

Transaction Overview

Overview

A \$350 billion merger creates the first company of a new era in media and Internet.

The \$350 billion proposed merger of America Online and Time Warner should create the defining media and communications company of the Internet era, with \$37 billion in projected annual revenue in 2000, \$9 billion in projected annual EBITDA, and the world's leading combination of content, distribution, Internet experience and broadband assets.

The terms of the deal call for every Time Warner share to be exchanged for 1.5 shares of AOL, with no collar on the transaction. Based on stock prices at the time of the announcement, the merger offered a 71% premium for Time Warner's stock. AOL's shareholders would own 55% of the new company; Time Warner's shareholders, 45%. While the amortization of goodwill created by the transaction's purchase accounting will be dilutive to GAAP earnings, we note that the transaction is strongly accretive to cash earnings (or, EPS + Goodwill Amortization). The transaction is expected to close in fall 2000.

Five key strategic factors underlie and arise from the merger of AOL and Time Warner: 1) AOL's dominant presence across the broad Internet landscape provides the ideal platform for bringing Time Warner's media assets into the digital world; 2) Time Warner's portfolio of recognized traditional media brands, alongside AOL's constellation of interactive Internet brands, forms the most attractive content engine in the media business; 3) The combined audience reach and marketing muscle of the new company will open up new advertising and e-commerce opportunities for both companies' customers and partners, boosting the most profitable revenue streams in both companies; 4) The installed and established infrastructures of both companies will provide unique cost advantages and operating leverage; and 5) The two companies together are poised to use their respective leadership positions to accelerate a unified international strategy built on the interactive future of media.

Regulatory Issues

While the two companies will likely fit nicely together, with little direct overlap, the concentration of media/online properties will be significant when compared to the second- and third-largest players in the field. As a result, the government may give special scrutiny to a deal of this magnitude. However, we would not expect any major regulatory roadblocks to arise in the end. Indeed, we believe that it is highly unlikely that the government will condition the merger, given the lack of overlapping businesses and the lack of aggregation of market share in one single industry. The recent AOL/Time Warner Memorandum of Understanding, proposed on cable Internet operating practices, is an important step toward allaying political concerns related to the "open access" issue. Further steps in this direction are likely to facilitate the approval of the merger transaction.

Integration/Execution Risk

Combining the efforts and activities of these companies will be a Herculean task. Inevitably, egos and cultural issues will surface. While Time Warner is managed in a decentralized fashion with an entrepreneurial spirit, the company has a long heritage in media. In contrast, AOL is a young company with a shorter track record of meteoric success. We believe a watershed deal like this must inevitably become the focal point of senior management's time and energy, potentially stealing attention away from running the business. While starting with a blank page to outline the new company's business model and management structure is probably intelligent, the near-term fluidity does pose some risks. In addition, it will be continually important for Chairman Case and CEO Levin to set a tone of cooperation, integration, and determination during and beyond the merger period. AOL Time Warner has yet to finalize its reporting structure.

Ability to Create "Transforming" Businesses

The big picture success of the AOL/Time Warner deal will depend, in the long run, upon management's ability to create new businesses that transform the way we communicate with each other and interact with various media. Many of these new businesses cannot currently be identified, as they will likely germinate from the new business model being created by the merger. The raw power of the asset mix, coupled with what we believe will prove to be a winning management team, should yield creative solutions that will prove to be financially viable. However, the ability to create "transforming" solutions cannot be guaranteed.

America Online's Objectives

Picking the right partner to propel the mission and capture even greater value.

While no single business dynamic or competitive strategy propelled AOL into its merger with Time Warner, we believe that three key considerations significantly influenced and guided AOL throughout the decision process:

- ▶ First, we believe that AOL sought to transform and reposition the company to capture an increasing amount of value as the nature of consumer online activity changes and evolves over time.
- ▶ Second, we believe that AOL's decision to move more deeply into the media and communications world by way of this strategic acquisition arose out of Steve Case's corporate mantra and mission statement: To make AOL as essential as the telephone and as entertaining as the television, and more valuable than both.
- ▶ Third, we believe the particular combination with Time Warner was motivated by a desire to gather the necessary brands, content, people, financial firepower, and distribution assets to build a wide array of wholly new interactive businesses.

