THE MERGER OF AOL AND TIME WARNER: A CASE STUDY

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CASE DESCRIPTION

The purposes of this case are several, and the potential uses fairly rich. From an accounting perspective, the assignment of a value to the transaction will directly affect the goodwill assigned to the merged firm's financial statements. From that, students can be given the opportunity to discuss such topics as measurement, earnings management, and efficiency with respect to analysts' capacity to filter through non-cash flow effects.

Interesting questions arise with respect to the adequacy of information about the probability of merger completion. Evidence suggests that analysts assigned a fairly high probability to the chance that the merger would not be completed. The fairness of this probability allows for speculation as to whether or not information available in the market, including that disseminated by the firm, was adequate to the task of assigning that probability.

Finally, because the case involved two very widely held firms, there are rich opportunities for students to research the wealth of information that exists on this merger.

At its highest level, the case is rich enough to be used for Masters of Accounting students and MBA students who have taken an MBA-level corporate finance class. Upper division accounting and finance students who are familiar with analysis of mergers and with theories of asymmetric information could also benefit from analyzing the case.

CASE SYNOPSIS

When AOL and Time Warner announced their proposed merger in January 2000, the securities of both firms experienced significant price adjustments. Initially, prices of both securities rose on the news. When details of the proposal became clear, the security price of Time Warner fell back somewhat, but remained approximately 30% above its pre-announcement selling price. AOL shares, however, retreated to a price about 15% below its pre-announcement price. Both of these prices were significantly below consensus price targets set by analysts.

Of special interest is the relative price level at which the two securities settled soon after the announcement. The merger proposal called for the issuance of a new security representing common

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ownership in the new firm. One share of the new security would be issued for each share of AOL, while each share of Time Warner would be exchanged for one and one-half shares of the new security. As weeks passed beyond the announcement date, the ratio of the Time Warner shares to the AOL shares ranged from just less than 1.4:1 to 1.5:1 (rather than settling at and sustaining the 1.5:1 ratio one would expect from the agreement.)

This case presents the circumstances surrounding the merger of AOL and Time Warner, including their respective business strategies, markets, financial structures, and price movements during the period leading up to the merger.

INTRODUCTION

Very early on Monday, January 10, 2000 news began to appear on wire services suggesting that an announcement was forthcoming of the merger between America Online (AOL) and Time Warner (TWX). At that time, the capitalized market values of AOL and TWX were $164 billion and $97 billion respectively. Value of the combined company was estimated at $361 billion (based on the $110/share value assigned to TWX in the merger agreement), making it one of the ten largest firms in the world as measured by capitalized market value. The $190 billion in stock AOL agreed to issue to acquire Time Warner made it the largest merger in U.S. history at that point in time. Together, AOL and TWX offer significant brand recognition including AOL, Warner Bros., HBO, NetScape, Time, CNN, TNT, CompuServe, Warner Music Group, Sports Illustrated, Fortune, People, and numerous others. TWX also brought with it a broadband distribution platform from which to expand significantly AOL's interactive market. As was later mentioned in the combined firm's annual report for fiscal 2000, executives felt the merger had the potential to "combine the power of the Internet with the world's most trusted information and entertainment brands."

A BRIEF COMPARATIVE ANALYSIS OF AOL AND TIME WARNER

AOL was founded in 1985 as Quantum Computer Services. After a name change in 1991, AOL underwent its initial public offering in 1992. As mentioned before, AOL was and continues to be the world's largest internet service provider, with in excess of 20 million customers. At a P/E ratio of 245 in early January, 2000, an investment in AOL stock prior to the merger was one reliant on persistent growth in cash flows. During the period between 1996 and 2000, AOL realized an 86% compound annual growth rate in revenues and 106% in stock price.

By comparison, Time Warner was more established and far more complex. During the same four years referred to above, TWX realized compound revenue and stock price growth of 18% and 36% respectively. As a result of the combination of Time Inc. and Warner Bros., TWX not only had an established history of operations, but had diversified into media industries including published, broadcast and other entertainment media. The company listed in its 1999 annual report five businesses as its principal sources of revenues: cable networks, publishing, music, filmed entertainment, and cable

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systems. Selected statistical and financial data prior to the merger announcement are provided in Appendix A.

