leisure hours. In a letter to AOL shareholders, published in the company's 1999 annual report, Steve Case made the following comments about the future of the Internet and interactivity:

> The interactive medium has already changed our lives in remarkable ways, and it will become even more central to people and businesses around the world with the dawn of the new millennium.
>
> The interactive experience is becoming increasingly embedded in consumers' everyday routines—everything from communicating, shopping, and keeping informed to investing, learning and just having fun. And nearly every company already has, or will, put its business online—seeking the benefits of the medium's efficiencies, convenience and reach.

[15]Speech given at ASNE Conference, April 14, 2000.

Today, we are seeing the next wave of Internet growth on the horizon. Interactivity is fast moving beyond PCs tethered to narrowband telephone lines. Consumers will have the ability to connect anytime from anywhere, as well as enjoy robust new high-speed online services, from interactive TV and handheld devices to broadband access.

This new world of interactivity is driving several significant trends that we believe will define the future of the medium.

First, online consumers are demanding new interactive tools and features to enhance their online experience and make it even more convenient and valuable to everyday life.

Second, many Internet consumers are seeking to extend their interactive experience beyond the PC in an integrated, affordable, and simple way.

Third, doing business and shopping online will become even more efficient and convenient as e-commerce reaches the next level of success.

Fourth, Internet use worldwide will explode with the increasing availability of connected devices.

Finally, as the medium becomes more central to people's lives, it will become increasingly critical that we build public trust and ensure that the medium serves the public interest.

Case went on to summarize what the company had done to position itself to be interactivity leader of the future. He listed the following AOL actions to improve and enhance consumers' online experiences:

Central to fulfilling these demands are the diverse acquisitions we made over the past year to broaden and enhance our offerings. Several of our newly acquired companies are helping us build usage around key functions or categories, creating deeper and stickier relationships with our members and other Internet consumers.

We have moved quickly to maximize Netscape's talent and technologies. For example, Netscape's expertise has enabled the development of an enhanced Web-based Quick Checkout "wallet" technology. And, with more than 17 million registrants, the addition of Netscape Netcenter to our portfolio of brands now gives the company the #1 reach in the work and home audiences.

We have positioned CompuServe as our value brand to enlarge the overall online audience by attracting price-sensitive consumers. We are continuing to grow ICQ and extend its communications functionality with services like free Web-based e-mail and ICQ-branded Internet telephony for its 38 million registrants. Also, Digital City offers local content in 60 markets nationwide, and has more than five million unique visitors monthly.

Steve Case went on to describe AOL's extension of interactivity beyond the PC:

We believe consumers are looking to AOL to pull all these interactive experiences together into a seamless and convenient package that requires, for example, just one e-mail address for any device or network. Over the past year, we extended our "AOL Anywhere" strategy with critical alliances and investments in interactive television, handheld connected devices and broadband connectivity.

Making real progress toward developing AOL TV for launch in the coming year, we concluded key partnering agreements with Philips Electronics for advanced set-top boxes enabled for AOL TV's Liberate Technologies for a comprehensive software platform; and Gemstar International for electronic programming guides, which will be the cornerstone of the AOL TV experience. We also formed a strategic alliance with Hughes Electronics to offer AOL TV to Hughes's DIRECTV subscribers.

Taking the first step to extend AOL-branded interconnectivity to handheld devices, we are making AOL e-mail available via personal organizers and we are exploring ways to develop a more full-featured version of AOL software for other portable devices.

Case also discussed how the company was becoming a key player in e-commerce solutions and generating revenues from its own e-commerce initiatives:

During fiscal 1999, we signed 58 multiyear advertising and commerce agreements, each worth in excess of $1 million. In the Internet's largest ever advertising and marketing partnership, we reached a five-year agreement worth up to $500 million with First USA.

Designed to enhance the shopping experience across our brands, our Shop@AOL initiative is setting a new industry standard for consumer convenience. Shop@AOL provides seamless integration to our commerce partners' sites and new Web-based tools to help them promote their products even more effectively on the service.

The Netscape-Sun Alliance has introduced "iPlanet" as its new product brand for its comprehensive, easy-to-deploy Internet infrastructure and e-commerce solutions. By fiscal year's end, more than 300 companies, including over half of the Fortune 100, turned to the Alliance to help put their businesses online.

