Table 4: Projected Free Cash Flow And Capitalization—PF1999–PF2002E ($ In Millions)

	PF1999	PF2000E	PF2001E	PF2002E
EBITDA (Pre-Corporate Overhead)	$9,802	$8,942	$11,592	$14,285
Corporate Overhead	(251)	(284)	(265)	(294)
Interest/Preferred Dividends	(1,829)	(2,276)	(1,876)	(1,626)
Cash Taxes	(1,550)	(612)	(376)	(754)
Capital Expenditures	(2,786)	(3,663)	(2,966)	(2,851)
Change in NWC	1,581	(349)	(502)	(536)
Acquisitions & Investments	(3,725)	(1,942)	(297)	0
Sale of Assets	16	0	0	0
Exercise of Stock Options	839	1,000	750	750
Other	(179)	(308)	(265)	(294)
Free Cash Flow	**$1,918**	**$507**	**$5,794**	**$8,680**
Beginning Net Debt	$16,843	$17,110	$16,893	$11,099
Common Dividends	(289)	(225)	0	0
Equity Issuances/(Repurchases)	(1,896)	(65)	0	0
Ending Net Debt	17,110	$16,893	$11,099	$2,419
Debt/1-Year Forward EBITDA	**2.0x**	**1.5x**	**0.8x**	
Debt/Total Capital	**10%**	**10%**	**7%**	**2%**
FCF/EBITDA	**20%**	**6%**	**51%**	**62%**

Source: Company reports and First Union Securities, Inc., estimates

Why We Use Cash Earnings And How We Calculate Them For AOL Time Warner

As detailed in the valuation discussion of the industry section (page 50), we prefer to track cash earnings multiples in addition to the more conventional EV/EBITDA multiples. Cash earnings is a more conservative methodology, which recognizes that depreciation is a real economic expense, and values all of a company's assets on those earnings (i.e., no off-balance-sheet adjustments are made). In short, we are closet earnings fans, and we like to hold companies accountable for their losses while giving them credit once things improve. In general, we define cash earnings as net income, plus amortization of goodwill, plus or minus the after-tax impact of any purchase accounting adjustments that may distort the underlying cash flow. Cash earnings can also be thought of as a good proxy for discretionary free cash flow, assuming capital expenditures are equal to depreciation. This offers a benefit over actual FCF multiples, which can fluctuate wildly depending on the capital spending needs in a given year.

Cash earnings include an adjustment for non-cash taxes

In the case of AOL Time Warner, we need to make one additional adjustment to arrive at true cash earnings. As mentioned above, the company is in a position where it will not pay federal taxes for the foreseeable future given the massive NOLs available. As a result, we also add back to earnings the difference between our estimate of reported taxes and the actual cash taxes to be paid. Theoretically, this is a good thing to do for all companies, but in most cases the difference is immaterial. For AOL Time Warner, however, we estimate the add-back to earnings at about $0.14 per share in 2001 and $0.27 per share in 2002. We caution that these estimates are our best preliminary guess, while recognizing that there is little visibility regarding how taxes will be handled on a pro forma basis at this point in time.

Private Market Value

PMV is estimated at $80 per share by the end of next year

As shown in Table 5, we estimate the net asset value of AOL Time Warner at $80 per share at the end of 2001. While the purpose behind the merger is to create a company that is more than the sum of its parts, we still find this net asset value analysis useful in that it provides visibility regarding where the value resides among each of the company's diverse businesses. Moreover, it offers the opportunity to walk through the complexities of the corporate structure of Time Warner Entertainment (TWE)—a topic that is almost always glossed over.

Most of the valuation assumptions in Table 5 are fairly self-explanatory. However, given the relative importance of AOL's advertising and commerce revenue to the overall value of the company (almost $200 billion, gasp!), we would like to point out that we are purposely trying to be conservative. Yahoo!'s is currently trading at 55x estimated revenue. AOL is at least as well-positioned with advertisers as Yahoo! (about three times as large), and we see no reason to assume that AOL should trade at a lower multiple. Nevertheless, we have applied a one-third discount to Yahoo!'s multiple for no other reason than to be conservative. Moreover, with advertising revenue estimated to grow in the 45%-50% range in 2001 and 2002, a 35x multiple seems reasonable given that most of the incremental advertising dollars flow down to profits. Other key assumptions include 23x for cable networks and $4,500 per subscriber for cable—nothing controversial there.

Explanation for how to figure the TWE partnership

That being said, the obvious question is how to read each of the following tables. The first table simply provides the answer at the top-most level—$80 per share for AOL Time Warner. Tables 6 and 7 provide the backup. Table 6 illustrates our assumptions for the value of off-balance-sheet and developing assets for the combined company. This feeds into the first table. Table 7 provides our valuation of TWE, a partnership between AOL Time Warner and AT&T/Media One that houses the Warner Bros. studio, HBO, and the large majority of AOL Time Warner's cable assets. It is necessary to arrive at a value for TWE in order to accurately subtract out the minority interest in TWE from AOL Time Warner's valuation. There are several layers to the capital structure of TWE. AOL Time Warner owns 74.5% of the Series A capital, 74.5% of the residual capital, and 100% of the Series B capital. In turn, AT&T/Media One owns 25.5% of the Series A capital, and 25.5% of the residual capital. The "residual" capital is estimated by taking the difference between the market value of the partnership and the Series A and B capital accounts.

By following these steps, we arrive at AT&T/Media One's ownership stake in TWE at $13.8 billion, which then gets subtracted from AOL Time Warner's consolidated valuation. This $13.8 billion is also a useful number to keep in mind since AT&T may want to restructure its ownership of TWE in order to close its acquisition of Media One; the FCC ruled that the combined company has too great a concentration of cable since the interest in TWE counts towards the 30% national limit. There are numerous interrelated topics that will be on the table during that negotiating process—cable telephony for AT&T, open access onto AT&T's cable and wireless assets for the AOL service, ownership of RoadRunner (which AT&T is also forced to sell), joint-marketing of services, and the value to be paid for AT&T/Media One's interest in TWE. Ignoring all of the other dynamics for the moment, we believe that the $13.8 billion is a reasonable estimate for the value of AT&T/Media One's stake in TWE.

Table 5: Projected Net Asset Value Of AOL Time Warner ($ In Millions)

				Valuation Methodology				
				One-Year Forward	Alternative	Value at End of		
	PF2000E	PF2001E	PF2002E	Multiple	Method	1999	2000E	2001E
Time Warner EBITDA:								
HBO	$636	$732	$839	17.5x		$11,137	$12,803	$14,689
Cable Networks - TBS	1,144	1,439	1,729	23.0x		26,310	33,105	39,762
Total Cable Networks	1,780	2,171	2,568			37,447	45,909	54,451
Publishing	858	1,039	1,171	14.0x		12,015	14,541	16,392
Music	539	601	665	15.0x		8,086	9,008	9,982
Warner Bros.	745	855	940	16.0x		11,926	13,676	15,047
Filmed Entertainment - TBS	226	259	284	15.0x		3,397	3,892	4,262
Total Filmed Entertainment	972	1,114	1,225			15,323	17,568	19,309
WB Network	(58)	(18)	44			1,000	1,000	1,000
Cable Systems	2,466	2,809	3,218		$4,500 Per Subscriber	49,050	50,031	50,781
Digital Media		25	100		15.0x Revenues	1,500	1,500	1,500
Time Warner Gross Assets						**124,421**	**139,557**	**153,416**
AOL Revenues:								
Subscription Services	5,050	6,325	7,682	5.5x		27,776	34,787	42,250
Advertising, Commerce & Other	2,460	3,749	5,399	35.0x		86,107	131,226	188,964
Enterprise Solutions	519	560	605	5.0x		2,593	2,800	3,024
AOL Gross Assets						**116,476**	**168,814**	**234,238**
Corporate Overhead	(284)	(265)	(294)	4.5x		(1,278)	(1,194)	(1,324)
Preferred Trust Securities						(575)	(575)	(575)
Net Debt (Incl. Stk. Option Loan Facility)						(17,110)	(16,893)	(11,099)
Time Warner Off-Balance Sheet & Developing Assets					See Details in Table 6	7,685	9,653	11,753
AOL Off-Balance Sheet & Developing Assets					See Details in Table 6	17,841	19,275	21,963
Minority Interests:								
Less: A/N Interest in Consolidated Cable Subscribers						(7,783)	(7,783)	(7,783)
Less: AT&T/Media One Interest in TWE					See Table 7	(11,806)	(12,819)	(13,787)
Private Market Value (Net Asset Value)						227,872	298,034	386,801
Shares Outstanding						4,790	4,805	4,853
Private Market Value Per Share						$48	$62	$80
Less: Discount to PMV						0%	0%	0%
Public Market Value Per Share						**$48**	**$62**	**$80**

Source: Company reports and First Union Securities, Inc., estimates.

