

The AOL Time Warner Merger



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INTRODUCTION

The proposed merger between AOL and Time Warner created shockwaves around the world. They were to become a media and entertainment behemoth, with countless distribution and production channels growing to dominate the worldwide market. However, within a short period of time, the new company lost billions of dollars in shareholder value, angering and shocking millions of people. Looking back on the merger and what is left of Time Warner, we would like to examine what makes the company successful and how it can work to bring back some of the synergistic value the management was never able to create. We will discuss advertising / marketing plans, production of content, and distribution of content.

ADVERTISING / MARKETING

Prior to the merger between AOL and Time Warner, each company employed different advertising / marketing techniques and each company had done well. Post merger advertising / marketing has not been as effective. We will consider previous techniques, their potential to be successful now, and whether Time Warner should market Time Warner and AOL independently or attempt to create brand name synergy by marketing a more integrated brand.

Historically, AOL has avoided using large numbers of print ads and TV commercials, opting instead to mail consumers directly. AOL's chief marketing officer Jan "Brandt stressed that advertising remained a relatively small part of the company's overall sales and marketing budget...Instead, AOL has relied heavily on direct marketing, such as mailing free software discs."¹

AOL still used traditional methods as well, including commercials which highlighted ease of use; as Edmund Sanders said, "Three of the four television commercials now airing nationwide tout AOL's popularity, ease of use and new features. 'So easy to use, no wonder it's No. 1' is the company's current advertising mantra."² AOL has also been extremely successful at subtly working their way into other advertisements. Sanders further explains, "AOL frequently piggybacks on other companies' TV commercials because partners must include the 'AOL keyword' in their ads."³

AOL's strategy has been to appeal to unsophisticated users and to keep them around with unique content. For a long period of time, their advertising methods seemed successful. However, even as AOL was growing, "Turnover among new members [ran] about 25% in the past several quarters [of 1996]."⁴ AOL enticed consumers into trying their service as they were bombarded with free disks proclaiming such messages as "1000 HOURS FREE FOR A MONTH!!" With a zero cost trial available, many people would be willing to sample the product. Unfortunately, as the average computer and internet user became more sophisticated and the importance of a large internet presence grew for most companies, AOL lost some of their unique content edge. Unclear signup information and extremely pushy sales representatives (from personal experience, if you ever sign up for a trial period you must be very forceful to convince them to cancel it) have further damaged AOL's marketability. In addition, if such high turnover

¹ Sanders, Edmund. "After Merger, America Online Revs up Advertising Internet" Los Angeles Times 6 March 2001: C1.

² id.

³ id.

⁴ Barrett, Amy. "Can Bob Pittman Upgrade AOL?" Business Week 11 November 1996: 44

rates persist (they are likely higher now than before), AOL is simply wasting money providing services to people who are not very interested in the first place.

Time Warner's magazines are very successful, and working with AOL has helped to increase their distribution. Even at a time when the failure of the merger was hot news, Joseph Weber noted, "AOL is now the company's top generator of subscribers for Time Publications."⁵ Obviously, there was some logic to their marketing philosophy. Even if the growth effect was small and the main effect was shifting from mail and telephone orders to internet orders, service costs were decreased.

Time Warner has also attempted to use cross promotions between AOL and its film projects. Sanders and Healey write, "Heavy AOL promotions of movies such as 'Harry Potter' and 'Lord of the Rings' helped turn those films into big moneymakers."⁶ Realistically though, most of the success of these films was due to the merits of the films and huge existing fan bases (both films are based on widely popular books), rather than AOL's promotion. Of course, even a top notch film will fail if no one knows about it, so advertising is still key.

Proposed Strategy

Most of AOL's marketing strategies are no longer effective, as shown by continually declining membership levels. They can no longer rely on free disks, free hours, and being easy to use. By contrast, Time Warner's other divisions have been performing well.