AMERICA ONLINE IN 2000

In 2000, AOL was growing closer (1) to being able to offer its services worldwide because of the alliances forged in 1999 with satellite, telecommunications, and technology firms and (2) to realizing its mission of building "a global medium as central to people's lives as the telephone or television . . . and even more valuable." AOL was accessible to subscribers and Internet users through its Interactive Services Group, Interactive Properties, Netscape Enterprise Group, and AOL International.

Interactive Services Group

AOL was America Online's flagship online service and the world's leading interactive service. AOL's content allowed members to spend 56 million hours collectively each month connecting in 15,000 chat rooms devoted to topics like politics, parenting, travel, the arts, romance, finance, and sports. AOL also provided its members with up-to-the-minute, in-depth news coverage. Subscribers could also read the latest entertainment and sports news on AOL. The company's news-related content partners included CBS, National Public Radio, the Associated Press, the *New York Times*, *Time* magazine, *People* magazine, and E! Online.

AOL's personal finance content allowed members to receive stock quotes, obtain the latest business news from Bloomberg News and *Financial Times*, and review financial analysis reports from TheStreet.com, The Motley Fool, and Morningstar. AOL customers could also trade stocks with DLJdirect, E*Trade, TD Waterhouse, and Ameritrade and could use the banking services of Bank of America, Citibank, Wells Fargo, Union Bank of California, and BankOne.

AOL also provided extensive health care information to its subscribers through partnerships with drkoop.com, the Mayo Clinic, AmericasDoctor.com, and other medical information services. Travel information and booking could be done online with AOL. AOL also had a special Kids Only section and hosted live events with such special guests as General Colin Powell, Mick Jagger, Rosie O'Donnell, and Michael Jordan.

AOL's e-mail service was thought to be among the easiest to use and was featured in a 1998 Warner Bros. film, *You've Got Mail*. Members could conduct spelling and grammar checks and customize e-mails with a variety of fonts and colors, photos, or hyperlinks. AOL's Instant Message feature allowed users to tell when friends, family members, or co-workers were online to receive and send real-time private messages. AOL members could also shop at what Forrester Research called the "Internet's Miracle Mile" via the Shop@AOL feature. AOL 5.0, introduced in 1999, allowed AOL subscribers to keep an online calendar, customize their AOL Welcome screen, and send and receive photos with "You've Got Pictures."

CompuServe, AOL's value-priced online service, had approximately 2 million members worldwide in early 2000. CompuServe lacked many of the features offered with AOL, but did offer subscribers 30 content channels, a Shop@CompuServe site that included many of the same partners found at Shop@AOL, and up to 100 free real-time stock quotes per day.

America Online's Netscape NetCenter came about through its acquisition of Netscape in 1999 and significantly increased AOL's daytime traffic by capturing complementary audiences and broadening AOL's reach both at home and at work. NetCenter was one of the most visited sites on the Internet during daytime hours, and 74 percent of NetCenter visitors went online every day. NetCenter featured a customizable My Netscape start page, numerous search engines, AOL's Instant Messenger, WebMail, a Web calendar, a Web site creation service, an address book, and an Internet telephony service. All NetCenter features were available to registrants free of charge. Netscape Communicator 4.7 also included an integrated Shop@Netscape button that linked users with hundreds of merchants.

AOL.com offered all Internet users, whether or not they were AOL subscribers, content, search tools like AOL NetFind, AOL NetMail, and a personalized news service. AOL Instant Messenger (AIM), also available at AOL.com, was the most widely used instant messaging system on the Internet. AIM 2.0 also allowed users to search the Web and yellow and white pages, and to complete file transfers. AIM was also available through co-branding agreements with Apple Computer, Mindspring Enterprises, Earthlink Network, and Juno Online services.

Interactive Properties Group

America Online's Interactive Properties Group included the company's brands that operated across multiple platforms. Digital City, which provided content of local interest for 60 U.S. cities, was accessible through AOL's online service, AOL.com, NetCenter, MCI WorldCom Internet, and its Web site (www.digitalcity.com). Digital City partnered with leading local media companies to deliver interesting local content and was named "1999's Best City Guide" by an independent panel of judges.