Table 6: Projected Value Of Off-Balance Sheet And Developing Assets ($ In Millions)

			Value at End of		
			1999	2000E	2001E
Cable JVs		$4,500 Per Subscriber	$1,357	$1,357	$1,357
Road Runner		Comparable Valuation	1,499	3,407	5,452
Time Warner Telecom	50 million shares	Market Value	3,063	3,063	3,063
Comedy Central	50% ownership	$17 Per Subscriber	543	577	603
Court TV	50% ownership	$17 Per Subscriber	319	344	374
Columbia House	50% ownership		50	50	50
Sports Assets			500	500	500
OpenTV Corp.	2.3 million shares	Market Value	121	121	121
Intervu Inc.	0.3 million shares	Market Value	18	18	18
Healtheon/WebMD Corp.	2.5 million shares	Market Value	35	35	35
Hoover's Inc.	2.6 million shares	Market Value	20	20	20
Other Internet Assets			150	150	150
Other			10	10	10
Total Time Warner Off-Balance Sheet & Developing Assets			$7,685	$9,653	$11,753
AOL Off-Balance Sheet & Developing Assets:					
AOL Investment Portfolio		Market Value	$3,400	$2,500	$3,000
GM (Hughes) Preferred Stock			1,500	1,500	1,500
AOL International Subscribers		Comparable Valuation/Bertelsmann Deal	6,941	9,275	11,463
ICQ			5,000	5,000	5,000
AOL Instant Messenger			1,000	1,000	1,000
Total AOL Off-Balance Sheet & Developing Assets			$17,841	$19,275	$21,963
Total AOL Time Warner Off-Balance Sheet & Developing Assets			**$25,526**	**$28,928**	**$33,715**

Source: Company reports and First Union Securities, Inc., estimates.

Table 7: Projected Net Asset Value Of TWE ($ In Millions)

		PF2000E	PF2001E	PF2002E	Valuation Methodology: One-Year Forward Multiple	Valuation Methodology: Alternative Method	Value at End of 1999	Value at End of 2000E	Value at End of 2001E
Cable Systems		$2,428	$2,781	$3,144		$4,500 Per Subscriber	$40,950	$40,950	$40,950
HBO		636	732	839	17.5x		11,137	12,803	14,689
Warner Bros.		745	855	940	16.0x		11,926	13,676	15,047
WB Network		(58)	(18)	44			1,000	1,000	1,000
Total							65,013	68,429	71,686
Net Debt							(6,144)	(6,144)	(6,144)
TWE Off-Balance Sheet & Developing Assets						See Details Below	2,895	4,471	6,163
Less: A/N Interest in Consolidated Cable Subscribers							(7,783)	(7,783)	(7,783)
TWE NAV							**$53,981**	**$58,974**	**$63,922**
Capital Structure:									
Senior Capital							$0	$0	$0
Series A Capital							14,464	16,344	18,469
Series B Capital							7,701	8,721	9,877
Residual Capital (based on NAV)							31,816	33,908	35,578
Total							$53,981	$58,974	$63,922
TWX Ownership:									
Senior Capital (100%)							$0	$0	$0
Series A Capital (74.5%)							10,774	12,175	13,758
Series B Capital (100%)							7,701	8,721	9,877
Residual Capital (based on NAV) (74.5%)							23,700	25,258	26,501
Total							$42,175	$46,155	$50,135
AT&T/MediaOne Ownership:									
Senior Capital (0%)							$0	$0	$0
Series A Capital (25.5%)							3,690	4,169	4,711
Series B Capital (0%)							0	0	0
Residual Capital (based on NAV) (25.5%)							8,116	8,650	9,075
Total						Used in Table 5	$11,806	$12,819	$13,787
TWE Off-Balance Sheet & Developing Assets:									
Cable JVs						$4,500 Per Subscriber	$1,357	$1,357	$1,357
Road Runner						Comparable Valuation	1,219	2,770	4,432
Court TV	50% ownership					$17 Per Subscriber	319	344	374
Total							**2,895**	**4,471**	**6,163**

Source: Company reports and First Union Securities, Inc., estimates.

Investment Conclusion—Strong Growth At A Compelling Value

As outlined throughout this report, we believe that while the investment community is debating short-term oriented questions (i.e., who bought who?, how do you value a blended Internet and media company?, etc.), a window of opportunity has been created to aggressively buy a uniquely positioned growth company with premier content, distribution, and Internet assets. In fact, AOL Time Warner is No. 1 or No. 2 in virtually every business in which it competes. Moreover, with 23-25% long-term EBITDA growth and powerful free cash flow generation (we estimate more than $5.5 billion in 2001, growing 50%), the valuation is compelling using traditional metrics. In other words, there is no need to rely on historical Internet valuations to justify significant upside from current levels. The heart of the issue is that the merger makes a great deal of sense by providing AOL with content, cable access, and a powerful media platform, while Time Warner can leverage its brands over the Internet in a way that was simply not possible before. Synergies of the merger will accelerate near-term EBITDA growth to 30% in 2001. These are the issues that the investment community will increasingly focus on once the initial period of adjustment has passed.

Several catalysts on the horizon...

The bottom line is that this is a powerful growth story trading at a price that even value-oriented investors should find compelling. In addition, there are several catalysts on the horizon that could narrow the disconnect between the stock price and the underlying value. These include the following:

- The merger closes in the fall. Once the companies combine, the focus will shift towards execution. At that point, we believe investors will see a company that delivers 30% EBITDA growth. The preoccupation with short-term trading questions should then fall by the wayside.
- An open access agreement between AOL and Time Warner should be announced very soon. This will be an important early milestone for the company, even before the merger is completed. By agreeing on the terms of open access, the companies will show that they are working together to achieve the first major synergy of the merger. As discussed earlier, one of the key reasons for the deal was for AOL to gain access to broadband over cable. The company's subscription service is a good business, generating about $10 per month in gross profit after paying network access charges—it is effectively compensation for the community and content that AOL so effectively provides. Therefore, it is important that AOL not lose that $10 per month as consumers switch to broadband over time. AOL needs to be everywhere, across all devices. Coming up with an agreement with Time Warner accomplishes the first stage of that open access. We expect the rest of the industry to follow over time as open access is a win-win situation for both AOL and cable operators. AOL is no longer the nemesis fighting for regulated open access. Commercially negotiated terms will provide AOL access to more customers and the cable industry now has a powerful partner to drive demand in the long run (leading to higher penetration for cable modems). Everyone wins, except perhaps other ISPs—would you want to compete against AOL?

- AT&T agreement – as discussed earlier in the valuation section regarding the TWE partnership, AOL Time Warner and AT&T have a lot of mutually beneficial issues to negotiate. We don't expect an agreement to be hammered out until after the AOL Time Warner merger closes, but there is certainly enough common interest that an agreement should be forthcoming before too long. The interrelated issues on the negotiating table include the following:
  - AT&T needs a cable telephony agreement, which will also prove incremental to the growth of the cable operator.
  - AOL Time Warner wants an open access agreement onto AT&T's cable and wireless assets – AOL Anywhere strategy.
  - AT&T may shed its interest in the TWE partnership in order to meet FCC guidelines regarding cable ownership limits. To be clear, AT&T has six months to decide which FCC alternative it will choose – divest either TWE, Liberty, or cable subs, and accomplish the chosen scenario within one year. As shown in the valuation section, the TWE partnership creates a complicated corporate structure, one that investors would prefer to see simplified. The value of AT&T interest in TWE will be a hot topic – we value it at almost $14 billion.
  - Ownership of the RoadRunner high-speed Internet service, which AT&T is also forced to sell given its ownership of Excite@Home.
  - Agreements for joint-marketing and bundling of services – for example, one bill for cable services, telephony, wireless, and AOL.