AOL must clarify its subscription policies, and concentrate on hooking consumers who will sign up for and keep the service, rather than surely cancel. Continuing direct mailings is no longer desirable, due to high costs and low efficacy. Free disks can be made readily available through other sources such as in store displays (as they already are). AOL also must reaffirm the value of their content. Highlighting the availability of popular Time Warner content through AOL is likely to generate new interest.

In general, AOL and Time Warner could create synergy on an advertising front, if AOL advertisers were to work more closely with the rest of Time Warner. AOL is a great venue for advertising, as some advertisements can be directed to all users while more detailed and exclusive information can be available to fans who visit the film and entertainment areas within AOL. Time Warner has already proven that cross promotion between AOL and the rest of the company can be successful and beneficial (note the aforementioned successes with Time magazines and film projects), yet AOL has not been employed nearly as well as it should have been.

PRODUCTION OF CONTENT

The production of content within Time Warner is organized into the divisions of Publishing, Television networks, and Filmed Entertainment. For the year ended December 31, 2003, these three businesses produced content that generated \$11.446 billion or nearly 29% of the company's consolidated revenues, representing a 12% increase in content revenue from 2002.⁷ The remaining divisions, AOL and Cable, encompass interactive services and cable

⁵ Weber, Joseph et al. "The Best Performers" Business Week 7 April 2001: 10.

⁶ Sanders, Edmund and Jon Healey "AOL Time Warner finds synergy and reality are often at odds" The Kansas City Star 20 July 2002: NP.

⁷ Time Warner 2003 Annual Report (March 29, 2004), pg. 23.

systems businesses through which producers can channel content to its subscribers. Although advertising and subscription revenues generated the majority of the company's revenues, the company's strategy for producing content arguably had a large impact on the success of these dominant revenue streams. In fact, Chairman and CEO Richard D. Parsons indicated in his recent letter to shareholders that the company's continuing strategy would be to allocate capital only to those content projects that were high-growth, high-return opportunities.⁸ Consistent with this established strategy, the following sections propose a set of decisions for each of the content-producing divisions in order to make them grow profitably and compete effectively over the next 3-5 years:

Publishing

The success of content that is produced for publishing is measured ultimately by the number of customers who subscribe to a particular publication in order to access this content. The production of content includes but is not limited to the processes by which information is obtained, written for publication, and published for an audience.

Proposed Strategy

A proposal for content production strategy would certainly need to consider many variables endogenous to the company, but exogenous variables with great uncertainty also exist. One of these risk factors is the level of spending by advertisers. Recently, however, the Publishers Information Bureau published data for total magazine advertising revenue that showed the growth in advertising revenue was slowing month-over-month for the first quarter of 2004. Previously, advertising revenue had grown by 12.7%, 9.2% and 19.2% for January, February and March of 2003 respectively, but the recent data showed smaller growth rates of 10.4%, 4.6% and 6.7% for those same months in 2004.⁹ This suggests that the company should increase its production of content by about 2-3% yearly in order to accommodate the increased advertising demand and to avoid overproduction. This could be accomplished through the introduction of new magazines, through acquisitions of other publications, or from opportunities of brand extensions with other Time Warner businesses. For instance, the company could produce books as companions to its shows on HBO, and the company could produce its movie scripts that were top box office hits into published versions to give readers an exclusive in-depth look at their favorite films. The effect of foreign exchange rates on costs is also more certain. With the Federal Reserve Board's intention to raise interest rates in the near future, the dollar can be expected to stabilize against foreign currencies.¹⁰ For the near-term future, the company should minimally adjust its 2-3% growth in content production due to expected exchange rate effects on manufacturing and editorial-related costs.

Consumers demand the most relevant, accurate news and information, and they want to be able to access it quickly at a reasonable price. In the long-term future, much of publishing content will likely be digitized and available to consumers on their laptops, handheld PDAs, and perhaps even through their televisions which will be hooked up to broadband networks. Some content is currently available as an Internet version, such as Dow Jones' *Wall Street Journal*, and

⁸ Ibid., Letter to Shareholders.

⁹ Publishers Information Bureau Reports for January-March 2003 and 2004.