ICQ (short for "I seek you") was an easy-to-use combination of e-mail, chat, and Internet telephony. Like e-mail, ICQ allowed users to exchange messages with other ICQ users, and like chat, ICQ messages appeared instantly. But ICQ users claimed that the service was more like using a telephone than using e-mail or chat. When ICQ users logged on, they would be immediately notified who among their correspondents was online. All of a user's correspondents would see any typed instant messages unless a private message was requested with a single correspondent. ICQ was most popular with Internet users seeking communications that were faster and more efficient than e-mail. ICQ was used by college students to exchange notes in Internet-wired classrooms, and some companies used ICQ for online training exercises for their employees. More than two-thirds of ICQ users were under the age of 35 and lived outside the United States.

MovieFone users could purchase movie tickets through a telephone service or by visiting www.moviefone.com. The Web site also provided extensive movie information, including reviews, movie trailers, theater locations, and show times. MovieFone services covered approximately 27,000 screens in 1,000 cities and had been used by 20 percent of U.S. moviegoers. AOL also could make music available over the Internet with its 1999 acquisition of Spinner Networks and Nullsoft. Spinner's Web site featured over 100 music channels, containing more than 175,000 songs, and allowed listeners to read information about a song while it was playing. The Spinner Web site also provided links for real-time listener feedback and allowed users to purchase music online. Nullsoft was the producer of the Winamp MP3 player and ShoutCast, a streaming MP3 system that allowed users to broadcast their own music programs over the Internet.

The Netscape Enterprise Group

America Online's Sun-Netscape alliance allowed the company to provide e-commerce solutions for the Internet economy. America Online offered end-to-end solutions, including hardware, software, operating system, consumer access, and content through its iPlanet branded products. Its e-commerce software provided calendar and message services, security services such as certificate management and firewalls, remote access, online business-to-business transactions, procurement, and sales and billing processing. In early 2000 more than one-half of Fortune 100 firms and 40 to 50 percent of the highest-traffic sites on the Internet were powered by America Online's e-commerce services.

AOL International

America Online had entered more than 100 international markets in Europe, Asia, Latin America, and Australia. America Online had entered into strategic alliances as part of its international strategy to acquire the resources necessary to provide local content in each specific country market. Its relationship with Bertelsmann allowed it to bring AOL Europe and CompuServe Europe to the United Kingdom, Australia, Austria, Germany, the Netherlands, Sweden, and Switzerland, and to provide local content to its customers in those countries. AOL Europe intended to enter more European markets in 2000, and America Online also planned to launch a new Netscape Online service in the United Kingdom in 2000.

In 1999 America Online began service in Hong Kong through a distribution agreement with China Internet Company, which was responsible for producing both Chinese and English-language content for the Hong Kong market. AOL also purchased an equity interest in China.com to expand its commitments in the region. AOL's joint venture with the Cisneros Group, a Latin American publisher, allowed it to bring service to Latin American markets in 1998. AOL Brazil was launched at the end of 1999.

AOL'S PROPOSED MERGER WITH TIME WARNER, INC.: A NEW ERA AND A NEW DIRECTION

The January 10, 2000, announcement by America Online and Time Warner executives of a $156 billion agreement to merge AOL's Internet franchises, technology and infrastructure, and e-commerce capabilities with Time Warner's vast array of media, entertainment, and news brands and broadband delivery systems stunned the business world. The *exhibit 8* Selected Financial and Operating Highlights, Time-Warner, Inc., 1995–99 (In Millions, Except Per Share Data)

	Year Ended June 30				
	1999	1998	1997	1996	1995
Income statement data					
Total revenues	$27,333	$14,582	$13,294	$10,064	$8,067
Business segment operating income	6,035	1,496	1,271	966	697
Net income	1,948	168	246	(191)	(166)
Preferred dividend requirements	(52)	(540)	(319)	(257)	(52)
Income (loss) per common share					
Net income (loss) per share—diluted	$1.43	($0.31)	($0.13)	($1.04)	($0.57)
Net income (loss) per share—basic	$1.51	($0.31)	($0.13)	($1.04)	($0.57)
Weighted average shares outstanding					
Diluted	1,398.3	1,194.7	1,135.4	431.2	383.8
Basic	1,267.0	1,194.7	1,135.4	431.2	383.8
Balance sheet data					
Total assets	$51,239	$31,640	$34,163	$35,064	22,132
Total debt	18,105	17,528	11,841	12,724	9,941
Stockholders' equity	9,713	8,852	9,356	9,502	3,667

Note: Since 1993, Time Warner had not consolidated certain parts of its entertainment operations because Media One, which owned a portion of these properties, had rights that allowed it to participate in the management of Time Warner Entertainment's businesses; these rights were subsequently modified as part of Media One's completion of its acquisition by AT&T. Thus, starting in 1999, Time Warner consolidated the Entertainment Group into its financial statements. This is what accounts for the substantial difference in revenues and income between 1998 and 1999.