Contrary to the views of some investors, we do not believe that AOL was significantly motivated either by a raw desire to own a large-scale cable television system *or* by fears about the future of pricing for Internet access services. Had ownership of cable television systems been AOL's primary objective, the company might have pursued a merger with or acquisition of one or more independent cable companies, at far smaller cost and much less exposure to integration risk. Of course, neither Cox Communications, Charter Communications, nor Adelphia Communications would have given AOL the cable presence that Time Warner does, but these alternatives might have been attractive enough had cable ownership alone been AOL's objective.

Likewise, if ISP pricing risk were AOL's primary concern, the company might have focused its energies toward purchasing, or partnering with, DSL or other high-speed access provider companies (which generally provide high-speed access to Internet users at premium rates), instead of acquiring the largest media company in the world.

Transformation requires boldness and creates risk, but can lead to tremendous new value.

Before moving into the more detailed portion of our discussions, it is worthwhile to explain in more detail what we believe were AOL's guiding strategic considerations. The process that ultimately led to the January 10 announcement of the pending merger between AOL and Time Warner began in earnest in spring 1999, and from the outset, AOL sought a "transforming" transaction. Management's most basic desire was to leverage and extend the strategic advantages attendant to AOL's status as the leading company in the fastest-growing industry in the world. In doing so, AOL sought to bolster existing businesses, accelerate the growth of new businesses, address certain strategic weaknesses, and broaden and diversify the company's operating base. In full analysis, AOL's motives and objectives are too many to count and too complex to accurately summarize, but we nonetheless believe three guiding factors were at work.

*Better, easier, faster
technology is changing
usage.*

Capture Increased Value as Nature of Usage Evolves

If there was any one development, trend, metric or number in AOL's businesses that could be said to have influenced the company more than any other such item, we believe it is the clear change in AOL usage patterns that is occurring as modem speeds and access technologies get faster over time. Furthermore, we do not believe, as some observers have suggested, that falling ISP prices or AOL's significant equity value and strong equity currency were the most influential statistics driving the deal.