Growth, value, and identifiable catalysts – this is a company to own. We recommend aggressive purchases. At current levels, we are largely indifferent regarding which of the two companies to buy since Time Warner is trading at only a 2% discount to the exchange ratio of 1.5 AOL shares for each Time Warner share. We look for almost 50% upside from current levels with a price target of $80 per share for the combined company (equivalent to $120 per share for Time Warner standalone). The shares of AOL and Time Warner are both rated 1.

DETAILS OF THE PROPOSED MERGER

Terms

- Exchange of 1.5 shares of AOL for each share of Time Warner
- No collar
- AOL stock survives with the combined company renamed AOL Time Warner
- AOL shareholders will own 55% of the new company; Time Warner shareholders 45%
- Deal is expected to close in the fall, following regulatory and shareholder approval

Management

- Sixteen-member board, split equally between AOL and Time Warner
- Steve Case, chairman
- Gerald Levin, CEO, running the company on a daily basis
- Ted Turner, vice chairman and senior advisor
- Bob Pittman, co-chief operating officer – responsible for subscription service as well as advertising and commerce-based businesses. These include AOL, cable, publishing, cable networks, and the WB Network.
- Dick Parsons, co-chief operating officer – responsible for content-based businesses, including filmed entertainment, music and books, as well as the corporate functions of legal and personnel development.
- Kenneth Novack, vice chairman
- Richard Bressler, CEO of AOL Time Warner Investment Corporation
- Michael Kelly, CFO
- Four-person integration committee, composed of Bob Pittman, Dick Parsons, Kenneth Novack, and Richard Bressler.
- AOL and Time Warner both have a bench of divisional operating heads, all of whom will remain following the merger.

BUSINESS DESCRIPTIONS

More in-depth detail by division

The following segment of this report is intended to provide some greater detail on AOL Time Warner's individual divisions. It is not comprehensive by any means, especially since the dynamics and outlook of each respective business are discussed in the industry section of this report. Following this section, the report concludes with the outlook for the upcoming quarter and investment risks.

AOL—Arguably One Of The Best Brands On The Internet

Overview – Dominant Market Share, Strong Growth, and Powerful Advertising Model

Strong economics in the ISP business if you're AOL

AOL is arguably the most-powerful brand in the Internet space. The company "owns" the highly attractive, premium segment of the Internet service market. When most people think of Internet access, they automatically think of AOL. The company has more than 50% of the online market, and the market itself if growing rapidly. It is estimated that 35-40 million homes will be online by the end of the year, up about 7-8 million from last year. AOL's branded service alone (not counting Compuserve or Gateway) is expected to add more than 5 million subscribers in 2000 – the company's market share is tremendous.

Some skeptics have historically argued that the ISP business is less than attractive; after all, why would consumers pay for something that they can get for free from the new free ISPs, such as NetZero, that have sprung up? AOL and free ISPs appeal to very different segments of the market. In some ways, they are not even competitors. AOL provides subscribers with more than just access to the Internet. It offers the content and "community" that subscribers find so entertaining and convenient. As evidence, of the 64 minutes per day that the average subscriber spends online (which is up from 46 minutes only two years ago), more than 80% is spent within AOL's proprietary service. Moreover, the prospect of changing e-mail addresses, not to mention the addictive nature of the chat rooms and buddy lists, makes switching costs very high. The AOL Anywhere strategy is to provide the same quality and consistency of service across all devices and means of access – the computer, television, cell phones, organizers, appliances, etc. Of course, the goal is to engrain the service even further as a necessary and entertaining tool for communicating and organizing one's life. In contrast, free ISPs operate in the far less desirable value segment of the market. They are geared toward customers looking for a very different experience and service than the typical AOL subscriber – bare bones access, nothing fancy, and often not very reliable, in our experience. Nevertheless, AOL has its Netscape and CompuServe brands to compete in the value segment of the market. As an aside, we are not convinced that free ISPs will even be around in the long run; the economics are poor for other ISPs under an advertising-only model. In Europe, free ISPs get a cut of the metered phone call, thereby making the model more supportable (although that may be changing with a shift to flat rate plans for data calls). However, no such compensation exists in the United States, where most of the country is on a flat rate plan.

On the contrary, the economics for AOL are impressive. Of the $21.95 per month charged for unlimited access AOL branded service, about $12 per month pays for telecommunication access fees (about $10.50) and billing (about $1.50). That leaves $10 per month as compensation to AOL for its content and community services. With nearly a 50% gross margin, this $10 per month is quite lucrative. Understandably, AOL is actively ensuring that it continues to make this profit in the access business by providing ubiquitous service regardless of the means of access. As discussed earlier, gaining access to cable broadband is certainly a significant benefit of the merger. The prospect of losing that $10 per month as some customers migrated over time to cable modems was not a pleasant scenario. Now the prospect is quite different – what ISP would want to compete against the AOL brand in an open access world?

Therefore, our conclusion is that AOL's service is a good business even before considering the advertising revenue that the company generates. AOL has a total of about 26 million subscribers around the world, making it practically a must-buy for many advertisers. AOL's advertising revenue is about three times larger than the next biggest Internet portal, Yahoo!. As is true for other advertising mediums, size matters and usually breeds success. AOL is one of the best ways to reach a broad audience on the Internet while still targeting highly attractive demographics. This is especially true given the large amount of captive time that subscribers spend on AOL's proprietary service. The company's advertising and e-commerce backlog currently stands at $2.7 billion, up from $2.4 billion and $700 million at the end of 1999 and 1998, respectively. This number is consistently vetted to eliminate any advertising contacts that may be in jeopardy. As a result, we judge the risk to the company's advertising revenue stream as minimal, even in light of the recent gyrations among Internet stocks.

We Project 50% EBITDA Growth, On Average, Between 1999-2002E – Before Synergies

Table 8: AOL Projections (Before Synergies)—1998–2002E ($ In Millions)

						% Change			
	1998	1999	2000E	2001E	2002E	1999	2000E	2001E	2002E
Revenues:									
Subscription Services	$2,765	$3,874	$5,050	$6,325	$7,682	40%	30%	25%	21%
Advertising, Commerce and Other	725	1,368	2,460	3,749	5,399	89%	80%	52%	44%
Enterprise Solutions	357	476	519	560	605	33%	9%	8%	8%
Total Revenues	3,847	5,718	8,029	10,634	13,686	49%	40%	32%	29%
Cost of Revenue	2,252	3,055	4,111	5,291	6,603	36%	35%	29%	25%
Cost of Revenue as % of Revenue	59%	53%	51%	50%	48%				
Sales & Marketing	670	872	1,123	1,482	1,778	30%	29%	32%	20%
Product Development	267	290	339	423	529	9%	17%	25%	25%
General & Administrative	290	410	528	687	893	41%	29%	30%	30%
Amortization of Goodwill & Other Intangibles	48	68	72	72	72	42%	6%	0%	0%
Acquired In-Process R&D	80	-	-	-	-				
Merger, Restructuring and Contract Termination Charges	50	98	-	-	-				
Settlement Charges	18	-	-	-	-				
Income (loss) from Operations	**$172**	**$925**	**$1,856**	**$2,680**	**$3,810**	**438%**	**101%**	**44%**	**42%**
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
EBITDA Margin	*14.5%*	*23.9%*	*28.4%*	*30.0%*	*32.6%*				
Operating Income Margin	*4.5%*	*16.2%*	*23.1%*	*25.2%*	*27.8%*				
Additional Information:									
AOL Subscribers at Period End	15.1	20.5	26.0	31.5	36.5	36%	27%	21%	16%
AOL Subscribers Added During the Period	4.4	5.4	5.5	5.5	5.0	24%	1%	0%	-9%
CompuServe Subscribers at Period End	2.2	2.5	3.1	3.6	4.1	14%	24%	16%	14%
CompuServe Subscribers Added During the Period	2.2	0.3	0.6	0.5	0.5	-86%	100%	-17%	0%
Customer Solutions/Gateway Subscribers at Period End	0.0	0.7	1.1	1.3	1.6		42%	24%	19%
Customer Solutions/Gateway Subscribers Added During the Period	0.0	0.7	0.3	0.3	0.3		-58%	-19%	0%
Total Subscribers at Period End	**17.3**	**23.8**	**30.2**	**36.4**	**42.2**	**37%**	**27%**	**21%**	**16%**
Total Subscribers Added During the Period	6.6	6.5	6.4	6.3	5.8	-2%	-1%	-2%	-8%
Average Subscribers	14.5	20.0	26.9	33.3	39.3	38%	34%	24%	18%
U.S. Subscribers at Period End	14.5	19.8	24.9	29.9	34.4	37%	26%	20%	15%
Average U.S. Subscribers	12.4	16.9	22.2	27.4	32.1	37%	31%	23%	17%
International Subscribers at Period End	2.8	4.0	5.3	6.6	7.8	42%	34%	24%	19%
Average International Subscribers	2.3	4.0	5.3	5.9	7.2	75%	34%	12%	21%
Monthly Subscription Revenue/Average U.S. Subscriber	$18.65	$19.12	$18.95	$19.27	$19.94	3%	-1%	2%	3%
Monthly Advertising Revenue/Average Total Subscriber	$4.17	$5.70	$7.62	$9.39	$11.46	37%	34%	23%	22%