¹⁰ Reuters, "Stocks to Get Cues from Fed Comments" by Rachel Cohen (May 2, 2004).

many magazines offer access to articles online for a small fee per article or they offer the service free to existing subscribers of their printed versions. But these versions lack the feel and visual image of a neatly organized newspaper or magazine. Before a true digitized format of published content can become a viable business, standards must be discussed and set for the visual format of the content. Ideally, the digitized format of published content should look and feel like the original, printed version. When standards are agreed upon, then distributors of content will have the ability to create this market and channel it to consumers through PDA-type or other personal electronics devices. Consumers also seem to be moving towards a trend of bundling their emails, cell phone communications, digital media and web access into a single device. Consistent with the company's focus to improve its AOL business, a partnership with a leading electronics manufacturer such as Sony or Dell Electronics may foster the development of consumer handheld gadgets that can incorporate all of these services as well as stream live, 24-hour published content. This type of project development may have enormous costs, and other companies such as Nokia and Samsung may already be a step ahead in this process, but the creation of this market seems to address what consumers would want, and it seems highly feasible given that the broadband network has been put in place. One day, business travelers may find the daily editions of newspapers to which they subscribe to being downloaded onto their handheld devices as they are published so they can be the first to talk about the Lakers' prospects of winning a basketball championship on their early morning flight.

Since publishing content is likely to be a small profit-growth business, the proposed strategy is consistent with the goal to only allocate capital to high profit-growth opportunities. In other words, a minimal amount of capital should be allocated for growth in the publishing content business.

Television Networks

The production of content for advertising-supported cable television channels and for paid-programming channels is determined by advertising revenues (directly correlated to the number of viewing households), basic cable licensing fees, and paid-programming subscription revenues.

Proposed Strategy

The company should continue to invest in its HBO-programming content in order to capitalize on the continued success of its shows. The most recent season of its popular shows can be released as home video sets, and the original programming can be syndicated to other television networks in order to capture this high profit margin market. HBO-related programming was responsible for an increase in content revenue of nearly 25%, so the strategy should focus on producing 3-5 high quality HBO-programming series that will have the potential to generate substantial future content revenue. The generation of content revenue is also dependent upon the extent to which the company can protect its intellectual property and copyrighted works from being stolen in their digital form and distributed unlawfully over the Internet—this could adversely affect current and future sales of home video releases. Cable and satellite service providers are increasing their resistance to wholesale price increases, and at the same time basic cable rates are expected to increase.¹¹ This would decrease the incentive for

¹¹ Ibid., pg. 75.

consumers to purchase premium programming in addition to the basic cable or satellite service. The continual introduction of new programming services in the entire market and/or the increased popularity of alternatives to television are also important factors to consider. To address the increasing popularity of alternatives, content should be directed toward captivating younger audiences, perhaps the 12-18 age range, since this group of people is typically deprived of forms of entertainment other than sports and television. Recently, reality-based television programming has been the main focus of broadcast networks such as NBC, CBS and FOX—and it has proven to be a very lucrative business. As such shows often incorporate sexual, violent and materialistic themes, the boundaries for what is considered to be socially acceptable programming are being overextended. Additionally, censorship has become an issue following the half-time show of this past Super Bowl, and the US Congress has taken appropriate steps to make television censorship a top priority. As a result, there seems to be an increasing sentiment among viewers that content is currently focused on controversial and/or inappropriate themes for general audiences, and that content should focus more on conservative, educational programming that promotes socially-accepted moral and ethical values.