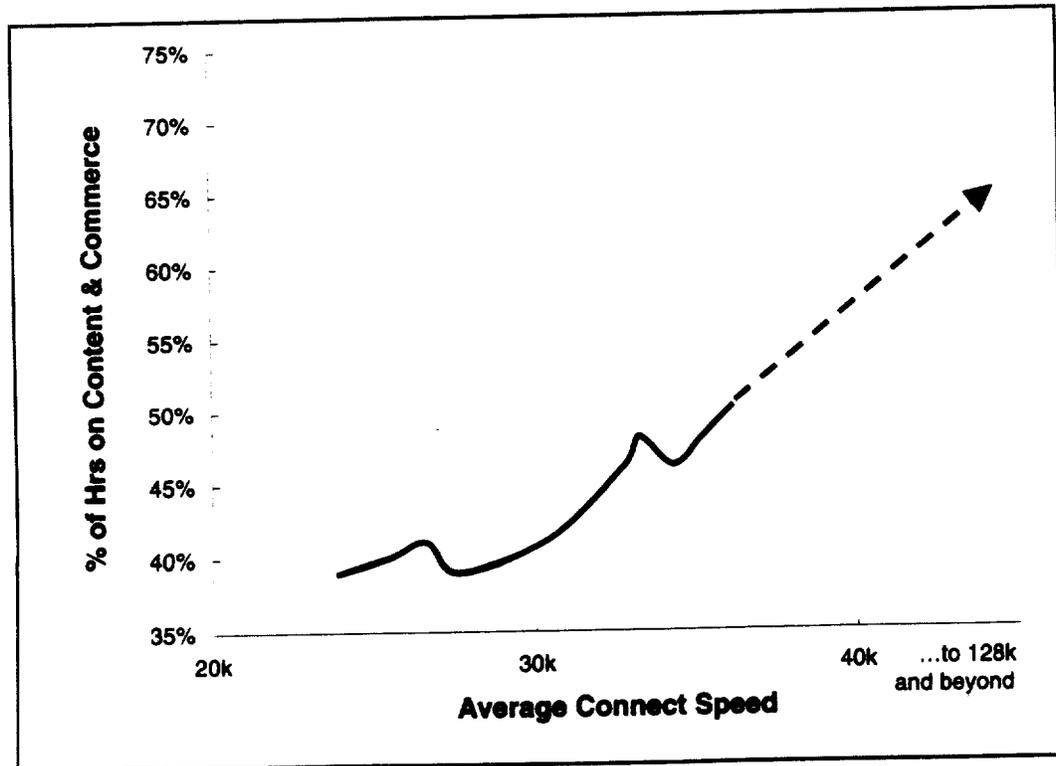
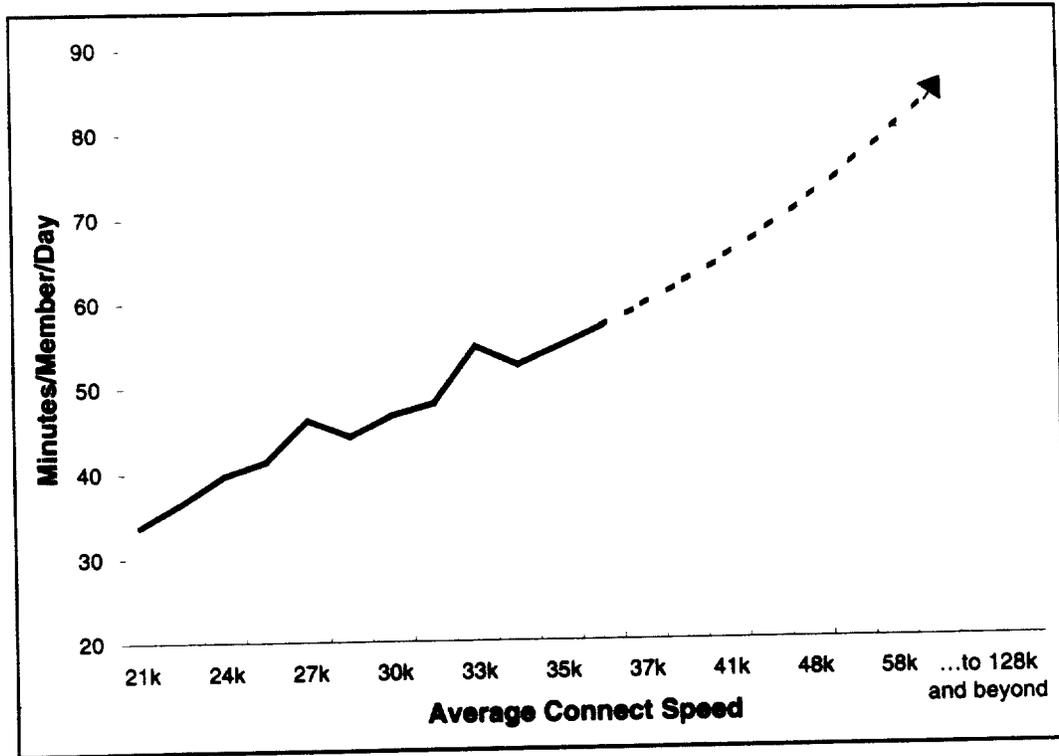
From the end of 1995 to year-end 1999, the average Internet connection speed employed by AOL's membership base has increased from 14.6 Kbps to 36.1 Kbps. Whereas 86% of AOL's members used 19.2 Kbps or slower modems in accessing the service at the end of 1995, over 36% of AOL's users are now on modems with 56 Kbps or faster capabilities. The steady increase in user access speeds has had several implications for AOL and its members:

First, as connection capacity has increased, AOL has been able to expand and improve the content and services delivered to its members. A good example of this would be the stronger offering of interactive games, which often require greater speed capacity. Second, as the service and user experience have improved, usage has increased. Before AOL abandoned its metered-minute pricing model in December 1996, the average AOL user was spending only 17 minutes per day on the service. Within a year of moving to flat-rate, use-all-you-want pricing, AOL's average member increased usage to 41 minutes per day. Eighteen months later, AOL's average user is online through the service 52 minutes per day (see Figure 3 below).

*User time is rising and
more of it is going to
content and
destinations.*

Third and perhaps most crucial, as the service itself has improved and usage per member continues to rise, the amount of time users spend engaged by content and/or online destinations has grown as a proportion of overall user time. In other words, as connection speeds have risen, the proportion of time spent by users on content and online destinations has expanded, even as usage per person has risen.

