Driving Digital Convergence: The AOL Time Warner Bet
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Executive Summary

Most analysts expect a digital convergence over the next several years that will link personal computers, telephones, television and household appliances into a single consumer network. Entrepreneurs who hope to dominate this network are putting together mergers and strategic alliances. What will be the key to profitability? Will it be delivery systems: telephone, cable, satellite? Or will it be technology: software and hardware? Or will it be entertainment content? The battle to become the dominant force behind convergence is raging and the stakes are enormous. Companies across the board from AOL Time Warner to Microsoft to AT&T are placing strategic bets in the hope that they will provide the winning answer. In this report Carnegie Consulting analyzes convergence for AOL Time Warner. We assess and recommend refinements to the strategies the company is employing in its quest to become the dominant player in this emerging digital age.

AOL Time Warner faces moderate internal industry competition in its various businesses. In the entertainment portions of its business, customer loyalty is low and competition to produce the next blockbuster movie or platinum artist is fierce. As an Internet Service Provider, America Online enjoys a fair amount of customer loyalty, though that may be waning. Entry is difficult because start-up costs are high and most entertainment companies have large economies of scope that an entrant would have difficulty overcoming. However, entry by existing firms into new businesses is a potentially serious threat. Various substitutes exist for the services this industry seeks to provide. There are many complements that benefit both firms inside the industry and producers of substitutes for the industry. Currently supplier power is moderate but it could potentially become a very dangerous threat to industry profits, especially if distribution drives convergence. Buyers are not able to exercise significant power.

Summary of Five-Forces Analysis

<table>
<thead>
<tr>
<th>Force</th>
<th>Threat to Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Rivalry</td>
<td>Medium to High</td>
</tr>
<tr>
<td>Entry</td>
<td>Low to Medium</td>
</tr>
<tr>
<td>Substitutes and Complements</td>
<td>Medium</td>
</tr>
<tr>
<td>Supplier Power</td>
<td>Medium</td>
</tr>
<tr>
<td>Buyer Power</td>
<td>Low</td>
</tr>
</tbody>
</table>

Carnegie Consulting’s industry wide analysis of AOL Time Warner’s positioning to achieve content dominated convergence leads us to a two-step strategy recommendation. First, AOL Time Warner must fortify its position as a content leader to become the dominant content provider once convergence becomes a widespread reality. Second, AOL Time Warner must prepare an exit strategy to mitigate the risk of losing its convergence gamble: expanding its delivery infrastructure. This step will have the double benefit of creating a larger market for its content while simultaneously diversifying its assets.
No matter which forces eventually dominate digital convergence, the payoffs will be enormous. AOL Time Warner is smart to place a strategic bet that its content will dominate convergence, but it must carefully develop an exit strategy in case it cannot achieve this dominant position. Currently, AOL Time Warner has solid revenue generating businesses capable of supporting the company in a world dominated by delivery or by technology.

**Company Overview**

On January 11, 2001 America Online and Time Warner completed the merger that was intended to begin the convergence of traditional and online entertainment. The new company expected to achieve synergies and multiple efficiencies that would allow it to provide service across a breathtaking array of entertainment mediums. So far the new company has been a financial disaster. Since the merger was announced in early 2000, market capitalization has plummeted from over $300 billion to about $105 billion today, though in fairness some of this drop was the result of AOL’s overvalued price at the time of the announcement. AOL Time Warner recently recorded a $54 billion charge to adjust inflated goodwill caused by AOL’s overvaluation. Nevertheless, AOL Time Warner has not been able to make convergence profitable and the market has punished the stock.

Even so, the company had some victories in the last year. For instance, Warner Bros. films produced two of the most successful movies of 2001. As of January 6th 2002, *The Lord of the Rings* had grossed $350 million worldwide and *Harry Potter* had surpassed $700 million worldwide. Also, the online division boasted 34 million subscribers. Overall however, the combined AOL Time Warner has been a major disappointment to analysts and stockholders.

**Internal Rivalry**

AOL Time Warner is a massive media company whose operations include online access and content, filmed entertainment, music, network and cable television, and publishing. No other entertainment firm has as diverse a product line as AOL Time Warner. As shown in Table 1, the company competes against a number of different entertainment companies across many product areas.
Table 1: Diversity of Entertainment Companies’ Holdings

<table>
<thead>
<tr>
<th>AREA</th>
<th>AOL TIME WARNER</th>
<th>CABLEVISION SYSTEMS</th>
<th>DISNEY</th>
<th>GE</th>
<th>NEWS CORP.</th>
<th>SONY CORP.</th>
<th>TRIBUNE CORP.</th>
<th>VIACOM</th>
<th>VIVENDI UNIVERSAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>New movies (New Line Cinema, Warner Bros.)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Film library</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Theaters</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>TV shows (Friends, Looney Tunes, ER)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Broadcast TV stations</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Broadcast TV networks (WB)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Basic cable networks (CNN, TNT, TBS)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Pay cable networks (HBO)</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Cable or satellite systems (Time Warner Cable)</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Radio stations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Recorded music (Warner Bros. Records, Atlantic Records, Elektra Entertainment)</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Theme parks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Pro sports (Atlanta Braves)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Publishing (Time, Sports Illustrated, Fortune)</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>