A telling comparison between the two firms comes from an examination of their respective cash flows. From its previous year-end cash flow statement, AOL had cash flows from operations of $1.1 billion, compared to $1.8 billion for TWX. AOL, however, used $1.8 billion in cash for investing activities compared to $353 million listed as ***sources*** of cash from investing activities for TWX (i.e., TWX was actually realizing a net disinvestment from its holdings. In years before the most recent one, TWX did have cash outflows from investing, but those were negligible.) As one might deduce, AOL supplemented its investing activities through additional financing, with a source of cash of $886 million by financing activities. TWX, in contrast, was using its operating cash flows to pay down its substantial debt and to pay dividends. Cash used by financing activities for the year amounted to $2.4 billion.

FINANCIAL EFFECTS OF THE MERGER ANNOUNCEMENT

The merger agreement between AOL and TWX called for the issuance of a new stock, to be named AOL Time Warner. For each share held of AOL, shareholders were to receive one share of AOL Time Warner. For each share held of TWX, investors in that stock would receive 1.5 shares of the new security. On the day of the announcement, although it opened with an initial surge, AOL closed at 72 5/8. The following day, the price fell to 64. TWX surged in pre-market trading and never looked back, gaining 27.5 points to close at 92 1/4. The ratio of prices of the two securities at the end of that first day following the announcement was 1.27:1, far short of the ratio of 1.5:1 established by the merger agreement.

Over the next few days, as the market digested the implications of the merger, arbitrageurs began seizing on what appeared to be a profit opportunity, effecting a January 11 closing price for AOL of 64, down 8 5/8, with TWX closing at 86, off 6 1/4, leaving the ratio at 1.34:1. Two weeks after the initial announcement, shares of AOL were trading at 62, with TWX at 87 5/8, a ratio of 1.41:1. Two weeks later AOL was at 57 13/16 while TWX was at 84 5/8 (closing prices, Friday, February 4) for a ratio of 1.46:1. Appendix B shows the ratio of prices as they emerged in weeks following the merger announcement. The mean value of the ratio in the two months following the announcement was 1.42:1, with a standard deviation of 0.05.

Following the announcement date, several key news reports by both company and government officials were issued that would serve to mollify concerns over potential antitrust conflicts or other reasons the merger might not be completed. SEC Chairman Arthur Levitt in a January 11 interview with Reuters news service, labeled the combination of AOL and TWX as “smart.” On January 12, Jon Friedman of CBS MarketWatch reported that several large shareholders of AOL had endorsed the concept of the merger. AOL, in past years, had petitioned the FCC to require cable companies to open their broadband networks to competitors in order to enhance competition. On January 19, FCC Chairman William Kennard pointed to the merger of AOL TWX as an example where the market could solve its own problems with threats to competition. Shortly thereafter, AOL TWX announced that they

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would open their cable systems to competitors (offering additional evidence that competitiveness in the cable media markets would be enhanced rather than inhibited). On February 3, Joe Wilcox of CNET News concluded, from interviews with several legal experts, the merger between AOL and TWX would very likely pass through antitrust scrutiny without difficulty. Senator Orrin Hatch (R-Utah), however, offered a cautionary note. Hatch, in a public statement reported by Bloomberg News on January 12, pointed out that internet combinations such as that represented by the AOL TWX merger could pose the same antitrust threats as those encountered in both railroad and oil industry combinations at the end of the 19th century.

EPILOGUE

Problems arose almost as soon as the merger was completed. The merger was finalized on January 11, 2001; shortly after, in 2002, the internet bubble burst, taking down share prices of internet companies generally, even those with positive earnings like AOL. The share price of the merged firm, which closed at $47.23 the day the merger was completed, fell to a low of $9.64 on July 25, 2002.