Figure 3. America Online Analysis of Average Speed and Minutes/Member/Day



Source: Company data and Salomon Smith Barney

Figure 4. America Online Historical Data of Average Connect Speed and Minutes/Member/Day

	1995		1996				1997				1998				1999			
	Sept.	Dec.	Mar.	Jun.	Sep.	Dec.												
Average Speed (in kbps)	13.3	14.6	16.3	18.1	19.3	20.3	21.5	22.7	23.9	25.5	26.5	27.6	30.3	32.7	33.2	34.2	35.2	36.1
Minutes/Member/Day (in minutes)	14	14	14	13	14	20	34	37	40	41	46	44	47	48	55	52	55	57

Source: Company reports and Salomon Smith Barney

**Internet access speeds
are about to get a lot
faster...**

With the usage trends described above already well documented in AOL's operating experience, we believe that the inevitable shift toward much faster broadband Internet access speeds must have gained the attention of AOL's strategic thinkers. Whereas user access speeds have grown only incrementally in the past — from 18.8 Kbps to 28.8 Kbps to 56.6 Kbps — the move to broadband access promises a change in user speeds that could be of a order of magnitude larger than anything AOL has ever seen. Previously, Internet access speeds have grown in increments ranging from 50% to 100%; however, with broadband, access speeds will jump by 25x overnight. For example, broadband residential services offer speeds up to 1.5 Mbps (or 1,500 Kbps), which is a 2,550% increase from the highest speed of dial-up connections at 56.6 Kbps. We anticipate that in the not-too-distant future, users will be able to obtain access speed through a cable modem of up to 2.0 Mbps, and through DSL of up to 3.0 Mbps. However, in most instances, broadband Internet access services currently deliver data at rates of anywhere from 128 Kbps–1.5 Mbps.

**...magnifying usage
trends already
established.**

As consumers eventually begin to use broadband Internet access in increasing numbers, we anticipate two straightforward changes in the online marketplace: 1) Usage per person will increase sharply, and 2) the proportion of users' time spent on content and destinations will expand further. Against this backdrop, AOL by itself might have faced increased operating challenges and a gradual weakening in strategic position. If minutes of use per member rise, but the bulk of the increase in user time is spent with content and destinations instead of AOL services and channels, the company could lose some of its financial traction. At the same time, if content becomes an increasingly important part of the AOL consumer proposition, then it is fair to project that the providers of content might move into positions of greater strategic leverage and financial clout vis-à-vis AOL. Thus, the company's ability to charge the creators of content for distribution and carriage within AOL's services could be weakened in this way by a change in user habits arising from the next leap in user access speeds.

However, with the addition of Time Warner's content assets, brands, and library of interesting subject matter, we believe AOL will be in an improved position to retain and capture an expanded share of its members' online usage minutes. Of course, we still expect AOL to carry and distribute the online content of a host of other programming partners. However, the company's intended ownership of Time Warner provides not only strategic opportunity to capture a larger share of usage on wholly-owned content and destination sites, but also, control of Time Warner protects AOL's content options, providing negotiating leverage should the content creators move into positions of increased strategic strength over time.

Pursue the Steve Case Mission

Chasing the telephone and challenging the TV—to become more valuable than both.

Over the past couple years, AOL Chairman and CEO Steve Case has refined and simplified an overall mission statement for the company, which we believe helps explain and anticipate the merger with Time Warner. It has been Mr. Case's mission to see AOL become "as essential as the telephone, as entertaining as the television, and more valuable than both." In our opinion, AOL has historically made greater progress on the telephone/essentiality front than it has on the television/entertainment front, and the merger with Time Warner, while it provides opportunity to advance on both fronts, should enable AOL to dramatically expand the entertainment value of its service over time.

Measuring AOL's progress along the strategic lines that Mr. Case has set as priorities is difficult and largely subjective. However, we believe that the success of AOL's unique bundle of Internet access, online content, and interactive services has depended to a large degree upon the convenience and ease of use of the AOL service. The AOL e-mail account has become a must-have and nearly-essential part of daily life for many of AOL's members. Each day, AOL handles more e-mail volume for its 22 million members than the amount of traditional mail handled by the U.S. Postal Service. AOL's instant messaging and chat services have become a daily part of adolescent life and teenage communication. With these benchmarks in mind, one might conclude that AOL has made reasonably good progress toward building an essentiality into its service, which, while still well shy of that of the telephone, is becoming a more credible rival all the time.