AOL’s subscription service allows the company to pursue a unique strategy going forward. Its plan is to build a capability to provide entertainment and content not only through traditional outlets such as movie theaters, magazines and television stations, but also online. Therefore, when defining AOL Time Warner’s industry, both traditional entertainment and online entertainment must be considered.

Standard & Poor’s currently estimates that U.S. consumers will spend about $84 billion next year for TV programming, movies, other types of videos, and recorded music. Advertising
expenditures to accompany this content will total $55 billion per year, almost entirely for television.¹ When international demand is factored in, the potential market is even larger. Companies compete on diversity of content and price. Entertainment companies cannot maintain significant customer loyalty, as ultimately consumers will spend their money on the ever-changing movies, music, and programs that appeal to them.

The entertainment industry is highly concentrated. Seven film distribution companies typically account for 70% of box office revenues. The music industry is even more concentrated with five distributors controlling 80% of retail sales.² Within the different segments of the entertainment industry, AOL Time Warner’s market share varies. For instance, the company claims 3 of the top 8 basic cable channels by number of subscribers. HBO has 33.3 million subscribers, which is 11 million higher than any subscription channel. Also, with 16.3% market share of domestic box office receipts, AOL Time Warner is the market leader.

The online industry has a different dynamic than the traditional entertainment industry. While there is little customer loyalty in the traditional entertainment industry, that is not the case among Internet Service Providers. Once a household subscribes to an Internet Service Provider (ISP), they are not as likely to change ISP’s as they are to buy CDs from different recording labels or watch a movie from a different studio. According to Standard and Poor’s, the ISP market will be about $80.6 billion per year by 2005.³

Table 2 shows that within the ISP market, AOL is positioned well. Not only does it have a subscriber base that dwarfs its nearest competitor, but also the AOL homepage is very user friendly offering parental controls, accessible email, and numerous content options unavailable anywhere else. On the other hand, the 34 million subscriber statistic is slightly deceiving. Approximately 20% of their subscribers at any one time receive free service due to various promotion packages. Analysts estimate that AOL has a churn rate, the rate at which subscribers leave AOL Time Warner’s service, of around 30% annually.

<table>
<thead>
<tr>
<th>Table 2: Internet Service Providers, by Membership as of year end 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>America Online, Inc. (including CompuServe)</td>
</tr>
<tr>
<td>MSN</td>
</tr>
<tr>
<td>United Online, Inc.</td>
</tr>
<tr>
<td>Earth-Link, Inc.</td>
</tr>
<tr>
<td>Prodigy Communications Corp.</td>
</tr>
</tbody>
</table>


Substitutes and Complements

Substitutes

Various substitutes exist for the technology and services AOL Time Warner provides. For content delivery systems, there are several alternatives. Satellite television is a serious rival to cable based content delivery and can provide Internet access. Another rival system is the brick-and-mortar retail rental store. Blockbuster, a video and DVD rental chain, has no desire
to see AOL Time Warner deliver its movies through cable rather than having customers rent physical movies from them. The increasing popularity of mail-order rental houses, such as Netflix, also represent a growing substitute. Illicit alternatives exist as well. Although the courts have shut it down, Napster parented many progeny. One popular service, Morpheus, improves on the Napster model by allowing users to download music and video from other users’ computers. By the standard to which Napster was held in court, however, it is likely that Morpheus will also be found illegal. Unfortunately for content providers, however, due to its unique design it will be difficult to shut Morpheus down. The Morpheus model exemplifies how content can be delivered in a peer-to-peer system with relative ease and low cost.

Complements

A variety of complements to entertainment delivery systems are now available. An increase in cable infrastructure could greatly improve the efficiency of cable delivery. Better broadband infrastructure would enable greater amounts of content delivery. It would also provide economies of scale, so Internet and content delivery could be sold at lower cost. Other complements to the growth of content delivery are appliances that will facilitate digital convergence, such as Wi-Fi (wireless networking) installation in personal computers and enhanced audio/visual equipment to take advantage of cable based content delivery. In general, greater proliferation of personal computers and streaming technologies also complement all-in-one networking. Finally, the growth of home networking and adoption of standards for such networking will greatly complement the growth of cable content delivery. Although standards for wireless networking exist, such as Wi-Fi and Bluetooth, none has emerged as the standard. As more and more consumers take advantage of home networking, linking personal computers, telephones, cable, and television, the ability to link these all will be greatly enhanced and simplified, giving AOL Time Warner a chance to make convergence profitable.