Source: Time Warner, Inc., annual reports.

agreement to create AOL Time Warner represented the largest merger in history to date and would create the world's first fully integrated media and communications company. Exhibit 8 presents a summary of Time Warner, Inc.'s financial performance between 1995 and 1999. Exhibit 9 presents an overview of Time Warner's company history, its business operations, and a brief biographical sketch of its key officers. Statistics related to the size and scope of AOL Time Warner's operations are presented in Exhibit 10.

America Online and Time Warner executives made the following comments regarding the benefits of the proposed merger.

- **Steve Case:**

  This is an historic moment in which new media has truly come of age. We've always said that America Online's mission is to make the Internet as central to people's lives as the telephone and television, and even more valuable, and this is a once-in-a-lifetime opportunity to turn this promise into reality. We're kicking off the new century with a unique new company that has unparalleled assets and the ability to have a profoundly positive impact on society. By joining forces with Time Warner, we will fundamentally change the way people get information, communicate with others, buy products, and are entertained—providing far-reaching benefits to our customers and shareholders.

exhibit 9 Profile of Time Warner, Co-Chairman and CEO Gerald Levin, and Co-Chairman R. E. (Ted) Turner.

Company History

In 2000 Time Warner, Inc.'s portfolio of businesses included cable television networks, cable movie channels, movie production, magazines, book publishing, syndicated television production, cartoon production, music production, local news channels, and cable systems. The company's history dated to *Time* magazine's founding in 1923 by Henry Luce. Time, Inc., expanded beyond print publications in 1989 when it acquired Warner Bros. film production and cable assets in 1989 and was renamed Time Warner. Time Warner acquired Ted Turner's Turner Broadcasting System, Inc., for $7 billion; Turner's company consisted of a variety of cable television channels (TBS SuperStation, CNN, TNT, the Cartoon Network, and Turner Classic Movies); MGM's extensive library of 3,700-plus films; and New Line and Castle Rock movie production companies.

Time Warner struggled throughout most the 1990s, not earning a profit until 1997. However, the company's cash flows and earnings before interest, taxes, depreciation, and amortization (EDITDA) were strong enough for the company to fund its portfolio and improve its competitive strength in most of its businesses. Time Warner's culture prior to its merger with Turner Broadcasting System in 1996 placed little emphasis on cost controls with the company's executives and entertainment personalities enjoying such lavish perks as private jet travel to almost any desired destination. Upon the completion of the merger, Ted Turner became the Time Warner's vice chairman; he reportedly pushed to cut Time Warner's expenses and continued to exercise influence over the Turner Entertainment division of Time Warner. Most analysts believed that Turner's influence had contributed greatly to Time Warner's improved financial performance and growing strength in its entertainment brands.

Time Warner had attempted to make publishing and entertainment content available to online audiences as early as 1994, when it launched its Pathfinder Web site. Plans called for putting its entire library of magazine and book titles online, but constant strategy changes, Web page designs, and personnel shifts made Pathfinder a fiasco. Later, Time Warner launched an interactive TV set-top service through its cable TV subsidiary called Road Runner, but it was still in the early stages and was unprofitable. At the time of the AOL–Time Warner merger announcement, Time Warner's president Richard Parsons remarked, "We could work for a decade and maybe still not get up to a level [with AOL]."*

Time Warner Co-Chairman and CEO Gerald Levin

In 1972, Gerald Levin began his career with Time, Inc., where he helped launch HBO in 1975 and was a chief architect of the company's merger with Warner Bros. in 1989. Levin became the company's CEO in 1992 upon the death of his predecessor, Steven Ross. Time Warner experienced lackluster financial and market performance during Levin's first years as CEO, largely as a result of the fiercely competitive environment of the U.S. cable industry. Analysts and investors saw Time Warner's cable business as a drag on earnings and made repeated calls for Levin to divest the business. Gerald Levin stubbornly clung to the business, which by the late 1990s was thought to be among the most valuable assets in the company's portfolio after new legislative and technological changes had made the industry highly attractive. Levin was considered a hardworking, resilient manager with good strategy-making skills.