Source: Company reports and First Union Securities, Inc., estimates

Note: AOL has a June fiscal year end. However, to ease comparability, earnings are presented on a calendar year end basis. iThis consistent with the merged company's planned fiscal year In contrast to the company's definition, our EBITDA calculation does not include "Other Income."

Strong top-line growth and improving EBITDA margins

Growth at AOL is driven by the company's dominant market share of the fast-growing online universe. We look for total subscribers to grow from 24 million at the end of 1999 to more than 30 million this year. AOL branded subscribers should increase by more than 25%, to 26 million.

Pricing on the subscription service is expected to grow in the low-single-digit rate area, primarily driven by new services, such as AOL TV and cable broadband access. Please note that the margin on cable modem subscribers will be lower than telephone dial-up service since the $40 per month charge to the consumer will likely be split $10 to AOL and $30 to the cable operator. Remember that AOL's goal is to maintain the $10 per month, not necessarily the 50% gross margin. Nevertheless, the total gross margin should still improve over time as the impact from cable modems is easily offset by contracted rate declines in the variable cost of telecommunication network fees. The access fee is currently $0.33 per network hour and is expected to decline to about $0.20 per hour in approximately two years. Usage will surely increase during this time frame, but the net effect should still be a 1-2 percentage-point improvement in the gross margin per year for the next few years.

Meanwhile, revenue from advertising and commerce is expected to grow by more than 50%, on average, between 1999-2002. As a result, with total revenue showing average growth of more than 30%, along with a material improvement in margins, we look for EBITDA to increase by more than 65% in 2000 and about 40-45% in 2001 and 2002 on a standalone basis. Even better, synergies from the merger should boost EBITDA to about 60% growth in 2001, primarily reflecting cross-selling of advertising, cross-promotional opportunities, and cost savings from the distribution of AOL disks. Accounting for about 32% of AOL Time Warner's total EBITDA after synergies in 2001, AOL is a powerful growth driver for the combined company.

Cable Networks—An Excellent Business With Strong Growth

Overview – One Of The Leaders Of The Industry

Almost 20% of AOL Time Warner's total EBITDA in 2001

As discussed in the industry section of this report on page 18, the cable network business is arguably one of the best businesses in the media and entertainment industry. In general, cable networks benefit from strong top-line growth, some insulation against economic downturns given its dual revenue stream, 20-40% EBITDA margins depending on the ratings success and programming requirements, and virtually no capital expenditures.

AOL Time Warner is one of the leaders in the industry, accounting for about 25% of total basic cable viewing (about 30% of advertising revenue). The division includes the Turner cable networks and HBO, which consists of the following widely recognized brands:

- CNN, cable television's leading news network reaching approximately 73 million subscribers
- TBS – more than 78 million U.S. subscribers
- TNT – more than 77 million U.S. subscribers
- Cartoon Network – more than 60 million U.S. subscribers
- Turner Classic Movies – more than 35 million U.S. subscribers
- Turner South – launched in October 1999
- Boomerang – launched in April 2000
- HBO and Cinemax, reaching 36 million U.S. homes and 12 million viewers internationally

Outlook – We Project 19% EBITDA Growth, On Average, Between 1999-2002E

Table 9: Cable Networks Breakdown—PF1998–PF2002E ($ In Millions)

	1998	1999	2000E	2001E	2002E	% Change 1999	% Change 2000E	% Change 2001E	% Change 2002E
Revenues:									
Cable Networks - TBS	$3,325	$3,942	$4,695	$5,640	$6,677	18.6%	19.1%	20.1%	18.4%
HBO	2,052	2,169	2,345	2,566	2,801	5.7%	8.1%	9.4%	9.2%
Total Revenue	5,377	6,111	7,040	8,206	9,478	13.7%	15.2%	16.6%	15.5%
EBITDA:									
Cable Networks - TBS	799	973	1,144	1,439	$1,729	21.8%	17.6%	25.8%	20.1%
HBO	477	556	636	732	839	16.6%	14.5%	15.0%	14.7%
Total EBITDA	$1,276	$1,529	$1,780	$2,171	$2,568	19.8%	16.4%	21.9%	18.3%
EBITDA Margins:									
Cable Networks - TBS	*24.0%*	*24.7%*	*24.4%*	*25.5%*	*25.9%*				
HBO	*23.2%*	*25.6%*	*27.1%*	*28.5%*	*30.0%*				
Total Cable Margins	*23.7%*	*25.0%*	*25.3%*	*26.5%*	*27.1%*				

Source: Company reports and First Union Securities, Inc., estimates.

Cable networks are a consistent driver of strong growth

As shown in the table above, we estimate that Cable Networks will generate $2.6 billion in EBITDA in 2002, double the $1.3 billion reported in 1998. The strength of the advertising market has been a critical driver of success at the Turner cable networks. A strong up-front market for advertising sales provides visibility for continued strength into 2001. On a normalized basis, we look for high-teens EBITDA growth at the Turner cable networks and 15% EBITDA growth at HBO. Growth is fairly consistent year over year, although quarterly variations can occur. For example, the second quarter of this year should report 15% EBITDA growth at the Turner cable networks, primarily reflecting the near-term increase in programming costs for sports, along with the cost of revamping World Championship Wrestling. These near-term factors should be offset by the tremendous strength of the advertising market on a full-year basis. Synergies from the merger should boost EBITDA growth above 20% in 2001, primarily reflecting the upside from cross-selling of advertising on the cable network's branded websites. We look for EBITDA to grow at a high-teens rate in 2002.

Publishing—Consistently Delivers Double-Digit EBITDA Growth

Overview – Leveraging Key Brands And Managing Costs

About 9% of AOL Time Warner's total EBITDA in 2001

AOL Time Warner is in the enviable position of having many of the most widely recognized brands in the industry – *Time, People, Sports Illustrated, Fortune, Entertainment Weekly,* and *In Style,* just to name a few. These assets provide the company with the means of launching new magazines as brand extensions with far less risk than would otherwise be the case. For example, the off-shoot, *Teen People,* was launched in 1998 and has already tripled its rate base to 1.5 million readers in 2000. With more than 20% of the consumer magazine industry's total revenue, and some of the highest margins in the business (averaging over 16% in 1999), Time Inc. is one of the leaders of the industry.

Synergies of the merger will improve already-strong economics

We expect the merger with AOL to further improve the company's already-strong economics. By leveraging AOL's 26 million subscribers, new launches can be tested at less cost and with a greater chance of success. We also expect the combined company to encourage customers to renew their subscriptions online automatically, using a credit card number that AOL already has on file. The combination of these two initiatives should lead to higher renewal rates, lower subscriber acquisition and mailing costs, and substantially reduced risk over time. We also expect that AOL's relationships with online advertisers should significantly boost the revenue at Publishing's branded websites. Furthermore, by more aggressively packaging magazines with the company's other products and services (i.e., three free months of *Time* for AOL subscribers), some increase in the number of subscriptions can be expected.