Entry

The sheer size of AOL Time Warner combined with the diversity of its product offerings prevents new firms from competing with it effectively. A smaller entrant could possibly challenge AOL Time Warner in some of its business segments, such as publishing or music, though these segments garnered over $4 billion in revenues for the company in 2001. However, new competition for AOL Time Warner will be limited mainly to players that already possess a significant presence in the media/entertainment industry or are in a position to gain such a presence.

To illustrate the possibility of entry into AOL Time Warner’s business we will briefly examine a company with a media presence transforming itself into a new competitor. Vivendi, previously a European water company with significant holdings in cable television, transformed itself into a direct competitor with AOL Time Warner through a $23 billion acquisition of Universal, Seagram’s film and media businesses. Vivendi then acquired Houghton Muffin, a Boston-based educational publisher, for $2.2 billion and MP3.com for $372 million. Vivendi is also capitalizing on cost saving measures much more efficiently than AOL Time Warner, boasting a 77% increase in EBITDA in 2001 partly due to merger-related cost cutting measures and savings. However, even following these acquisitions, Vivendi has not become a media corporation anything close to the magnitude of AOL Time Warner. Vivendi’s filmed
entertainment, cable, television and especially its Internet business are significantly smaller than AOL Time Warner's holdings. This discrepancy, particularly in the crucial Internet category, prevents Vivendi from effectively competing with AOL Time Warner online. Vivendi is currently planning further acquisitions and business ventures to alleviate some of these shortcomings, though depressed equity value in the media sector inhibits its ability to attract the capital for further acquisitions.

Other companies that could enter the media/entertainment industry with enough presence to threaten AOL Time Warner include Disney, Viacom, News Corp. and Liberty Media. All these firms currently lack the exposure to the Internet and music businesses necessary to compete as effectively in online distribution. This situation may change if these firms are able to market their cable operations as Internet solutions, but this outcome is highly unlikely. Microsoft's and Yahoo's significant Internet presence could potentially lead these firms further into the media/entertainment industry and to eventually compete more intensely with AOL Time Warner, though a major film and cable television acquisition by either of these companies is also unlikely in the near future.

Supplier and Buyer Power

Supplier Power

In the entertainment industry there is a significant amount of vertical integration. Studios or other content developing units are often aligned with the distribution network. In filmed entertainment for example, the company that handles the theatrical release of a film also typically owns the rights to distribute the film to the home video market. According to The Economist, "The bulk of stuff that fills prime-time television screens in America is filmed between two valleys in Los Angeles, and is in the grip of a handful of production companies belonging to large media conglomerates. While content development is sometimes contracted out, the majority of it comes from within the firm.

Even though there is a significant amount of vertical integration at the company-to-company level, some groups still maintain supplier power. For instance, a limited number of actors possess a sizable amount of power over production companies. Of the approximately 163 movies released since 1990 that topped $100 million at the domestic box office, about 28% of them starred one or more of just seven performers: Tom Hanks, Julia Roberts, Robin Williams, Jim Carrey, Tom Cruise, Mel Gibson, and Arnold Schwarzenegger. Each of these actors has appeared in five or more blockbuster movies in the 1990's. While the presence of these actors in a movie does not guarantee that it will be a blockbuster, their presence certainly gives it a better chance for success. These performers, and maybe a few others, are able to exercise some power over movie companies.

Another area where AOL Time Warner specifically suffers from supplier power is from cable companies. Broadband is becoming increasingly important for AOL Time Warner's online unit, but the company currently does not own nearly enough cable lines to provide broadband access to all of its subscribers. There are 40 markets where Time Warner Cable is available, but only 24 of those offer broadband Internet access. AOL Time Warner must depend on contracts with cable companies to provide last-mile service to its subscribers. This puts the
cable companies in an advantageous spot. Providing broadband access is going to be critical for AOL Time Warner soon, and the cable companies control the equipment necessary to supply access. As a result they increasingly will be able to exercise some supplier power.

Buyer Power

In the traditional entertainment industry, buyers have limited power. While there is an increasing amount of consolidation among movie theaters, they do not have significant buyer power because only 20% of the revenue from movies comes from box office receipts. Theater chains are not able to exercise significant buyer power.

In the online portion of AOL Time Warner’s business, buyers also do not have much power. Users of AOL’s Internet services are a diversified group who cannot exercise much power over the company. Last summer AOL raised its rate for unlimited Internet access and its revenues increased, showing that buyers are not able to influence AOL Time Warner’s behavior significantly.

Financial Overview

AOL Time Warner’s stock performance is very disappointing (Figure 1). The firm’s market capitalization has fallen substantially from over $300 billion when the companies initially merged, to today’s value of $105 billion, less than the announced price AOL offered for Time Warner.