On the television side, AOL had made progress toward establishing itself as an entertainment vehicle, but we believe AOL's functional and convenience value still outstrip its entertainment value in the eyes of most consumers. According to Nielsen, the average American household watches seven hours of television each day, a number so large that it is somewhat difficult to fathom (or believe). In comparison, AOL's members have recently surpassed an average of one hour of use per member per day. Clearly, television still has an enormous edge on AOL in terms of occupying consumers' leisure moments and providing their main source of daily entertainment and information.

All the "dials and levers" are working...

AOL's pursuit of the Case mantra explains the company's growth strategy: Build greater functionality and convenience into the AOL services to spur increased adoption or penetration for AOL, while also establishing greater user loyalty and dependence over time; and, at the same time, deepen and broaden the AOL content and services in order to gain an increasing share of the consumers' time, attention, interest and spending. The strategic formula has worked financially too: As AOL's subscriber numbers have risen over time, minutes of use per person have grown; revenue per member continues to climb, and sales, margin, and earnings have exploded.

...and Time Warner will help turn up the volume.

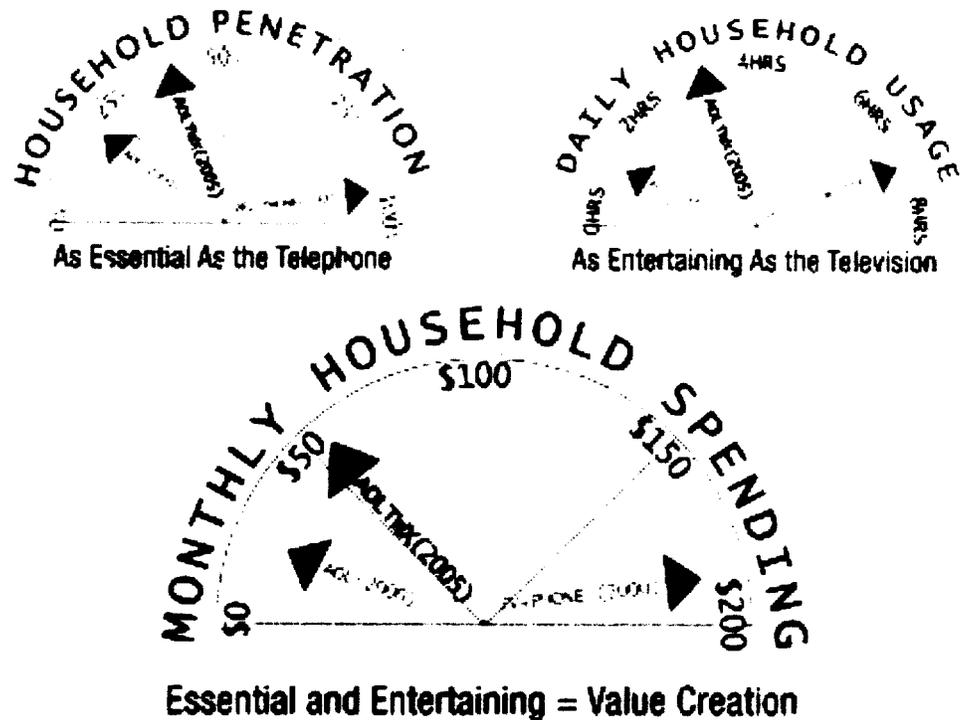
In many respects, we believe AOL's merger with Time Warner positions the company to accelerate and expand its pursuit of the core AOL mission. With Time Warner's media content and brands in hand, we believe AOL will be able to more easily increase the entertainment and information value of its services. Of course, AOL has used and incorporated third-party content into its service for a long time,

but we believe owning and controlling the Time Warner franchises will enable AOL to more quickly develop new interactive media franchises that leverage off of Time Warner content and AOL technology. As separate companies, the process of mixing, commingling, and integrating one side's content with the other's technology requires detailed operating and financial negotiations at the outset and ongoing adjustments. With AOL and Time Warner under one roof, we believe the two companies should be able to push forward new products and services with greater ease and speed, and less inter-company horse trading and dickering.

There are many other ways in which the AOL Time Warner merger can facilitate the AOL mission. We believe that Time Warner's cable television system will be used as an incubator, test bed, and launch pad for new broadband AOL services, such as AOL TV and AOL Plus. Time Warner's magazine and cable television network franchises contain valuable content and programming expertise that can be applied to the AOL service. Time Warner's music and entertainment divisions will be able to plug their content and entertainment franchises directly into the AOL service, enhancing the AOL service and opening up new distribution channels through which Time Warner content can reach consumers.