We Look for 12-13% Long-Term EBITDA Growth, Synergies Should Boost 2001

Table 10: Publishing Projections—PF1998–PF2002E ($ In Millions)

	1998	1999	2000E	2001E	2002E	% Change 1999	% Change 2000E	% Change 2001E	% Change 2002E
Publishing Revenue	$4,496	$4,663	$4,608	$5,054	$5,398	3.7%	-1.2%	9.7%	6.8%
Publishing EBITDA	687	760	858	1,039	1,171	10.6%	12.9%	21.0%	12.7%
Publishing Margin	*15.3%*	*16.3%*	*18.6%*	*20.5%*	*21.7%*				

Source: Company reports and First Union Securities, Inc., estimates

Fueled by the strength of the brands, and complemented by new magazine launches, we generally expect Publishing to show high-single-digit advertising gains and low-single-digit circulation growth. The result is top-line revenue growth in the 5-6% area. By managing costs, the company has been able to translate this into 11-13% EBITDA growth for years. Taking advantage of the company's online capabilities should allow Publishing to continue to expand margins over time. We look for 13% EBITDA growth in 2000. Synergies from the merger are expected to boost growth to around 21% in 2001 – in particular, boosting online sales at the branded websites should offer low-hanging fruit. More normalized 13% EBITDA growth should follow thereafter.

Warner Music Group—Soon to Become Warner EMI Music

Overview – Only 5% of Total AOL Time Warner EBITDA

Music... a fundamentally good business

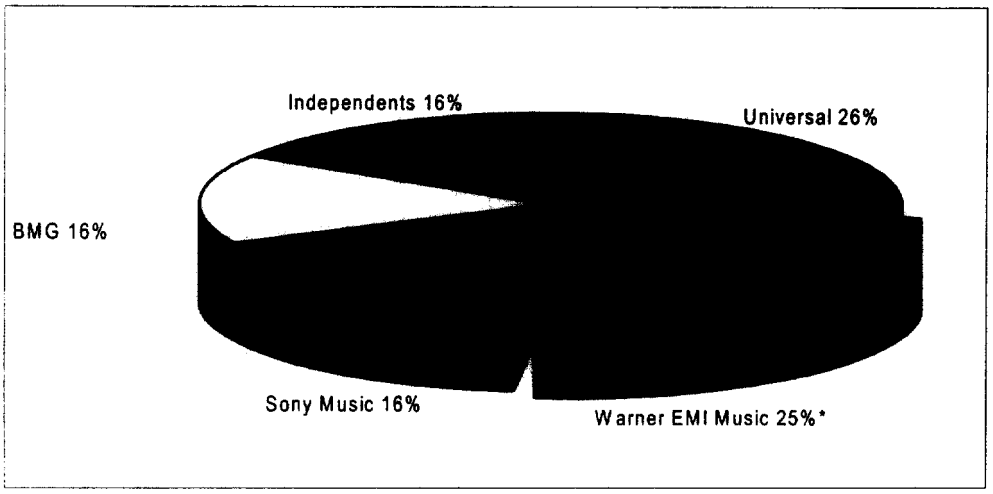
As discussed in detail in the industry section on page 28, we consider the music business to be a good one. The industry offers modest growth, diversified risk, a manageable cost structure, and generates significant free cash flow. Moreover, there is the potential for the Internet to substantially accelerate growth as industry leaders, such as Gerald Levin and Edgar Bronfman, Jr., have predicted. In our view, the impact of the Internet should be noticeable, but not earth-shattering. We estimate 1-2% annual incremental growth in the United States over the next five years; less than 1% worldwide. Of course, we could easily be wrong to be so conservative but, regardless, music is a strong business.

As mentioned when we explained our projections earlier in this report, our numbers are not pro forma for the proposed joint venture between Warner Music and EMI. The information is not readily available to do a complete set of pro forma numbers since the companies have different fiscal years. Moreover, it would add a level of complexity that is not really necessary at this point in time since it is a 50/50 joint venture, and the two entities are of roughly similar size. However, it should again be noted that our numbers for AOL Time Warner are inherently conservative; they do not include the cost savings that are expected from the joint venture in music. The joint venture is expected to close after the AOL Time Warner merger. Nevertheless, it is important to understand the deal...

Joint venture to form Warner EMI Music

The joint venture between Warner and EMI makes good strategic sense. Warner's music operations are weak internationally (and, recently, in the United States as well), while EMI has a stronger international presence. Warner's market share of total albums in the United States was 15.8% in 1999; EMI's was only 9.5%. The merger combines the fourth- and fifth-ranked players into the No. 2 player with 25.2% market share (still behind Universal with 26.4%). International market share data is difficult to come by, but we estimate that Warner EMI will have just over 20% market share globally (again, right behind Universal). These rankings are based on recorded music.

Chart 4: U.S. Market Share Of Total Albums Sold—1999



Source: Soundscan
* Pro forma for Warner Music and EMI announced joint venture

In terms of total revenue, the combined music company would have generated more than $8 billion in 1999, by far the largest in the industry since EMI and Warner also include the No. 1 and No. 2 music publishing operations – a high margin, annuity-like business. Companies will debate over who is bigger based on various metrics, but the point is that Warner EMI will have tremendous scale both in terms of recorded music and music publishing (assuming regulators do not require the company to shed some of the music publishing assets).

Economies of scale lead to significant cost savings

As a result of the combined company's scale, Warner EMI should be able to generate significant cost savings in a relatively short period of time. As a reminder, Universal is on track to save at least $300 million in EBITDA within three years of the closing of PolyGram. Universal's margins are estimated to approach 19% in FY2001 (fiscal year June). In contrast, EMI's margins are only 14%—despite roughly 30% of its EBITDA coming from music publishing, which has about a 30% EBITDA margin. Warner Music's EBITDA margins are also only about 14%. As a result, there is significant room for improvement here. The company estimates $400 million in cost savings a few years after closing the joint venture. We believe that could be conservative since music publishing should allow the venture to show margins that are at least as high as Universal. We will have to wait and see.

The impact of synergies

Cross-promotional opportunities with AOL should also boost the growth rate for music, although we expect the impact of that alone to not be especially material—Warner EMI may have 25% of the U.S. music market, but AOL still needs to provide its subscribers with 100% of the industry's product. However, the music industry as a whole should benefit from AOL potentially accelerating the speed of consumer acceptance of digital downloading. More importantly, we believe that the bigger synergy for music comes from eliminating a potential threat to the music industry. AOL was in the position of pushing whatever digital format of music that was best for the consumer. Now, with ownership of one of the largest music companies in the world, we suspect greater diligence will be made to push consumers to use a format that is more protective of copyrights. This is clearly an un-quantifiable synergy.

Outlook—We Project Low-Double-Digit EBITDA Growth In 2001 And 2002

Table 11: Warner Music Group Projections (Pre-Joint Venture With EMI)—PF1998–PF2002E ($ In Millions)

						% Change			
	1998	1999	2000E	2001E	2002E	1999	2000E	2001E	2002E
Warner Music Revenue	$4,025	$3,834	$3,886	$4,155	$4,422	-4.7%	1.4%	6.9%	6.4%
Warner Music EBITDA	536	523	539	601	665	-2.4%	3.1%	11.4%	10.8%
Warner Music Margin	*13.3%*	*13.6%*	*13.9%*	*14.5%*	*15.0%*				

Source: Company reports and First Union Securities, Inc., estimates

As alluded to in the above discussion, Warner Music Group has had a difficult past few years. Softness in profitability was originally attributed, by the Street, to the weakness in certain international markets, such as Japan, Brazil, and Germany. Undoubtedly, this was partially to blame, but the bigger impact came from losing market share to Universal in the United States (Warner's historical base of strength). This is the entertainment business, and it is fair to expect companies to go through cycles. Warner Music has been bouncing along the bottom of one such valley for a couple of years now. Performance in the June quarter shows signs that the music operations are reaching a turning point, and we are encouraged to see that the release schedule in the second half of the year looks somewhat improved. Nevertheless, it is best to be conservative with expectations for music growth. We look for low-single-digit growth in EBITDA in 2000, followed by a boost in 2001 from merger synergies to 11% growth. Again, this is on a stand-alone basis before considering the joint venture with EMI.

Filmed Entertainment—A Leader In Both Film And Television Production

Overview

As discussed in detail in the industry section on page 41, we view the production of motion pictures as a difficult business, on a standalone basis, generating returns that often do not compensate for the inherent risk. Nevertheless, current production offers strategic benefits to the company as a whole by acting as a locomotive for improving the value of the library and filling the distribution pipe. The Warner Bros. and New Line studios, in total, have about 5,700 feature films and 32,000 television titles – strong assets to leverage across AOL Time Warner's distribution network.