Recently, Time Warner announced that it was developing an Internet pay service for its CNN news network that would be unveiled in the first quarter of 2005.¹² The 24-hour broadband news channel will be available to subscribers through their Internet Service Providers (ISPs), and the ISPs will pay to license CNN content so they can offer it to their customers. Essentially, Time Warner is creating an Internet distribution network in much the same way it operates its cable segment—the ISP of a consumer will pay for the Internet content in the same manner in which cable operators pay to carry CNN on their cable networks. Since improving the AOL business has been the main focus of management and investors, Time Warner has an opportunity to employ this same Internet pay service strategy with its large base of AOL subscribers, and perhaps offer an exclusive package of content at a price that would enable AOL to compete against other ISPs. Rivals have already implemented similar strategies. Walt Disney Co.'s ABCNews.com, a similar 24/7 broadband news service, has already been in place for almost a year, and although executives have declined to give current subscription and revenue growth rates, the business has been profitable according to an interview with ABCNews.com manager Bernard Gershon. Disney's news network is being distributed by Real Networks, AOL, and SBC Yahoo's DSL service. This business can be profitable for Time Warner if it moves fast to bundle content, digitize the media, and offer service to AOL members as well as other ISPs. To promote a dominant market position, AOL and television/film production executives could work together to cut the cost of providing this content to its customers, and then AOL could offer an attractive, competitive price for this bundled product to provide incentive for its subscribers to remain loyal to AOL. Offering this bundled content will likely not affect demand from cable operators, since many cable operators are positioning themselves in the broadband market as well in order to bundle broadband and cable service.

The Television Networks division will continue to grow content revenue if it aligns the programming that it produces with the changing interests of audiences. If the company chooses censorship and educational programming to be the hallmarks of its produced content, and it targets younger audiences, then it may have the first-mover advantage of dominating a potential future market for broadcast programming. Capital should be allocated towards the prestigious documentary division of HBO, because its production represents an opportunity of high growth and profit.

¹² CBS MarketWatch.com, "CNN plans Internet pay service" by Frank Barnako (May 25, 2004).

Filmed Entertainment

Content productions of filmed entertainment businesses by far generate the most revenue and income for the company than any other type of content. This success is measured by how well the content generates revenue from sources such as box office ticket sales, home video release, and the distribution of television series.

Proposed Strategy

The most viable strategy for this division is very similar to the strategies that the Warner Bros. and New Line Cinema movie studios have employed to currently make them 2 out of the top 5 movie studios in terms of production. Some of the risk factors include the ability to attract talent and desirable scripts at manageable costs, the development of content in a digital format to be produced and distributed securely, and increasing marketing costs due to highly competitive nature of theatrical releases. With regards to production costs, competitors such as Disney and Dreamworks SKG have partnered with computer graphics companies Pixar and Silicon Graphics to develop animation technology that will allow them to produce animated movies at a relatively cheap cost and become the only content producers for youth audiences.¹³ The company can avoid rising production costs of motion picture films and become a dominant player in the feature animation industry if it can reduce the production costs of the technology from R&D. The emphasis on only best-in-class quality of stories and plots is important as well as a meticulous re-working and re-editing of movie production as it progresses to a final product. Digital technology has arrived as a means for film production, but its costs still remain far too high relative to traditional filming methods. Marketing costs will be a deterrent for smaller movie studios to advertise and compete for box office release performance. The company, however, has a substantial amount of capital to devote to advertising, and squeezed profit margins from this segment will unavoidably result. Finally, consolidation has become a growing trend in the entertainment industry, and it is becoming increasingly important for a company to be able to both produce content internally and distribute it through cable, television, internet and film channels.¹⁴

The feature animation industry presents a high-growth opportunity if capital is allocated to develop animation technology and to develop the feature animation infrastructure as setup by industry-leader Disney. The targeting of youth audiences remains a theme and the commitment to high quality content is pivotal.

DISTRIBUTION OF CONTENT

AOL began offering Internet access services for the public in 1989 using a publicly available data network, the telephone system. Its user base grew as its number of local telephone numbers increased, and it quickly became the largest ISP in the nation. By 1994 there were one million AOL subscribers in the United States, all of them connecting using phone line modems. Beginning in 1995 through 1998 AOL expanded into Germany, the UK, Canada, France, and Latin America. All of these worldwide customers were using narrowband phone line

¹³ Kellogg Graduate School of Management case: The Feature Animation Industry in 1995.

¹⁴ Reuters, "Sony in Late-Stage Review on MGM Offer" by Julie MacIntosh (April 28, 2004).