Time Warner shareholders initially seemed to be receiving a huge premium for their shares in the merger. (Under the terms of the merger, AOL's shareholders would take ownership of only 55% of the new firm, even though AOL's share of the combined market capitalization of the two firms was 65% at the time the merger was announced.) After the merger, former Time Warner shareholders saw the value of their investment fall precipitously, with share prices of the combined firm dropping 90% from their peak value. (Economist *AOL Time Warner: A Steal?* Oct 24th 2002) Several shareholders filed lawsuits claiming that AOL executives deliberately and fraudulently inflated the value of AOL shares prior to the merger, partly by covering up steep declines in advertising revenue. At about the same time, news came out that 14 AOL Time Warner executives had sold hundreds of millions of dollars worth of shares shortly after the announcement of the merger. AOL eventually paid $2.4 billion to settle these claims.

In the intervening years, several business publications analyzed the merger, with several calling it the "worst deal in history." Most writers faulted the execution of the merger or its timing however, rather than the logic behind the merger itself. The two companies had very different corporate cultures and there was serious friction after the merger between AOL executives and employees and Time Warner executives and employees. Very few executives from either company had been in on the merger negotiations and Time Warner executives in particular (other than the very few who worked on the merger) were reluctant to work with AOL. In fact, the original idea behind the merger, pairing Time Warner's content with AOL's delivery capabilities was turned on its head – the AOL website was the one place that Time Warner content could not be found.

When the internet bubble burst, it took down nearly any and all companies that had participated in the earlier internet craze; AOL Time Warner was no exception. Because of this it is difficult to untangle the effect of the merger alone on company value from the effect of the general market downturn.

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As much as five years later, Steve Case continued to defend the logic behind the merger, noting that "AOL needed Time Warner for its cable division," while accepting blame for the failure of execution.

On May 28, 2009 Time Warner Inc. announced that it would spin off AOL; the news came as no surprise. At least one publication again defended the concept of the merger, noting that while the merger may have been the worst deal in history, it didn't have to be. The day Time Warner announced the AOL spinoff, Steve Case, no longer with Time Warner, posted a Twitter entry that said, "Thomas Edison: 'Vision without execution is hallucination' - pretty much sums up AOL/TW - failure of leadership (myself included)."

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Questions

1. What synergies exist in the combination of AOL/TWX?

2. What evidence of capital market efficiencies or lack thereof existed in the circumstances surrounding the AOL/TWX merger announcement and subsequent price fluctuations?

3. Discuss the difficulties of initially estimating the negotiated exchange value in the merger of a volatile, highly growth oriented firm with a stable, moderate growth firm?

4. In this merger only stock was exchanged. Under the purchase method of accounting for business combinations, goodwill must be recognized and amortized. What are the implications for earnings of the merger?

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5. Referring to Appendix B, one observes that the ratio of TWX:AOL prices ranged from just below 1.4:1 (allowing for an initial settling period) to above 1.5:1. What implications for accounting are there in the seeming persistent lack of stability of that ratio?

6. Which firm is left better off? Is there a "winner" and/or a "loser"?

APPENDIX A

Selected Statistical and Financial Information		
	AOL	Time Warner
Friday, January 7, 2000 Closing Stock Price	73 3/4	64 3/4
Shares Outstanding, January 10, 2000	2,278 Million	1,375 Million
Market Capitalization January 7, 2000	$164 Billion	$97 Billion
Market Capitalization February 11, 2000	$129 Billion	$108 Billion
4-year Compound Annual Growth Rate: Revenues Stock Price	 86% 106%	 18% 36%
Total Revenue (FYE 1999)	$4.8 Billion	$27.3 Billion
Net Earnings (FYE 1999)	$762 Million	$1.95 Billion
Earnings per Share (FYE 1999)	$0.298	$1.42
Total Assets (FYE 1999)	$10.3 Billion	$48.4 Billion
Total Liabilities (FYE 1999)	$4.1 Billion	$39.6 Billion
Annual Dividend	$0	$0.18