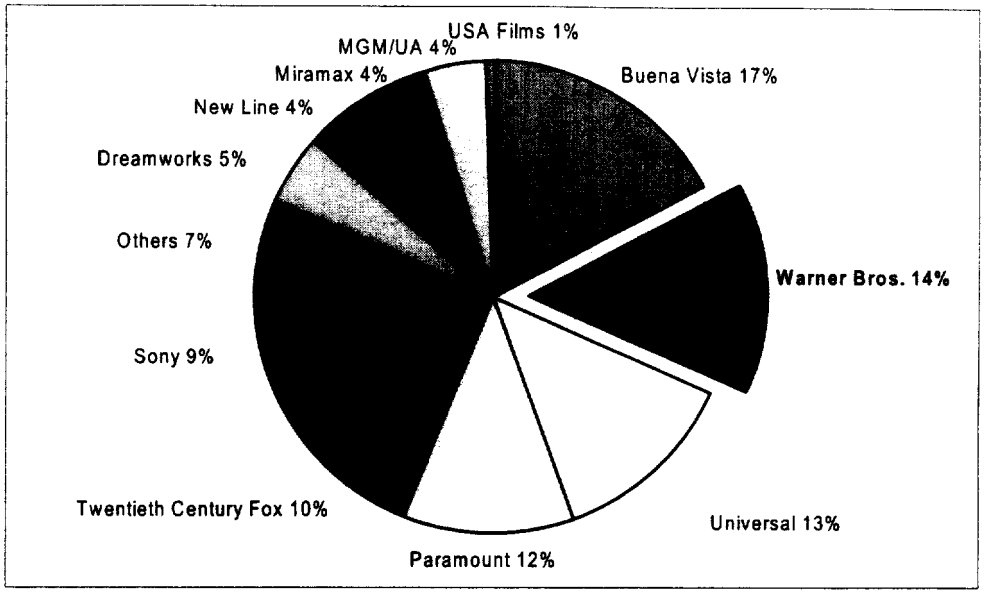
The trick to running the film studio is to intelligently manage the capital employed and diversify risk. Historically relying on high-priced star power, Warner Bros. is now actively managing a diverse slate of 20-25 movies per year, including many co-financed and distribution-only deals. In our view, the upcoming films to keep an eye on include *The Perfect Storm*, *Pokemon 2*, *The Red Planet*, *Harry Potter* (November 2001), and *Lord of the Rings* (a New Line production for the end of 2001).

Table 12: Warner Bros. Film Release Schedule

1999	*Analyze This*	February 26,1999
	The Matrix	March 31, 1999
	Austin Powers: The Spy Who Shagged Me (New Line)	June 11, 1999
	Wild Wild West	June 30, 1999
	Eyes Wide Shut	July 16, 1999
	Deep Blue Sea	July 30, 1999
	Pokemon: The Movie	November 12, 1999
	The Green Mile	December 17, 1999
2000	*Magnolia (New Line)*	January 7, 2000
	Boiler Room (New Line)	February 18, 2000
	The Whole Nine Yards	February 18, 2000
	Romeo Must Die	March 24, 2000
	Love And Basketball (New Line)	April 12, 2000
	Battlefield Earth	May 12, 2000
	The Perfect Storm	June 30, 2000
	In Crowd	July 21, 2000
	Pokemon 2	July 21, 2000
	Space Cowboys	August 4, 2000
	Bait	August 11, 2000
	The Replacements	August 25, 2000
	The Art Of War	September 8, 2000
	Chain Of Fools	September 15, 2000
	Play It Forward	October 6, 2000
	Best In Show	October 13, 2000
	Get Carter	October 20, 2000
	Red Planet	November 10, 2000
	13 Ghosts	December 8, 2000
	Proof Of Life	December 15, 2000
	Miss Congeniality	December 22, 2000
	The Pledge	Holiday
2001	*Osmosis Jones*	Future
	Metal God	Future
	See Spot Run	Future
	Sweet November	Future
	Angel Eyes	Future
	Collateral Damage	Future
	Summer Catch	Future
	A.I.	Future
	Lord Of The Rings (New Line)	October
	Harry Potter	November

Source: ACNielson and Company data

Chart 5: Major Studio Market Share—1999



Source: ACNielson data

The real driver of profitability at the studio is television production. The company enjoys an annuity-like stream of revenue from hit network series, including *Friends, ER, The Drew Carey Show*, and *Seinfeld*, as well as top first-run syndicated shows, such as *Rosie O'Donnell*. The company does not break out details of the Filmed Entertainment division, but we estimate that about 60% of EBITDA is derived from television production. The other 40% is split between film and consumer products. While it is difficult to grow the television business off of such a high base, modest growth should be achievable over time given pricing increases in the syndication market and barter advertising sales. In addition, the studio is still one of the top suppliers of new series, delivering seven new shows and 11 returning series in the upcoming network season.

Synergies of the merger with AOL are expected to be primarily strategic in nature, allowing AOL to accelerate the supply of interactive content. Nevertheless, there should also be some modest operating efficiencies as AOL spurs some incremental revenue and marketing-cost savings through cross-promotional opportunities.

Outlook – Estimated To Account For About 10% Of Total EBITDA

Table 13: Filmed Entertainment Breakdown—PF1998–PF2002E ($ In Millions)

	1998	1999	2000E	2001E	2002E	% Change 1999	% Change 2000E	% Change 2001E	% Change 2002E
Revenues:									
Warner Bros.	$6,061	$6,628	$7,168	$7,710	$8,263	9.4%	8.2%	7.6%	7.2%
Filmed Entertainment - TBS	1,917	1,447	1,514	1,614	1,715	-24.5%	4.6%	6.7%	6.2%
Total Revenues	7,978	8,075	8,682	9,324	9,978	1.2%	7.5%	7.4%	7.0%
EBITDA:									
Warner Bros.	669	731	745	855	940	9.3%	2.0%	14.7%	10.0%
Filmed Entertainment - TBS	198	216	226	259	284	9.1%	4.9%	14.6%	9.5%
Total EBITDA	$867	$947	$972	$1,114	$1,225	9.2%	2.6%	14.6%	9.9%
EBITDA Margins:									
Warner Bros.	11.0%	11.0%	10.4%	11.1%	11.4%				
Filmed Entertainment - TBS	10.3%	14.9%	15.0%	16.1%	16.6%				
Total Filmed Entertainment Margin	10.9%	11.7%	11.2%	11.9%	12.3%				

Source: Company reports and First Union Securities, Inc., estimates
Note: 1999 Warner Brothers line excludes a $215 million gain from video distribution settlement with MGM, $97 million for the sale of 10% interest in Canal Satellite, and a non-cash charge of $106 million relating to the WB retail store.

As shown in Table 13 above, which has been adjusted for a $215 gain on the termination of a video distribution agreement with MGM and other non-recurring items, we look for Filmed Entertainment to generate EBITDA of $972 million this year, up 3% from 1999. The first quarter of 2000 showed strong gains at New Line, but the second and third quarters will both face difficult comparisons. The June quarter of last year had the hit *Austin Powers: The Spy Who Shagged Me* at New Line, and the September quarter of 1999 was boosted primarily by the syndication of *The Drew Carey Show*. This year's production of further episodes of *Friends* and *Drew Carey*, along with tremendous strength in barter syndication, should only partially offset last year's high hurdle. As a result, we expect EBITDA to be up only in the low-single-digit area. Normalized EBITDA growth is projected to be around 10% going forward, although 2001 may see further upside as synergies from the merger are included.

WB Network—We Project Breakeven In 2002; Network Is A Small Piece Of The Combined Company

The WB Network has suffered a minor setback for the coming year; ratings are down 17% season to date. As a result, the network only took in about $425 million in the upfront advertising market, versus $450 million last year. However, since it held back some inventory, hoping for better ratings for the scatter market, it is probably reasonable to assume that unit prices were flat in the upfront market for primetime programming. We assume that with programming for the other day-parts up 10%, and scatter pricing up 15%, the network should still be able to increase revenue for 2001 in the high-single-digit area. The company's original hope was for breakeven in 2000. We now think that is probably two years away, although it is largely inconsequential for a company the size of AOL Time Warner.