Time Warner Co-Chairman R. E. (Ted) Turner

R. E. (Ted) Turner began his media career in 1960 when, after leaving college without a degree, he went to work for his father's Georgia-based outdoor advertising company. At age 24, Turner found himself in charge of the business that was short of cash and $6 million in debt after his father had a breakdown and committed suicide. Within two years, Turner successfully turned around the company that sold advertising on billboards and beginning in 1970, Turner began making acquisitions. Turner first acquired two Chattanooga radio stations and an Atlanta UHF television station before launching Turner Broadcasting in 1976. Turner later launched CNN in 1979 and CNN Headline News in 1982 before purchasing the MGM's and RKO's libraries of films, television programs, and cartoons. He also purchased the Atlanta Braves Major League Baseball franchise and the Atlanta Hawks (a National Basketball Association franchise). Turner Broadcasting System's newly acquired programming allowed it to broadcast live sports programs and TV reruns, cartoons, and movies on TBS, charge royalties for broadcasts of the programs by other networks, and provide content for the launch of the Cartoon Network, TNT, and Turner Classic Movies. When Turner Broadcasting System was acquired by Time Warner in 1996, Ted Turner became Time Warner's largest shareholder, holding approximately 12 percent of the company's shares. Ted Turner was also named co-chairman of Time Warner and was involved in key management decisions at the company.

exhibit 9 (continued)

Composition of Time Warner's Business Units

1999 Financial Performance Summary, by Business Segment

Business Segment	Revenues	Operating Income	EBITDA
Cable networks	$ 6.1 billion	$ 1.2 billion	$ 1.4 billion
Publishing	4.7 billion	627 million	679 million
Music	3.8 billion	179 million	452 million
Filmed entertainment	8.1 billion	796 million	997 million
Broadcasting (WB Network)	384 million	(96) million	(92) million
Cable systems	5.4 billion	3.4 billion	3.9 billion

Turner Entertainment Group

TBS Superstation (most-watched cable TV network)
TNT (available in 75 percent of U.S. homes)
Cartoon Network (50 million-plus U.S. subscribers, plus 20 million foreign subscribers in 120 countries)
Turner Classic Movies (30 million U.S. subscribers)
Atlanta Braves (Major League baseball franchise)
Atlanta Hawks (NBA franchise)
Atlanta Thrashers (NHL franchise)
World Championship Wrestling
Goodwill Games
New Line Cinema
Fine Line Features
CNN News Group (more than 75 million U.S. subscribers; reaches nearly 150 million households in 212 countries; more than 1 billion people worldwide have access to a CNN service)

Home Box Office (34.6 million U.S. subscribers and 12 million foreign subscribers)

HBO
Cinemax

Publishing Business Segment

Magazines (32 publications with combined readership of 130 million)
- *Time*
- *Fortune*
- *Sports Illustrated*
- *People*
- *Entertainment Weekly*
- *Life*
- *Money*
- *Southern Living*
- *Southern Accents*
- *Cooking Light*
- *Parenting*
- *Health*
- 20 others

Book-of-the-Month Club

(continued)

exhibit 9 (*concluded*)

Warner Books
Time-Life Books
Sunset Books (a publisher)
Oxmoor House (a publisher)
Filmed Entertainment Business Group
Warner Bros. motion pictures (5,700 full-length and feature films and 13,500 animated titles)
Warner Bros. television series (32,000 episodes of various programs)
Castle Rock motion pictures
New Line Cinema
Telepictures Productions
Warner Bros. Television Animation
The WB Network
Hanna-Barbera Studios
Music Business Segment
Warner Music Group (5 studios, over 1,000 recording artists, 1 million music copyrights, 20 percent market share of U.S. album sales, world's most diversified and vertically integrated music company)
The Atlantic Group music production
Elektra Entertainment Group
Sire Records Group
Warner Bros. Records
Warner Music International
Columbia House Records (joint venture with Sony)
Cable Systems Business Segment
Time Warner Cable (this division had 100,000-plus subscribers in each of 34 areas of the United States and served 12.4 million homes)
Road Runner (a jointly owned high-speed online service with 320,000-plus customers and approximately 10,000 new customers being added weekly)
Local news channels (a total of 4)

**"AOL, Time Warner Set Plan to Link in Mammoth Merger," *The Wall Street Journal Interactive Edition*, January 11, 2000.