![Figure 1](http://finance.yahoo.com/)

AOL Time Warner Inc
as of 29-Mar-2002

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A more detailed analysis of the company’s financial statements provides some hope for the struggling firm.

In fy2001, AOL Time Warner’s revenues grew by 5.3%. Although significantly less than AOL’s historical revenue growth over 25%, this figure is not too disappointing considering both the U.S. recession, which especially hurt advertising, and the fact that AOL represented only slightly more than 20% of the merged companies revenue stream for AOL Time Warner Pro Forma 2000. Over this same period, costs grew at 3.5%, pushing operating income out of the red to $453 million opposed to a negative $383 million in fy2000. However, for both of these years amortization of goodwill from the merger represented over 19% of total costs. EBITDA (earnings before interest, taxes, depreciation and amortization) was at $9.7 billion for 2001, a 16.8% increase from 2000. EBITDA, representing the core business profits of AOL Time Warner, is clearly less depressed than operating income, which includes non-cash expenses. Significant investment losses and an asset write-down also contributed to a negative net income and return to shareholders.

An analysis of AOL Time Warner’s individual business segments paints a similarly uncertain picture for the firm’s future (Table 3).

### Table 3
**AOL Time Warner Revenues and Revenue Growth by Business Segment**

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td><strong>Intersegment Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AOL</td>
<td>$8,718</td>
<td>$7,703</td>
<td>AOL</td>
<td>$228</td>
<td>--</td>
</tr>
<tr>
<td>% Growth</td>
<td>13.2%</td>
<td></td>
<td>% Growth</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>% Total Revenue</td>
<td>22.8%</td>
<td>21.3%</td>
<td>% of Total Segment Revenue</td>
<td>2.6%</td>
<td>--</td>
</tr>
<tr>
<td>Cable</td>
<td>6,992</td>
<td>6,054</td>
<td>Cable</td>
<td>57</td>
<td>7</td>
</tr>
<tr>
<td>% Growth</td>
<td>15.5%</td>
<td></td>
<td>% Growth</td>
<td>714.3%</td>
<td></td>
</tr>
<tr>
<td>% Total Revenue</td>
<td>18.3%</td>
<td>16.7%</td>
<td>% of Total Segment Revenue</td>
<td>0.8%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>8,759</td>
<td>8,119</td>
<td>Filmed Entertainment</td>
<td>784</td>
<td>560</td>
</tr>
<tr>
<td>% Growth</td>
<td>7.9%</td>
<td></td>
<td>% Growth</td>
<td>40.0%</td>
<td></td>
</tr>
<tr>
<td>% Total Revenue</td>
<td>22.9%</td>
<td>22.4%</td>
<td>% of Total Segment Revenue</td>
<td>9.0%</td>
<td>44.5%</td>
</tr>
<tr>
<td>Networks</td>
<td>7,050</td>
<td>6,802</td>
<td>Networks</td>
<td>618</td>
<td>451</td>
</tr>
<tr>
<td>% Growth</td>
<td>3.6%</td>
<td></td>
<td>% Growth</td>
<td>37.0%</td>
<td></td>
</tr>
<tr>
<td>% Total Revenue</td>
<td>18.4%</td>
<td>18.8%</td>
<td>% of Total Segment Revenue</td>
<td>8.8%</td>
<td>35.9%</td>
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<tr>
<td>Music</td>
<td>3,929</td>
<td>4,148</td>
<td>Music</td>
<td>302</td>
<td>211</td>
</tr>
<tr>
<td>% Growth</td>
<td>-5.3%</td>
<td></td>
<td>% Growth</td>
<td>43.1%</td>
<td></td>
</tr>
<tr>
<td>% Total Revenue</td>
<td>10.3%</td>
<td>11.5%</td>
<td>% of Total Segment Revenue</td>
<td>7.7%</td>
<td>16.8%</td>
</tr>
<tr>
<td>Publishing</td>
<td>4,810</td>
<td>4,645</td>
<td>Publishing</td>
<td>35</td>
<td>29</td>
</tr>
<tr>
<td>% Growth</td>
<td>3.6%</td>
<td></td>
<td>% Growth</td>
<td>20.7%</td>
<td></td>
</tr>
<tr>
<td>% Total Revenue</td>
<td>12.6%</td>
<td>12.8%</td>
<td>% of Total Segment Revenue</td>
<td>0.7%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Intersegment Elimination</td>
<td>(2,024)</td>
<td>(1,258)</td>
<td>Total Intersegment Revenue</td>
<td>2,024</td>
<td>1,258</td>
</tr>
</tbody>
</table>

Total Revenue             | 38,234| 36,213|
% Growth                  | 5.6%  |       |