Table 14: WB Network Breakdown—PF1998–PF2002 ($ In Millions)

	1998	1999	2000E	2001E	2002E	% Change 1999	% Change 2000E	% Change 2001E	% Change 2002E
WB Network Revenue	$260	$384	$453	$495	$588	47.7%	18.1%	9.2%	18.7%
WB Network EBITDA	(92)	(91)	(58)	(18)	44	-1.1%	-36.5%	-68.0%	-337.3%

Source: Company reports and First Union Securities, Inc., estimates.

Cable—New Services Will Drive Growth, Strong Strategic Value

Overview

An above-average business given strong potential of new services

As discussed in detail in the industry section on page 35, a few years ago we would have characterized cable as only a fair business given its high capital intensity. Today, the power of cable's growth prospects as the preferred conduit for reaching the consumer justifiably bumps it up a notch or two to an "above average" business. This view is based on the growth and free cash flow prospects for the underlying business, not including the strategic value that it holds for AOL. We have already discussed several times throughout this report how owning cable is a major synergy of the merger—it prevents the potential erosion of AOL's subscription revenue by stimulating commercially negotiated open access and expanding the reach of content and community across higher-bandwidth users. Here, we will focus the discussion on the underlying fundamentals for Time Warner cable.

First, the facts. Time Warner cable includes 12.6 million subscribers, reaching about 20% of the country (20.6 million homes passed). The subscribers are held within different areas of the corporate structure. Of the 12.6 million subscribers, 10.9 million are consolidated and 1.7 million are off-balance-sheet. Of the 1.7 million in off-balance-sheet subscribers, 1.2 million are held within the TWE-Advance/Newhouse partnership (of which Advance/Newhouse owns 33%) and the remainder are in the TWE partnership. Of the 10.9 million consolidated subscribers, 1.8 are held at the Time Warner corporate level, while the bulk (9.1 million subscribers) are held within the TWE partnership. Of the 9.1 million subscribers within TWE, 5.5 million are embedded within the TWE-Advance/Newhouse partnership. Confused? If so, that's fine. We provide the detail just in case the reader wants to understand the numbers behind our net asset value analysis.

We look for 12-13% revenue growth before making any assumptions for cable telephony or synergies

The cable industry is less about traditional video services than it is about offering consumers enhanced video (more channels and video on demand), data (high-speed Internet access and e-commerce), and voice (cable telephony) services. As a point of evidence, many of the biggest investors in cable—not just AOL, but also AT&T and Microsoft—view the cable pipe as a means to an end. This is certainly true for AOL Time Warner's cable system, which is more capable of offering non-traditional services than any other competitor, since it is further along with its upgrade to 750 Mhz. The upgrade was 85% complete at the end of 1999 and is expected to be finished by the end of this year (after which, capital spending is presumed to come down to about $1.6 billion in 2001).

There are a number of factors that contribute to our 12-13% revenue projection for Cable (see Table 15 for details):

- Basic subscribers are expected to grow between 1.5-2.0% over the next few years.
- Pricing increases on basic cable service are projected at about 5% going forward. In contrast, pricing increases have been in the high-single digits in recent years. However, Time Warner is now less reliant on basic price increases as its new services roll out. It also helps to keep pricing increases modest to avoid regulatory problems and to remain competitive against satellite service providers.
- These first two factors are estimated to contribute between 5-6% to Cable's revenue growth rate over the next three years. (Note that the math does not work to simply add subscriber growth and basic pricing growth since these traditional services will account for a declining percentage of total Cable revenue.)

Traditional cable contributes 5-6% growth

- Local advertising on the company's cable systems is estimated at about $675 million this year. This is likely to be conservative since we simply took 20% of our estimate for the total cable industry's advertising (to match AOL Time Warner's percentage of homes passed). This source of revenue should continue to see strong double-digit growth given the strength of the overall advertising market, as well as the benefits of geographic clustering (which makes advertising buys easier). This contributes about 1-2% to Cable revenue growth.

Advertising contributes 1-2% growth

- Digital set-top box subscribers are estimated to grow from 430,000 at the end of 1999 to 1.75 million at the end of this year. Digital subscribers could approach 5 million by the end of 2002, representing roughly 25% penetration of homes passed. These digital set-top boxes will offer not only more channels, but also an electronic program guide and, eventually, true interactive television services, such as video-on-demand (VOD) and e-commerce. We assume an incremental $12 per subscriber in the near term to account for the cost of the box (which gets spread over all cable subscribers), the electronic program guide, and the charge for the digital-tier channels. Over time, this should increase as subscribers spend more on pay-per-view viewings and, eventually, interactive services. We estimate that digital set-top boxes contribute 3%-4% to Cable's revenue growth rate.

Digital set-top boxes contribute 3-4% growth

- High-speed Internet access cable subscribers are projected to more than double this year from the 330,000 cable modems at the end of 1999. Subscribers are expected to increase to 1.7 million by the end of 2002, reflecting 9% penetration of homes passed. Having AOL as a partner to spur demand is clearly a long-run benefit, but since the immediate bottleneck is installation speed (not demand), we are assuming no material near-term synergies of the merger for cable modems. Assuming the cable operator will retain roughly three-quarters of the estimated $40 per month subscriber charge over time, we project that high-speed Internet access should contribute 2%-3% to the company's Cable revenue growth rate.

Cable modems contribute 2-3% growth

- These five factors should lead to 12-13% growth for Cable over the next three years. This does not include the impact of cable telephony, which is on the negotiating table with AT&T. It is premature to build telephony revenue into our model at this stage. However, it is probably fair to say that it would likely be a disappointment if cable telephony did not contribute a couple of percentage points of growth to Cable's growth rate starting in a few years. As a result, while growth would normally start to decline slightly in 2003-2004, telephony should keep Cable revenue growth at least in the 12-13% area (or perhaps higher). We will wait and see.

Cable telephony is additive but unclear at this point

Table 15: Breakdown Of Cable Projections (Pre-Synergies)—1998–2002E (In Millions)

	1999	2000E	2001E	2002E
Traditional Cable	$4,709	$5,039	$5,366	$5,715
Traditional Cable Growth		*7.0%*	*6.5%*	*6.5%*
Cable Advertising	569	674	775	892
Cable Advertising Growth		*18.5%*	*15.0%*	*15.0%*
Digital Set-Top Box Revenues	31	170	393	672
Digital Set-Top Box Growth		*449.2%*	*131.1%*	*71.0%*
Cable High Speed Internet Access Revenues	65	162	319	490
Cable High Speed Internet Access Growth		*148.8%*	*96.7%*	*53.7%*
Total Revenues (Before Telephony)	**$5,374**	**$6,045**	**$6,853**	**$7,768**
Total Revenue Growth (Before Telephony)		***12.5%***	***13.4%***	***13.4%***
Contribution to Total Cable Revenue Growth				
Traditional Cable		6.1%	5.4%	5.1%
Cable Advertising		2.0%	1.7%	1.7%
Digital Set-Top Boxes		2.6%	3.7%	4.1%
Cable High Speed Internet Access		1.8%	2.6%	2.5%
Total Cable Revenue Growth		**12.5%**	**13.4%**	**13.4%**
Time Warner Cable Assumptions:				
Total U.S. TV Households	100	101	102	103
Total Basic Cable Subscribers	12.6	12.9	13.0	13.2
Consolidated Basic Cable Subscribers	10.9	11.1	11.3	11.5
Consolidated Homes Passed	17.8	18.2	18.4	18.7
Digital Subscribers	0.4	1.8	3.3	4.8
Cable Modem Subscribers	0.3	0.8	1.2	1.7
Basic Cable Subscriber Growth	0.0%	2.0%	1.5%	1.5%
Digital Subscriber Growth	nm	307.0%	85.7%	46.2%
Cable Modem Subscriber Growth	217.3%	127.3%	60.0%	41.7%
Basic Cable Subscriber Penetration of Homes Passed	61.2%	61.2%	61.2%	61.2%
Digital Subscriber Growth of Homes Passed	2.4%	9.6%	17.6%	25.4%
Cable Modem Subscriber Growth of Homes Passed	1.9%	4.1%	6.5%	9.1%
Average Digital Subscribers	0.2	1.1	2.5	4.0
Average Cable Modem Subscribers	0.2	0.5	1.0	1.5
Revenue/Digital Set-Top Box Subscriber	$12	$13	$13	$14
Revenue/High Speed Internet Access Subscriber	$25	$25	$27	$28

Source: Company reports and First Union Securities, Inc., estimates

It is important to note that the return on investment for the incremental services outlined above appears to be quite high. For example, with a 60% EBITDA margin on $12 per month incremental digital set-top box revenue, the after-tax unlevered cash return on investment for the box (costing about $300, including installation) would be about 25%. Therefore, the new services appear to represent profitable incremental growth.