AOL's pursuit of the Case mantra is important not only strategically, but also, as we have said, its also has important financial implications. To put the mantra in context financially, we envision three dials or gauges that measure AOL in comparison to the telephone and the television (see Figure 5 below). First, as we think about how AOL stacks up against the essentiality of the telephone, we would use household penetration of the two technologies as our measuring unit. In the United States, telephone penetration of households is 95%, whereas AOL's domestic penetration is 21%, suggesting that AOL is "essential" to 22% of as much of the population as is the telephone at the moment. The good news for AOL is that its penetration continues to rise, and with the benefits of the Time Warner merger and an array of new AOL access devices, platforms and technologies, we could envision AOL's household penetration reaching 40%-50% within the next five years.

Figure 5. Household Speedometers



Source: Company reports and Salomon Smith Barney

A second dial attempts to measure AOL's entertainment value by gauging the average usage of use of AOL by its members in relation to the seven-plus hours of viewing that the average household supposedly directs to the television. Here, hours of use become the yardstick for entertainment values, and our basis for comparing AOL to television. At present, AOL receives from its members only one-eighth the viewership that television gets in the average household. However, online consumers have generally indicated that their Internet surfing time comes at the expense of television time, so we would expect this gap to narrow over time.

The third theoretical dial we think of is one that measures AOL's value in relation to the phone and TV. Here we look at AOL's revenue per month per member against the household revenue captured by the telephone and the television. As of 4Q99, AOL was generating \$19.98 per member per month in subscription revenue, with another \$5.83 per member per month in advertising/e-commerce revenue on top. A year earlier, AOL's subscription revenue was \$19.26 per member per month and ad/e-commerce sales were \$4.30 per member per month. However, our research suggests that the average household in the United States generates \$187 per month in revenue for the telephone and television industries. On this basis, we believe AOL currently has 14% the value of the telephone and television.

The leverage is huge and Time Warner can provide a fulcrum.

With this framework established, it is easy to understand AOL's key points of operating and financial leverage: Increasing household penetration (becoming as

essential as the telephone) and building up minutes of use per household (becoming as entertaining as the television). The financial implications of growing along these two dimensions are potentially enormous. Assume that AOL, with the help of Time Warner, were to grow to half the household penetration of the telephone and half the usage of the television over the course of the next five years, and that this progress enabled AOL to at least double its monthly revenue per household. By our math, these assumptions would make AOL a business with \$25-\$30 billion in annual revenue, compared to \$7-\$8 billion in projected sales for calendar year 2000, suggesting a five-year compound annual growth rate in revenue of almost 40%.

Our bottom-up analysis and projections do not currently envision the AOL service becoming a \$30 billion business as soon as 2004, but we also acknowledge these kinds of numbers are probably not as unreasonable as they might seem at first glance. Inasmuch as AOL's merger with Time Warner is likely to lead to developments and products that enhance the AOL service, drive penetration, increase usage, bring in new advertising and e-commerce revenue streams, and help lift revenue per household, the recently announced deal could be exactly the kind of event that propels AOL toward levels formerly unimagined. Along the way, the company's focus on catching up with the telephone and the television, to become nearly as essential and also highly entertaining, remains an ambitious and worthwhile pursuit for partners, consumers, and shareholders, in our opinion, and one that should drive significant value creation in the future.

As a final coda on the discussion of AOL's corporate mission, we should mention that Bob Pittman has added his own variation on Steve Case's tune. In Mr. Pittman's more operational, less visionary perspective, AOL is all about serving consumers with compelling brands and a portfolio of products, all of which share a common infrastructure to the benefit of overall growth and profitability for AOL. Along these lines, the addition of Time Warner's brands and infrastructure fits in as a logical extension of the business model championed by Pittman. We believe these somewhat fuzzy, but nonetheless critical aspects of AOL's own perception of its strategic trajectory were critical in guiding AOL to its merger with Time Warner. While investors are understandably focused on the financial details of the merger and the combined company, we believe that the strategic and cultural components of the transaction are essential to building internal consensus and determination about what the merger should allow and deliver.

Transformational ideas were the original source of strategic discussions.