Source: AOL Time Warner 2001 Annual Report
The America Online Internet business’ revenues grew by over 13% in fy2001 and the business comprised 22.8% of the firm’s total revenues. However, 22.5% or $228 million, of the increase in Internet revenues was a product of increased intersegment revenue, which is revenue paid to the Internet business by another AOL Time Warner company. Therefore, one-fifth of the increase in America Online revenues does not translate into an actual cash gain. Although the incensement revenue is a fairly insignificant portion of America Online’s total revenue, only 2.6%, it is being used to deceivingly bolster revenue growth for the business. Revenue growth for America Online without intersegment gains amounts to only 10.2%. America Online’s EBITDA grew a substantial 25.3% reflecting increased cost savings, as well as an increase in the intersegment revenue. The Internet business’ EBITDA is 33.8% of total revenue.

AOL Time Warner’s cable business’ revenues increased 15.5% to $7.0 billion. Only 5.3% of this growth came from intersegment revenues. This business comprises 18.3% of total firm revenues and 45.8% of cable revenues translate into EBITDA, which include nearly one-third of total EBITDA in fy2001.

Filmed entertainment revenue expanded by 7.9% in fy2001 and consists of 22.9% of total revenue. Intersegment revenue accounted for 35% of revenue growth. Revenue growth would only be 5.1% in this business segment without it. 11.6% of film revenues transform to EBITDA. Filmed entertainment EBITDA grew by 27.8%, but all of this growth can be attributed to increases in intersegment revenue.

AOL Time Warner networks revenue increased 3.6%, comprising 18.4% of total revenue. Once again, a significant portion of revenue growth is attributed to intersegment revenues, a whopping 67.3% and 57% of EBITDA growth is explained by increases in intersegment revenue. About a quarter of network revenue turned into EBITDA and network EBITDA is 19.6% of the total.

The music business actually shrank, experiencing negative growth of 5.3%. The business garnered $3.9 billion, 10.3% of total revenues. EBITDA similarly lost 19.1% and consists of 4.3% of total EBITDA.

Publishing revenues grew 3.6% and represent 12.6% of the firm’s revenue. Only 3.6% of revenue growth is intersegment revenue. EBITDA grew 21.7% and is 9.4% of total EBITDA.

AOL Time Warner uses intersegment revenue to inflate growth rates for business segments, particularly in high growth businesses that have been affected by the recessed economy, e.g. filmed entertainment and America Online. Clearly this fact should be taken into consideration when evaluating the firm’s financial position. Equally important is the reduction of the business’s core earnings due to extraneous costs, such as goodwill amortization and investment losses. These two expenses alone cost the company over $10 billion in fy2001. The core business of AOL Time Warner will appear much stronger financially after the company has moved beyond these expenditures.
Strengths, Opportunities, Weaknesses, Threats

Strengths

Economies of Scale and Scope

AOL Time Warner is a company with tremendous scale and scope, and it benefits greatly from both. Economies of scale allow for efficient risk management and entry into a variety of markets. Firm size also helps establish assets such as brand recognition, relationships with creative talent, and product distribution capabilities.

AOL Time Warner enjoys other cost advantages related to its size. Because it is so large it has sway that other vendors might not. Further, because its presence is felt across many markets, it has influence that other firms cannot have. Its position on broadband delivery of movie content, for example, is strengthened by its strong position in both broadband and content creation markets.

Economies of scope are essential to AOL Time Warner. Through the years both of these companies have developed expertise in marketing. AOL is known for its success in marketing of technology products, while Time Warner is a veteran at marketing traditional products. With their combined expertise they are able to reach customers at a low cost and with great success. Further, products in a wide range of fields means that the company may be more successful marketing to customers combinations of new technology and traditional content.

Customer Base

Probably the biggest strength of AOL Time Warner is its customer base, though as discussed earlier it is not as strong as it first appears. In March 2002, AOL had 34 million subscription customers, the most of any online service provider. The next largest, the Microsoft Network, has only 7.7 million customers. Every day AOL Time Warner delivers quality Internet access to these millions of customers, who in turn have learned to trust and depend on the AOL Time Warner brand name. AOL has been able to advertise for Time Magazine very successfully, creating about 100,000 new subscriptions a month. Further, AOL subscribers spent over $33 billion last year in online sales. If AOL Time Warner can position itself effectively, the company will capture a significant portion of this spending.

Weaknesses

Stock Price

AOL Time Warner’s weak stock valuation is indicative of the low expectations analysts hold for future growth. In order to grow stock valuation, therefore, it is necessary not only for AOL Time Warner to increase current revenues and profits, but it must also deal with low analyst expectations. This cannot be done with smoke and mirrors. Improvements in performance on a wide range of activities will be required.
Integration of Two Distinct Cultures

Integrating the cultures of newly merged companies is always difficult. Integrating the personnel of a technology company with that of a traditional media conglomerate is proving especially problematic. Although certain business units, such as AOL’s electronic publishing and Time Warner’s print publishing, meshed well, others have not. Synergies expected to develop between AOL’s content business and Time Warner’s business have not materialized.