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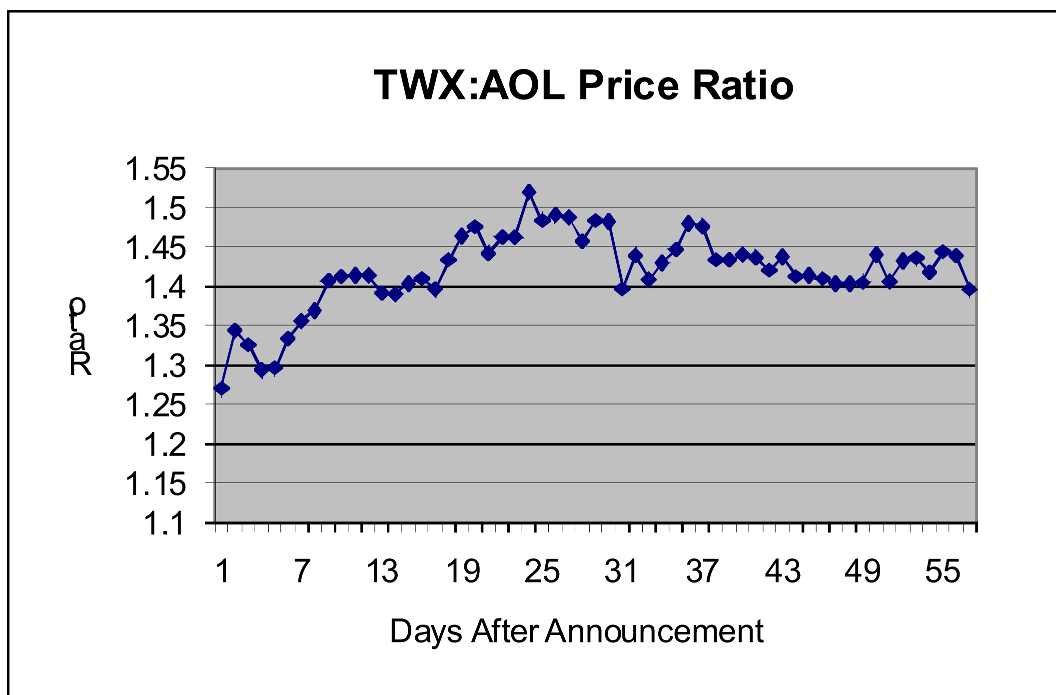
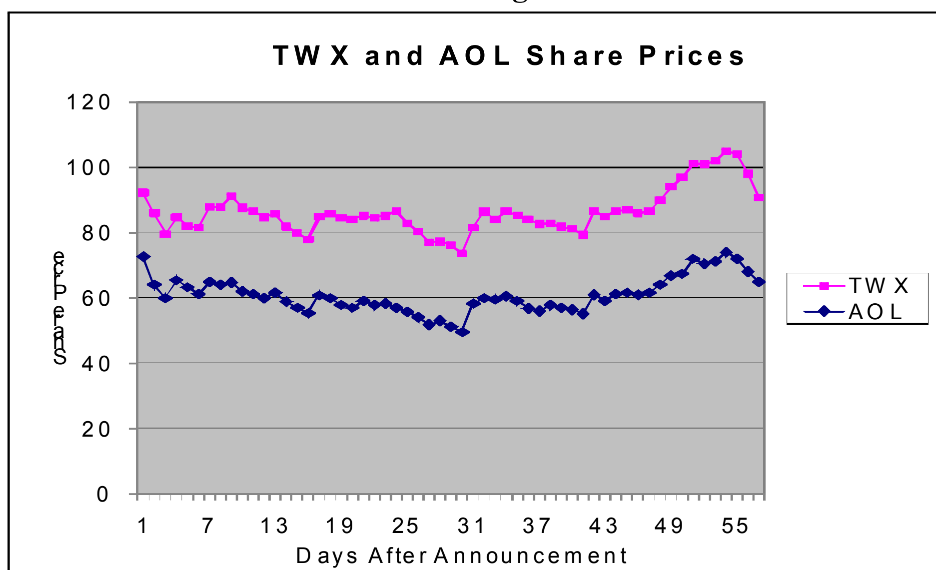
APPENDIX B
Price Ratio Following Announcement



APPENDIX C
Share Prices Following Announcement



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