- **Gerald Levin, Chairman and CEO of Time Warner:**
  This strategic combination with AOL accelerates the digital transformation of Time Warner by giving our creative and content businesses the widest possible canvas. The digital revolution has already begun to create unprecedented and instantaneous access to every form of media and to unleash immense possibilities for economic growth, human understanding, and creative expression. AOL Time Warner will lead this transformation, improving the lives of consumers worldwide.
- **Bob Pittman, AOL's president:**
  The value of this merger lies not only in what it is today but in what it will be in the future. We believe that AOL Time Warner will provide companies worldwide with a convenient, one-stop way to put advertising and commerce online as well as take advantage of the best in traditional marketing. We will accelerate the development of Time Warner's cable broadband assets by bringing AOL's hallmark ease-of-use to this platform. We expect America Online to help drive the growth of cable broadband audiences, and we will use our combined infrastructure and cross-promotional strengths to enhance the growth and development of both America Online and Time Warner brands around the world.

exhibit 10 Combined AOL–Time Warner Statistics

Selected financials*		
Revenue	$32.8 billion	
EBITDA	7.5 billion	
Net income	2.4 billion	
Cash and cash equivalents	3.7 billion	
Long-term debt	19.8 billion	
Employees	82,100	
Customer relationships		
Online subscribers		24 million
Magazine subscribers		25.4 million
Cable TV network subscribers		73 million
ICQ, AOL Instant Messenger, and Netscape NetCenter registrants		107 million

*Based on the combined year-end 1999 financials of each company.
Source: "The Men Who Would Be King," *Fortune*, February 7, 2000.

- **Richard Parsons, Time Warner's president:**
This is a defining event for Time Warner and America Online as well as a pivotal moment in the unfolding of the Internet age. By joining the resources and talents of these two highly creative companies, we can accelerate the development and deployment of a whole new generation of interactive services and content. The heightened competition and expanded choices this will bring about will be of great benefit to consumers. For the creative and innovative people who are the lifeblood of our companies, it means a truly exciting range of new opportunities to explore and give shape to. For our shareholders, it means we'll be able to grow in ways we couldn't have as separate companies, producing superior returns in both the short and long term.

Steve Case later further discussed the benefits of the merger and how AOL Time Warner would be positioned to lead the second Internet revolution:

> One thing the last few years have made crystal clear is that in such a rapidly changing, Internet-charged economy, companies must constantly reinvent themselves to attract new customers. And today, it's not how many assets your company has, it's how you connect those assets and constantly innovate to better serve consumers.
>
> In this new environment, it is critical to integrate the new technologies for consumers. Whether in wireless or other new markets, both individual companies and industries must build bridges between platforms, mediums, content and services—capitalizing on new synergies, creating new businesses, and taking advantage of transforming business opportunities.
>
> That, in fact, is our game plan for AOL Time Warner. And we believe we are uniquely positioned to put it into play, for a number of reasons.
>
> First, our combined assets are unrivaled—not only because of their range and value, but because of the way they fit together like pieces of a puzzle. From the world's most popular media, Internet and communications brands and properties, to our technological expertise and infrastructure, we are poised to lead the next wave of growth.
>
> Second, we have strong, sticky relationships with our customers, including more than 110 million paying subscribers between the two companies. In fact, our combined brands touch consumers more than 2.5 billion times monthly, all around the world.
>
> Third, our combined resources give us the strength to take full advantage of new opportunities. With significant revenues, critical strategic partnerships, a world-class

operational team, management vision, and a deep talent pool, we will drive strong and consistent growth.

Finally, we are committed to putting the interests of both our customers and shareholders first. AOL and Time Warner have always believed that the best way to return shareholder value is to bring new value into the lives of consumers.

That's what we'll do as a combined company. Just as *Time* has been a part of people's lives for 75 years, and CNN for 20, we plan to entwine our brands into the fabric of society, improving our customers' lives . . . and becoming the most valuable company in the world.[16]

Preliminary Plans of How the Merged Companies Would Operate

As part of the merger agreement announcement, the two companies said they would begin new marketing, commerce, content, and promotional agreements that would immediately expand various relationships already in place. Subsequently, AOL's online service added Time Warner content that included *InStyle* magazine, *People, Teen People,* and *Entertainment Weekly.* Time Warner's CNN.com and Entertaindom.com programming was prominently featured on various America Online services, and AOL members were given access to a wide range of Time Warner promotional music clips from Time Warner's selection of popular artists. In addition, Time Warner and AOL MovieFone participated in online–offline cross-promotion of Time Warner movies and related content, including live events.