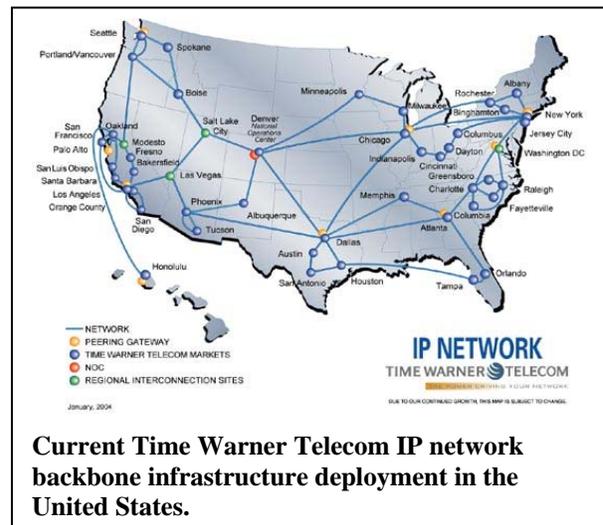
connections to access the Internet and their AOL accounts. At this point AOL had made several attempts to sign contracts with DSL and cable modem companies, but their success had been minimal and a negligible portion of their user base was connecting through broadband connections. The company could foresee that future growth in internet access subscriptions was going to be broadband based, but they were saddled with the problem that cable and DSL lines were by law controlled by the companies that had laid and owned them. AOL desperately needed nationwide access to broadband connection lines or it was going to be left behind as all new users signed up for broadband, and its current subscribers switched to broadband.

The Time Warner Company built its large cable networks as a way to gain direct access to its television audiences. All of its cable facilities were controlled by a separately operated entity, Time Warner Cable. In addition to having cable networks, Time Warner also owned Time Warner Telecom which had spent years building a nationwide fiber network that provided a massive backbone for digital data transmission throughout the country. The incentives for management in both of these companies, Time Warner Cable, and Time Warner Telecom, strongly encouraged growth of the companies in any way possible, without regard for the impacts on other divisions of the Time Warner Company. As a result the

resources of the two networks were pooled, and the Road Runner broadband Internet service was offered to cable subscribers on the Time Warner Cable network. The Road Runner service attempted to offer broadband content and act as a portal to the Internet for its subscribers, but its resources and content never reached a state near that of AOL's "walled garden". In fact, Time Warner's attempts at producing digital magazines were wholly unsuccessful.

One of the major reasons AOL wanted to acquire Time Warner was to gain access to Time Warner Cable's cable networks. Time Warner Cable provided service to 20% of the nation's cable subscribers, and this was an excellent opportunity to begin building its base of broadband users. In addition, AOL knew that it would have to open Time Warner Cable's networks to other ISP's, which would help them in their legislative push to enforce the opening of all broadband networks to all ISP's nationwide. Acquiring Time Warner would provide AOL with a path to gain new customers and continue to grow.

As part of the merger process the Time Warner Cable networks were opened to all ISP's, but AOL had anticipated gaining an edge and not losing many users to other ISP's on its own networks. This plan backfired because of the incentive plans given to the management of Time Warner Cable. The managers felt no need to push AOL as the primary ISP because they were only rewarded for the growth of the broadband market. This goal was most easily met by pushing the incumbent Road Runner services. As a result, very few new subscribers joined broadband services with AOL as their ISP, even through AOL's own cable lines. In an attempt to solve this problem AOL began offering a "bring your own broadband" plan for a reduced monthly \$14.95, but very few users signed up for the service. AOL was also having problems integrating the new broadband services into their "walled garden". The company's focus for its



entire existence had been in providing rich content to users over limited bandwidth connections. They were unfamiliar with and had yet to adapt to the needs and wants of high bandwidth customers.

Proposed Strategy

The move to acquire the Time Warner Company appeared at first glance to be a great opportunity for AOL to gain a distribution edge. We believe that this could have been advantageous had it been carried out more carefully. Unfortunately, many aspects of the merger and its repercussions within the two entities were not considered, and as a result the merger harmed rather than helped AOL's ability to distribute content. The actions that AOL needs to make to return it to its state of dominance as an ISP, and to rectify the mistakes made during the merger process, are not simple.