Under Norman Pearlstine, Time Inc. developed more than a dozen new magazines, including In Style magazine and Teen People. Since Time Warner’s merger with AOL, however, the emphasis has shifted from product creation to product acquisition. Although this is not necessarily a bad strategy, it does mark a change in corporate culture. AOL Time Warner’s focus on financial performance rather than journalistic excellence, in the words of one former Time Inc. executive, is “eating into the muscle, not the fat of the company.” Without greater cooperation and internal unity, many of the synergistic expectations will not be achieved.

Control of Significant Broadband Lines

As discussed in the Supplier/Buyer Power section, controlling cable lines capable of providing broadband access is crucial. AOL Time Warner is dependent on other cable companies to provide the infrastructure for high-speed online content delivery. In the future, cable companies may force AOL Time Warner to buy “last-mile” service at high prices.

Dependence on Microsoft

Microsoft and AOL Time Warner are increasingly becoming combative companies. Therefore, AOL Time Warner’s dependence on Microsoft, for key technologies has become problematic, especially as technologies continue to converge. Recent talks between AOL Time Warner and Microsoft show that AOL Time Warner’s position is tenuous. It previously relied on Microsoft to provide the Internet Explorer browser, as well as technology for delivering streaming media (such as real time radio or news). Several potentially uncomfortable choices remain for AOL Time Warner: either begin developing technologies or licensing them from less mainstream third parties, or continue relying on Microsoft. The latter of these choices has become both less likely and less attractive recently as tensions grow between the two companies. AOL Time Warner has taken steps to reduce this vulnerability by partnering with RealNetworks to develop a proprietary streaming technology to compete head to head with Microsoft’s Media Player, and by purchasing the Netscape browser.

Opportunities

Growth of Time Warner Cable

Time Warner Cable has a significant growth opportunity. Currently the company provides high-speed digital access in 24 of the 40 markets it serves and plans to expand that to include all 40 by July 2002. If this succeeds, they will be able to capture more revenue in the cable division and also provide the infrastructure to support high-speed AOL access.
**Red Hat Linux**

AOL Time Warner may acquire Red Hat, the makers of Linux. Linux is an operating system that competes directly with Microsoft’s Windows. AOL Time Warner has the size and marketing know-how to sell operating systems with Red Hat and AOL as their main software. Because Linux is an open sourced program (meaning the code is developed by volunteer programmers, rather than in-house), AOL Time Warner could achieve a significant cost advantage over Microsoft PCs. Although Red Hat represents tremendous potential for AOL Time Warner, it is largely recognized in technical communities that AOL Time Warner’s expertise is in marketing, not in hardware and software development so this opportunity is most likely out of their reach.

**Instant Messaging**

Instant messaging is still a relatively young medium, but the opportunities it presents are very large. Instant messaging may become a standard workplace communication tool, used by large companies to help their workers communicate efficiently. It may also become a tool for telecommuters. Cellular phone makers are beginning to integrate instant messaging capabilities into their phones, which could lead to instant messaging becoming tool for family communication as well.

AOL Time Warner is in the best position to take advantage of this market. AOL Time Warner’s service is the largest instant messaging service available. AOL Time Warner has kept the code for the service a secret, so its system remains closed to outside competitors. Acquisitions, such as the purchase of ICQ messaging service, also support growth of the AOL network.

AOL Time Warner could begin to license its software to competing messenger services or for use by large corporations. It could also charge modest rates for home customers who want to access their large network of users. Recent maneuvers, such as the creation of the Instant Messenger based digital wallet, will allow AOL Time Warner to direct and monitor their customer’s shopping. Finally, instant messaging’s broad reach make it an appealing content deliver vehicle once the technology becomes available.

**Threats**

Media and technology companies are in the early stages of a war to reach one common end: dominating the convergence of the personal computer, telephone, television, and other household appliances into an all-in-one network. AOL Time Warner’s strategy is to use its content as the driving force for convergence. The company hopes that AOL Internet and Time Warner content and cable will drive their customers toward an all-in-one network. Robert Pittman, co-chief operating officer of AOL Time Warner, estimated that potential revenue per household could be as high as $230 per month.

However, the strategic victor in the battle for dominating convergence is far from certain. Jupiter Communications estimates that 29% of US households will have access to interactive television by 2004\(^6\). Competitors have surfaced to challenge AOL Time Warner, each representing a different strategic approach to delivering home technology convergence.
Convergence Through Delivery - AT&T-Comcast and DirecTV-EchoStar

The AT&T-Comcast merger created the first national cable company with the potential to challenge both television broadcasters and local telephone companies. Through economies of scale, AT&T-Comcast will be able to deliver broadband Internet for less than the cost of digital subscriber line (DSL) service offered by phone companies, predicts former Federal Communications Commission chairman Reed Hunt. Also, two satellite TV providers, DirecTV and EchoStar, currently are planning to merge.