Outlook – We Project 14% EBITDA Growth, On Average, Between PF1999–PF2002E

Table 16: Cable Projections (Post-Synergies)—PF1998–PF2002E (In Millions)

						% Change			
	1998	1999	2000E	2001E	2002E	1999	2000E	2001E	2002E
Cable Revenue	$5,342	$5,374	$6,045	$6,953	$7,918	0.6%	12.5%	15.0%	13.9%
Cable EBITDA	2,288	2,466	2,809	3,218	3,639	7.8%	13.9%	14.6%	13.1%
Cable Margin	*42.8%*	*45.9%*	*46.5%*	*46.3%*	*46.0%*				

Source: Company reports and First Union Securities, Inc., estimates
Note: Cable EBITDA figures are adjusted for non-recurring items

We estimate Cable should generate $2.8 billion in EBITDA in 2000, up 14% over last year. We look for a slight boost in 2001 (to almost 15%) from the onset of merger synergies, followed by 13% thereafter. These modest near-term synergies primarily reflect the cross-promotional opportunities to drive basic and premium cable services. It is also worth noting that we are somewhat conservatively assuming very slight margin pressure in 2001 and 2002, although there are no signs to suggest that to date. If all goes according to plan (not normally the case for the cable industry), AOL Time Warner's cable division should start to generate meaningful free cash flow in 2001 once the build-out to 750 Mhz is complete. We are partial to businesses that regularly produce free cash flow. That being said, the outlook for AOL Time Warner's cable business looks strong. However, regardless of free cash flow, there is no doubting the strategic value that cable plays within the larger company.

Digital Media

At the moment, Digital Media includes those businesses that are independent commercial ventures over the Internet – in contrast to marketing and brand extensions. The plan was for this division to include four vertical portals, based on various themes, such as Entertaindom, news, and two others that have yet to be announced. Whether this remains a separate division on the income statement following the merger is unclear (probably not is our guess). Nevertheless, what *is* clear is that the initial start-up losses of $200–250 million per year are no longer valid once the merger is complete. Leveraging AOL's expertise, infrastructure, and subscribers should significantly reduce the initial losses. We look for losses to lessen from $200 million in 2000 to $100 million in 2001, likely breaking even by 2003.

PROJECTIONS FOR JUNE QUARTER

Please note that our standalone models for AOL and Time Warner are provided at the end of this report as Tables 19-22. Since the merger is expected to close in the fall, the pro forma projections for 2001 and 2002 are most meaningful from an investment standpoint. Nevertheless, it is still important to gauge the near-term momentum of the business. Our read is that the operating momentum for AOL is quite high, while Time Warner should show a solid (but not stellar) quarter. The dynamics at play have already been discussed throughout this report, so we will be brief here.

- **America Online.** We look for EBITDA in the June quarter of $543 million, up about 67% from $326 million last year. Earnings are expected to come in at around $0.11 per share, up from $0.06 per share last year and $0.10 per share in the March quarter. This reflects 31% growth in subscription service revenue, driven by a similar increase in the average number of U.S. subscribers. AOL is projected to add 900,000 AOL-branded subscribers in the quarter. Complementing this strong growth, advertising and commerce revenues are projected to show another quarter of powerful upside – rising more than 90% from last year. With total revenue expected to increase by 42%, along with continued improvement in the cost of revenue (due to declining telecommunication network charges), we look for powerful EBITDA growth.

- **Time Warner.** While we believe EBITDA will be the commonly used measure of operating performance following the merger, Time Warner currently reports EBITA (after depreciation). We expect the company to show EBITA of $1.310 billion, up only 5% from last year after adjusting for non-recurring items. However, this number still misrepresents the underlying momentum in the quarter, since it includes Digital Media start-up losses. Excluding these initial investment costs, EBITA in the quarter should rise by about 10% over last year – a few percentage points lower than the normalized long-term growth rate. The primary culprits are short term in nature and offer no cause for alarm. Cable Networks are expected to grow in the 15%-16% range (slightly below the long-term rate), primarily reflecting slower growth for the Turner networks. Higher amortization of programming costs, including the NBA contract, along with weakness in World Championship Wrestling (WCW) are a drag in the quarterly performance for Cable Networks. Music is expected to show some improvement in the quarter over recent results given the success of several new releases, but the division should still be about flat. Filmed Entertainment should also be flat in the quarter as New Line faces difficult comparisons against *Austin Powers* last year. Publishing, Cable, and the WB Network should offer consistently solid performances. Earnings per share should come in at around $0.07, down from $0.12 per share last year – tracked by FirstCall, but paid little mind by investors at this point.

INVESTMENT RISKS

As is true for all of the companies that we cover, AOL Time Warner is vulnerable to macro-level dynamics outside of its control.

- **Economic Downturn**. AOL Time Warner is clearly vulnerable here. We believe that the advertising market is still cyclical despite the uninterrupted growth experienced for the past decade. Cable Network's advertising would likely fair relatively well in an economic downturn (given its low-cost pricing and subscriber fees), and AOL's backlog would also offer some protection. Nevertheless, we expect that the downside from current estimates would still be quite meaningful. AOL Time Warner generates approximately 25% of total revenue from advertising. Moreover, entertainment is not a necessity during a severe economic slump, thereby hurting publishing, music, film, and AOL's subscriber growth.
- **Market Downturn**. We believe that in a bear market, investors would gravitate to those stocks with traditional valuation metrics. While we consider AOL Time Warner's growth prospects to be currently trading at an extremely reasonable value, companies analyzed using EBITDA or even cash earnings could fair poorly.

In addition, AOL Time Warner could also suffer from the following unique risks:

- **Integration Risk.** The recent merger raises the issue of integration risk, in which there is always some risk of management turmoil, political infighting, and a disruption in the fundamental business. On all accounts, the merger appears to be transitioning smoothly. The proposed management structure seems to keep all key business heads doing what they do best, and our sense is that employees are excited about the new opportunities. Remember that this is not a situation in which there is extensive overlap of personnel. As a result, there is little need for the typical in-fighting that can prove disruptive during the integration period.
- **Regulatory Risks.** We see little risks on this front. Of course, a merger of this size will be put through the ringer, but we expect few material concessions to be required. Again, this is not a horizontal merger resulting in the new domination of key markets. If one wanted to accuse the company of having monopoly power, those same critics could have made a similar argument for each company on an standalone basis. For example, much was made in the press of Time Warner Cable's "monopolistic" power to block ABC's content. While at the end of the day this proved to not be true given the appeal to the content, AOL's market power in the Internet space had little to do with the situation. The one major sticky area could have been high-speed Internet access over cable, if the company decided (unwisely) to use Time Warner's cable on an exclusive basis. Having taken clear steps towards open access for multiple ISPs (thereby promoting competition), the company has effectively nullified a potential problem. On a separate note, as mentioned in the music section, the joint venture between Warner Music and EMI may result in too much concentration in the music publishing business. While music publishing is a regulated industry, we would not be surprised to see the requirement of certain asset sales.
- **Perceived Risk In Exposure To Internet Advertisers**. The company consistently culls the advertising backlog to eliminate contracts at risk. Moreover, many companies that are considered "Internet advertisers" are the Internet arms of major corporations. For example, Blockbuster.com has a multi-year deal with AOL. It is an Internet advertiser by definition, but the chance that Viacom would allow its subsidiary to default on payments is close to zero. Those companies that do not have the backing of a major parent, and are judged to be a risk, are typically required to make cash payments in advance. We judge the actual risk here to be relatively small. However, if investors become worried that the backlog is at risk (even if it is not), then the damage to the stock price is already done—perception matters.

Additional information available upon request.