AOL also planned to use Time Warner's broadband capabilities and content to help launch AOL Plus, AOL's broadband service scheduled for a spring 2000 release. Time Warner began making a series of special offers exclusively to AOL members that included discounts on magazine subscriptions, premium cable subscriptions, and movie passes. Time Warner began aiding AOL in building its online membership by distributing AOL disks in its Warner Bros. retail stores and including AOL trial-offer disks in promotional mailings and product shipments. AOL services such as Instant Messenger, Digital City, AOL Search, and MovieFone were to be made available to the subscribers of Road Runner, Time Warner's broadband service.

Other specific opportunities that AOL and Time Warner executives identified as revenue- and profit-enhancing synergies between the two companies included the following:

1. Combining Time Warner's music labels with America Online's online marketing and e-commerce capacities presented opportunities for growing Time Warner's music revenues.
2. Combining America Online's AOL TV and MovieFone with Time Warner's cable networks and Warner Bros. movies and television offered valuable programming, cross-promotional, and e-commerce opportunities.
3. AOL's ability to use Time-Warner's broadband capabilities could expedite Internet access at high speeds via cable modem, DSL, wireless, or satellite.
4. AOL could enhance its online news offering with content from CNN, *Time,* and local all-news channels such as NY1 News.
5. AOL Time Warner could develop and leverage technology across all of the businesses, creating new opportunities to expand services and share infrastructure.

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[16]Speech given at CS First Boston Global Telecom Conference, March 8, 2000.

6. AOL Time Warner could offer businesses and consumers a communications platform that combined America Online's popular instant messaging products with Time Warner's ability to offer local telephony over cable.
7. AOL could devote a large percentage of its advertising budget to Time Warner publications and broadcast media outlets.

Planned Roles of AOL Time Warner's Top Executives Steve Case's role as AOL Time Warner's chairman of the board was to oversee the new company's technological developments and global expansion initiatives. As CEO, Gerald Levin would set the company's strategy and oversee its management. Ted Turner would have the title of vice chairman of the new company. AOL president and COO Bob Pittman and Time Warner president Richard Parsons would act as co-chief operating officers of the new company. When questioned by analysts and business reporters about whether AOL Time Warner would be top heavy, with highly-talented executives whose egos and management styles might conflict, Steve Case responded, "There's a big meal to serve."[17] He and Levin expressed the opinion that a deep, talented senior management team was a strong asset, given the ambitious objectives of the new company; the broad range of products, brands, and services to be integrated; and the fast-paced changes occurring in the marketplace.

Reaction to the Merger

Reactions to the proposed merger were quite mixed. Some analysts were unconvinced that the merger made good sense for AOL, arguing that the combined companies could not increase net income and cash flows at rates sufficient to keep AOL's stock price at its former levels, much less keep it rising. Other analysts saw the merger as beneficial, making comments like "The merger of America Online with Time Warner is one of the greatest strategic alliances in the history of the Internet."[18] Merger proponents saw very little downside risk in the merger and great potential for the new company to be a global leader in interactive communications. One communications industry analyst commented, "They don't stand to lose much. And what they stand to gain is enormous." Another characterized the merger benefit as "one plus one equals four."[19]

Skeptics predicted that AOL Time Warner would have difficulty integrating AOL's technology-oriented culture with the celebrity-based culture of Time Warner's entertainment business and the no-nonsense culture of its cable business. Negative analysis centered on the price AOL had agreed to pay for Time Warner's shares and the level of cash flows needed to justify the rising stock price to which AOL investors had become accustomed. While there were obvious synergies between the two companies (like AOL's ability to offer broadband service over Time Warner cable's cable lines, which served 20 percent of all U.S. cable subscribers), there were concerns that AOL's proposed buyout price gave Time Warner shareholders a far-too-rich 71 percent premium over its market valuation at the time of the merger agreement. The premium would

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[17]"Investors Puzzle as AOL, Time Warner Integration Begins," The Associated Press State & Local Wire, January 12, 2000.

[18]"Fletcher and Faraday Announce Investment Opinion," PR Newswire, January 14, 2000.