Convergence Through Technology - Microsoft

Microsoft has invested $5 billion in the new AT&T Comcast system and has made substantial investments in other delivery systems, such as satellite technology. Unsure as to how content will ultimately be delivered, Microsoft is placing bets to ensure that regardless of the delivery vehicle, its software will be present. Lacking the tremendous content creating base of AOL Time Warner, Microsoft is attempting to dominate convergence through its power in the software market.

The high stakes battle between Microsoft and AOL, who stand firmly as the two dominant players in consumer technology, is far from over. After months of negotiations, Microsoft decided in January not to incorporate AOL software with Windows XP. AOL Time Warner for its part has refused to share the code for its instant messaging service. Both companies are pushing new technologies to store customer information, such as credit card information, Internet based calendars and address books.

Strategic Analysis:

The AOL – Time Warner merger initially was hailed as a new beginning for entertainment companies. The new company was supposed to realize synergies between AOL’s online dominance and Time Warner’s traditional media empire. However, over the last two years that has not occurred and Wall Street has punished the stock.

Before the merger, America Online had phenomenal growth. However, the market in which AOL has been so successful is now maturing. Over 60% of American homes are now online. AOL’s subscription growth rate has slowed recently to 24% in 2001, down from 30% growth in 2000 and 36% in 1999. A large percentage of AOL’s growth has been in traditional dial-up service. Furthermore, as consumers become more Internet savvy, they may shift to a less expensive ISP. To maintain AOL’s previous growth rates in a maturing market, the company not only must make the transition to becoming a dominant high-speed provider but must also achieve economies of scope by cross selling AOL Time Warner’s other products.

The dominant driver for AOL Time Warner’s growth is its subscriptions. In order for AOL Time Warner to recapture its subscription growth rate and increase its revenue per subscriber, the company must first increase its penetration of broadband. Currently, there are approximately 15 million digital cable subscribers and 6.5 million new subscribers are estimated for next year. Obviously, there is significant and growing demand for digital access and while digital subscribers do not necessarily receive high-speed Internet access,
switching costs are low once the infrastructure is in place. If convergence is dominated by delivery systems, increasing AOL Time Warner’s broadband penetration will reduce cable companies’ supplier power and provide the company increased revenues in the cable business.

Carnegie Consulting’s first recommendation involves the Time Warner Cable division. The company must continue to increase the number of high-speed subscribers. To that end, the company plans to offer high-speed Internet access in all 40 of Time Warner Cable’s markets by July 2002. However, Time Warner Cable only serves about 20% of American homes, which means that in order to provide high-speed access to many of their existing AOL customers, the company will be extremely dependent on other cable companies. As discussed in the Supplier/Buyer Power section, being dependent on other cable companies to supply the product creates a situation where the cable companies may be able to extract profits from AOL Time Warner. Carnegie Consulting recommends that AOL Time Warner pursue exclusive long-term contracts with several cable companies or attempt to acquire a cable company, while simultaneously increasing Time Warner Cable’s penetration. It seems more practical at this point for the company to form long-term contracts with cable companies, but once the current merger integration is completed the company should consider purchasing a cable provider. Two leading candidates for partnership are Charter Communications, with 6.4 million subscribers, and Cablevision Systems with 2.8 million subscribers. Both of these cable companies are leaders in providing digital service and possess the infrastructure necessary to provide high-speed AOL Time Warner content.

This leads to Carnegie Consulting’s second recommendation. AOL Time Warner must succeed in its effort to develop a market for high-speed delivery of its content. Small steps in this direction have already been taken. The Wall Street Journal reports that, “Warner Bros. is crusading to drive down the prices of all DVDs, preferably so low they’ll become an impulse purchase like magazines.” Warner Bros. has increased its sales of DVDs to discount retailers like Wal-Mart and Target, and attempted to cut out movie rental companies such as Blockbuster. The long-term goal of this strategy is to reduce consumers’ dependence on rental firms for home viewing. Then, once the infrastructure is in place for high-speed delivery, AOL Time Warner will be well positioned to deliver entertainment content straight to the home personal computer. This strategy is dangerous because driving down the price of DVD’s may hurt the company’s short-term revenues while not creating significant demand for online delivery. Driving rental firms like Blockbuster out of business will not help AOL Time Warner if consumers simply buy low cost DVD movies and play them on their DVD home systems. This danger can be mitigated somewhat if online delivery has features unavailable on DVD’s, such as interactive retailing or better quality picture and sound.