Gather Assets to Build Wholly New Businesses

Beyond the obvious tactical synergies and strategic opportunities available in the combination of AOL and Time Warner, we believe that one of the primary arguments and motivations for the proposed combination is the future company's promised ability to create new products, services, and businesses from the commingled assets and resources of the two entities. In the near term, investors are likely to focus on "merger mileposts," such as the achievement of anticipated cost savings and accelerated EBITDA growth, deeper integration of Time Warner content into the AOL service, and the introduction of broadband AOL service on the Time Warner cable systems. However, the real source of long-term return and opportunity at AOL Time Warner is more likely to center around the combined

company's ability to create whole new services, products, business lines, and even markets, few of which might have been accomplished by either company on its own.

Although it is relatively easy to see where new areas of opportunity might arise from integration between AOL and Time Warner — AOL service on Time Warner's cable systems, Time Warner content promoted and delivered over AOL, cross-selling and co-marketing of all kinds of products, joint advertising sales efforts, shared network infrastructure, back office consolidation and so forth — we believe that both companies enter into the merger with their sights set on larger, less easily defined, longer-term opportunities. Both AOL and Time Warner recognize that the Internet and interactivity are rapidly reshaping the media business, and amid that environment of change and growth, myriad new business opportunities are emerging every day. With that in mind, we believe that the merger of these two companies is about combining a vast array of assets and resources under one roof in order to facilitate and accelerate the development of new products, services and businesses.

Amid unstoppable industry changes, AOL Time Warner will lead.

With the advent of the Internet as a mass media format and with interactivity becoming increasingly familiar to a growing number of consumers, the media world has begun to evolve and change at an accelerating pace: Television and the Internet appear to be on a collision course, leading to convergence of the two media; traditional advertising is blurring with direct marketing to drive e-commerce; spanking new media franchises are using the Internet to build enormous and worldwide audiences; software features and functionalities are becoming "content," long-established mastheads and media franchises are being challenged by super-capitalized upstarts, and growth rates and profit margins across much of the media industry have started to be altered and polarized. Every media company in the world is faced with the opportunity and challenge of adapting, evolving, and extending itself as the Internet becomes mainstream.

The basic rules of Internet/Online media are by now pretty clear...

As we think about where the media business is headed and what media companies must have and must do in order to position themselves to capitalize upon the changes wrought by the Internet, we come to a few core tenets or observations. First, we believe that if content is king, brands are godly in the media business on the Internet. The profusion of choice and confusion of alternatives available online have raised the power, clout, and value of well-defined, widely understood media brands to new levels. Second, as suggested, we also believe that content *is* king, and that, over time, an increasing proportion of consumers' online time and attention will be centered on high-quality content, conferring upon the owners of such intellectual property a growing share of the economic opportunity in Online Media as well. Third, we believe that success in Online Media depends upon and is magnified by focusing on the unique capabilities and characteristics of the Internet. Media companies now must build expertise in technology; become skilled at developing and programming software (in a media sense, i.e., packaging) alongside traditional content; gain understanding of networked audiences, viral growth, and increasing returns competitive environments; and learn how to provide and promote interactivity. Fourth, audience scale is absolutely essential.

...and AOL Time Warner is poised to capitalize on all of them.

Prior to the merger, neither AOL nor Time Warner had each one of its bases covered with all-star players all by itself. AOL has certainly mastered the technology of the Internet, and it continues to pioneer new forms of interactivity and networked services all the time. AOL has also built or acquired not one, but several of Online Media's leading brands, with a stable of leading franchises that includes AOL, CompuServe, Netscape, ICQ, Digital Cities, and others. And, while AOL's gross audience of 135 million monthly users across its array of services is the largest aggregate audience on the Internet, AOL remains a smaller player in the field of creating content, be it in a textual, video, or audio format. Time Warner, for its part, is also long on audience, with 2.5 billion people consuming the company's content each month. Furthermore, Time Warner is clearly the world's media powerhouse when it comes to traditional media content, with the largest magazine publishing house in the world, the second-largest cable and music businesses, one of the leading film and entertainment studios, and several of the world's leading cable television networks. However, Time Warner has been somewhat frustrated in its efforts to "Internet-ize" itself, with the Full Service Network in Orlando, Florida, and the Pathfinder content site being the two most obvious examples of Time Warner's Internet tribulations.