AOL does not profit sufficiently from the "bring your own broadband service". Emphasis needs to be removed from such services and more pressure needs to be made to gain users with AOL as their ISP. Control over the Time Warner Cable executives needs desperately to be exercised. Creating synergy absolutely requires that their incentives have to be broadened to allow them to make moves advantageous to the company as a whole, not just their subsidiary portion. AOL must be pushed on the Time Warner Cable networks as the primary ISP, while the Road Runner service should be relegated to an inexpensive house brand alternative.

AOL also needs to pursue as aggressively as possible contracts with the other 80% of the nation's cable networks, as well as legislation to mandate the opening of the other cable networks. All growth trends show that new Internet subscribers are connecting through broadband services, and dial-up users are changing to broadband services at a very rapid rate. Its current available market share is only 20% of the US population, without acquiring other broadband distribution networks, the company cannot achieve dominance in the broadband ISP arena, and cannot maintain dominance in the ISP market as a whole. If AOL can accomplish such contracts they will further the interests of Time Warner as a whole, providing a much broader audience to sell and promote Time Warner's other content.

CONCLUSION

AOL was so successful for so long not just because of ease of use, but because of well designed and bundled content. When AOL merged with Time Warner, a company with a long record of excellent content production, it was an attempt to take this uniqueness to an entirely new level. Richard Siklos explained at the time: "The key to the deal is developing new types of Web sites and services using Time Warner's rich content and getting them up quickly using AOL's vast Web infrastructure."¹⁵ The company (especially Miller who took over AOL in 2002) had other excellent ideas as well, such as following the lead of the magazine department and tailoring online content to individuals (allowing for valuable segmented advertising), further improving content to make AOL a "must-see", and adding perks for heavy users.¹⁶ Unfortunately Miller cracked under the pressure of turning AOL around and facing angry investors, and ended up resigning his position before his ideas could be well implemented.

¹⁵ id.

¹⁶ Yang, Catherine. "Can Miller Put the Oomph Back in AOL?" Business Week 26 August 2002: 42.

Recent plans to turn the division around have been similar. CEO Richard Parsons has planned to follow the model of HBO, creating a web service with content much more valuable than just internet service. He also plans to further strengthen and differentiate some of the stations run by Time Warner (for example, he will have CNN again focus on just journalism).¹⁷

While these are good plans, they are not that different than what AOL has always strived to do. If this is to work effectively, Time Warner must increase the value of AOL by allowing it a great deal of content exclusivity. In other words, AOL subscribers should receive a large amount of Time Warner content that is not available elsewhere online. Furthermore, the cross promotion that was always planned but never well executed should be put into play, allowing Time Warner to reach an ever larger audience. Only recently has the company made small steps in this direction, as they report, "America Online, Inc. and Time Warner Cable today announced reaching agreements on a series of new relationships that will have the two Time Warner divisions each promote the other's services, and enable millions of Time Warner Cable and Road Runner customers to sample AOL(r) for Broadband content. AOL will promote the Road Runner High Speed Online service, making it easy for AOL(r) members to purchase both Road Runner's High-Speed Online service and AOL for Broadband's premium features."¹⁸ This sort of cross promotion (creating added value and lock in) is essential to the success of AOL and Time Warner in the future. However, such direction should really be coming from the top down, rather than negotiated between the divisions. The divisions are part of one company, they must work to promote products as one company.

¹⁷ Bianco, Anthony & Tom Lowry. "Can Dick Parsons Rescue AOL Time Warner?" Business Week 19 May 2003: 86.

¹⁸ Bentley, Anne and Keith Coccozza. " America Online, Inc. and Time Warner Cable Have Reached New Agreements to Cross-Promote AOL(r) for Broadband and Road Runner High-Speed Online Services." 22 April 2004. <http://media.aoltimewarner.com/media/press_view.cfm?release_num=55253919> (2 May 2004).

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