In a world where the infrastructure is in place to make movie and music delivery viable, AOL Time Warner can add more subscribers and invigorate its subscriber growth rate. More importantly, the company will be able to increase revenue per subscriber by charging for special services such as movie and music downloads. Increased traffic will also generate more advertising revenue. As more and more features become available online, demand for high-speed access will increase.

The company possesses a massive customer base already willing to pay for Internet access and content. Moreover, its subscription television network, HBO, has over 33 million subscribers. While there is certainly double counting between those figures, AOL Time
Warner already has a large customer base willing to pay for content. The key strategic move rests on the company’s ability to convert current subscribers to future high-speed subscribers.

If AOL Time Warner’s wins its bet and its content dominates convergence, then the company is well positioned. However, the timing and success of content driven convergence is uncertain and the company may be a few years too early. This probably explains the falling stock price. The stock market does not believe AOL Time Warner will prevail any time soon. Failure to dominate convergence in the near term will hurt the company because it will not have significant growth. On the other hand, the company does not have to dominate convergence right away to achieve its goal. Time Warner’s traditional media business is a solid revenue producer. This solid base allows the company to withstand a few years of slow growth while waiting to see if it can achieve profitability through content driven convergence. If content delivery becomes profitable, then AOL Time Warner’s position is excellent, because it is the only company positioned to become the dominant content provider.

If convergence is driven by delivery systems or technology, then AOL Time Warner will need to reevaluate its position. It is not too soon to be considering an exit strategy from its attempt to dominate convergence.

Broadband will most likely make ISPs a commodity with low profits. AOL Time Warner will then have two choices: (1) shut down the ISP business or (2) differentiate AOL’s content. The company may decide that competing as an ISP is not profitable and sell the service provider business. On the other hand, AOL Time Warner’s expertise is at producing differentiated content that consumers are willing to buy. If ISPs become a commodity, then the company can seek other ways to differentiate its service so that people still subscribe to AOL. Various methods of differentiation include offering special promotions available exclusively to subscribers such as tickets to screenings of Warner Bros. movies or discounted magazine subscriptions. The most promising strategy would be for the company to tie access to online movies and music to its homepage. So far, AOL Time Warner has not been able to capitalize on its massive economies of scale, but in the future the company would have to achieve economies of scope to provide differentiated service.

If the company is able to convince consumers that the AOL homepage has value, then that will provide a different growth engine for the company. First, the company could receive a fee for service and broadband access, especially if existing AOL subscribers make the transition from dial-up to broadband. Another revenue source could be from its large music and movie libraries. Using its proprietary instant messenger and RealNetworks’ streaming technology, the company could offer exclusive access to entertainment available to AOL customers. Finally, AOL Time Warner could tap into the large online retail market. For instance, consumers who watch a movie or sporting event using AOL Time Warner’s technology on AOL Time Warner’s network, could also be able to purchase goods through the AOL homepage linked to on line portals like eBay and Amazon. If AOL Time Warner were able to capture pennies on the dollar of each purchase, they could cash in on an enormous market.

The one large drawback to this strategy is that it hinges on AOL Time Warner becoming the dominant content provider. So far, the company has not been able to succeed in achieving this goal. AOL Time Warner’s only chance to become the dominant provider will come from
convincing its current subscribers to cross over to AOL’s broadband service and providing substantial benefits to its subscribers.

The company can relieve some of the pressure from the content side of the business by simultaneously growing its penetration of the cable market. Currently, Time Warner Cable is the second largest cable provider, behind AT&T-Comcast. If the company can successfully continue its growth in high-speed Internet access, it can further mitigate some of the risk of the convergence gamble. As noted, AOL Time Warner is positioned better than any of its competitors to become the dominant content provider. Increasing its influence in distribution will reduce supplier power while also reducing the size of its strategic bet that content distribution will come to dominate convergence.

Another crucial issue the company must tackle is integration. The post-merger effort is failing badly because executives from each company do not communicate with each other well enough. In order to facilitate integration more quickly, Carnegie Consulting recommends AOL Time Warner form a special integration committee within its strategic planning division, based on the Hewlett Packard-Compaq model. This committee will be inward looking and focus on ways to make economies of scope more profitable and create synergies among business units.

**Conclusion**

No matter which forces eventually dominate digital convergence, the payoffs will be enormous. AOL Time Warner is smart to place a strategic bet that its content will dominate convergence. But it but must carefully develop an exit strategy in case it cannot achieve this dominant position. Currently, AOL Time Warner has solid revenue generating businesses capable of supporting the company in a world dominated by delivery or by technology.


Standard & Poor’s Industry Surveys, Computers: Consumer Services and the Internet.” March 28, 2002


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“Time Inc. Staff Adjusts Warily to Life Within AOL”


AOL to Meld TV and Internet; Service Set to Debut in Baltimore, Seven Other Cities Ariana Eunjung Cha

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