[19]"AOL: You've Got Content, but Is Content Still King?" *Investors Business Daily*, January 13, 2000.

create a $150 billion goodwill charge resulting from the difference between the company's purchase price and book value that AOL would be required to write off over the next 10 years—the $15 billion per year goodwill writeoff would result in the company's reporting a loss each year for an indefinite time. This was why AOL executives and some Wall Street analysts were arguing that the profitability of the combined companies had to be viewed from the perspective of earnings before interest, taxes, depreciation, and amortization (EBITDA) rather than net earnings. But even using this measure, many analysts believed that the new AOL Time Warner would need to increase EBITDA to approximately $11 billion soon after the merger to maintain the growth of its share price.

Analysts were additionally concerned that the market would have trouble choosing earnings multiples to set a price on the new company's shares. Prior to the merger, Time Warner shares traded at a multiple of 14 times EBITDA, which was consistent with many old-economy firms, while AOL traded at 55 times EBITDA, which was consistent with the multiples of most growing new-economy firms. Some analysts were concerned that the new AOL Time Warner would become an old-economy company rather than a more competitively powerful new-economy company, since Time Warner's media properties accounted for about 80 percent of the combined company's 1999 cash flow. An analyst for J. P. Morgan Securities remarked, "That's what everyone is trying to get their arms around now: what this new entity is, and how to value it. This is going to continue to evolve. I think we need to take some time and see how things settle out."[20] Investment company Edward Jones's chief market strategist said that he no longer considered AOL a high-flying Internet company that could "grow 40 or 50 percent per year."[21]

An analyst for Merrill Lynch stated that if the new AOL could achieve $11 billion in EBITDA and a multiple of 40, the company's shares could trade as high as $90 within a year of the merger. If the market saw the company as less of an Internet company and more of a traditional media company, then an EBITDA multiple of 25 might be more realistic. The Merrill Lynch analyst stated that under the latter valuation scenario, AOL's message to shareholders would be "You've got losses."[22] AOL's shares, trading in the $90 to $95 per share range in the weeks prior to the merger, subsequently drifted downward to trade in the $55 to $65 range in March–April 2000.

In a speech given in April 2000, Steve Case reflected on AOL's growth and discussed how convergence would affect the future of the interactive medium:

> The average AOL user has gone from being online one hour a week to one hour a day. And while that's been gratifying for us and a sign of real progress, it's just scratching the surface. Having gotten a taste of interactivity, people are starting to say, "Why can't my PC be as simple and visually compelling as my TV—and why can't my TV be as powerful and flexible as my PC?" They're starting to ask, "Why can't I send instant messages from my cell phone?" And, "Why can't all these new devices work together in a way that's simple and easy to understand?"
>
> These days, we call it convergence—and it is turbo-charging a second Internet Revolution that will make the first one look almost quaint by comparison.
>
> Just think about the four devices we rely on the most in our homes: the television, the PC, the telephone, and the stereo. Already, the distinctions between these four devices are

[20] "Investors Puzzle as AOL, Time Warner Integration Begins.

[21] "Wall Street Doubts AOL's Staying Power after Its Merger with Time-Warner," *St. Louis Post-Dispatch*, January 15, 2000, p. B1.

[22] "Welcome to the 21st Century," *Business Week*, January 24, 2000, p. 39.

blurring—and interactivity is starting to connect all of them—giving people access to the Internet wherever they are and whenever they want.

Soon, televisions will come equipped with interactive program guides, and people will be able to bookmark their favorite programs like they bookmark their favorite Web sites. They will even be able to access interactive services like e-mail and Instant Messaging while they're watching TV—and trade comments on breaking stories or sports events.

The role of the PC will change, too. Just as the TV has evolved in many houses from a single console in the living room, people will have interactive devices all through the house. A recent AOL survey found that 52 percent of people online are already rearranging the furniture for the PC.

The fact is, the first steps of convergence already are driving consumers' expectations—and the more they get, the more they want.

The Internet has already changed the landscape of our lives. Ten years ago, the Internet was the exclusive province of researchers. Just five years ago, the World Wide Web barely existed, there was no talk about a "new economy," and, hard though it may be to believe, "e" was just the fifth letter in the alphabet.

Today, more than 200 million people are online worldwide, and if projections hold true—as I think they will—that number will more than double in the next three years. There are around 800 million Web pages, covering everything from world markets to world wrestling. And "e" has become the prefix for a massive social and economic transformation.[23]

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[23]Speech given at ASNE Conference, April 14, 2000