The most important piece is also the most difficult to appraise.

In a way that goes far beyond simple cross-pollination of business lines, we believe that AOL and Time Warner are engaging in their merger in order to amass assets, expertise, and leadership in each of the key areas that are being emphasized as the Internet affects and broadly changes the media business. Thus, in addition to calculating how the merger will affect the existing businesses of both companies, investors should not overlook the strategic value of accumulating and combining the resources of both companies to position AOL Time Warner to generate new products, services and brands. In this way, AOL Time Warner will have in front of it a laboratory table — stocked and supplied with many of the world's leading media brands, far-reaching content resources, great technical expertise, deep Internet experience, enormous audiences, multiple distribution networks, talented employees, and vast financial capacity — from which the combined company will be able to engineer and concoct all manner of new products, services and businesses over time.

In speaking with the management of both companies, we believe that the gathering together of the right raw materials to create entirely new business opportunities is one of the central motivations of the merger. Furthermore, existing businesses will be able to cross-promote and redistribute each other with limited incremental expenses. For example, AOL will be able to greatly expand distribution of its CD-ROMs for Internet access service by simply inserting these into the huge volume of popular magazines published and circulated by Time Warner, all with very minimal incremental cost to the combined company. Over the long term, the "new businesses" idea is also likely to be the most important one from a growth and investor return standpoint. Interestingly, this is also the least concrete and most difficult-to-appraise aspect of the proposed merger.

Time Warner's Objectives

Capturing the lead in media's next big thing.

In our opinion, the driving notion for Time Warner to merge with AOL was to capture an otherwise irretrievable first-mover advantage on the Internet. While Time Warner historically has been an early supporter of new interactive services, the end results have often been disappointing. For instance, in the 1970s, Time Warner's corporate ancestor, Warner AMEX, created QUBE, an early version of interactive television, which allowed consumers to (among other things) request whichever programs they wished to see, participate in interactive quiz shows, and send messages over their televisions. In addition, in the mid-1990s, Time Warner undertook the creation of the "Full Service Network" in Orlando, which featured video on demand and other interactive applications. Seeking to capitalize on the Internet, Time Warner also launched Pathfinder in 1994, a Web site that featured Time Warner's proprietary content from Time, Inc.

Unfortunately, each of these ventures fell short of achieving commercial success for Time Warner. While the lack of success can be attributed to a variety of factors (e.g., cost of deploying services, corporate politics, and the need to protect existing businesses), the result is that Time Warner has been ineffective in capitalizing on the digital media revolution, in stark contrast to the leading position AOL has built on the Internet over the past 15 years. In our opinion, by merging with AOL, Time Warner regains a critical first-mover advantage and binds itself to a proven digital media master. From the Time Warner perspective, we believe that AOL's businesses dovetail well with Time Warner's business units, with little overlap.

Time Warner's proposed merger with AOL also allows Time Warner to align itself with other alternative forms of high-speed Internet access beyond cable systems. AOL has already struck access agreements with Bell Atlantic and SBC Communications to provide its service over Digital Subscriber Lines (DSL), an alternative means to enable high-speed Internet access over traditional telephone lines. Furthermore, AOL also has a \$1.5 billion partnership with Hughes Electronics and DirecTV. Under this agreement, AOL will have access to Hughes' Spaceway broadband platform, while DirecTV will become the first platform to launch AOL TV.

Another driving force behind Time Warner's decision to merge with AOL is the latter company's growing subscriber base. This irreplaceable base of users provides an attractive platform for Time Warner to sell its variety of goods and services, such as magazine subscriptions, premium cable services (most notably, HBO), and Warner Bros. branded consumer products. With AOL boasting 23 million subscribers, costs such as marketing and advertising can be amortized over a larger base as well.

From a broader media industry standpoint, we view the AOL Time Warner merger as a natural extension of the ongoing vertical integration of entertainment. Over the past decade, media companies have pursued an aggressive consolidation strategy, in order to both capture a greater share of the entertainment dollar and control the distribution as well as the creation of content. In our view, Time Warner's merger

with AOL extends this strategy to the online world, with AOL providing both the preeminent distribution platform on the Internet and unparalleled interactive/online content creation skills. In turn, Time Warner, with unique branded content developed over decades of experience, provides valuable franchises that can be leveraged throughout AOL's variety of businesses.

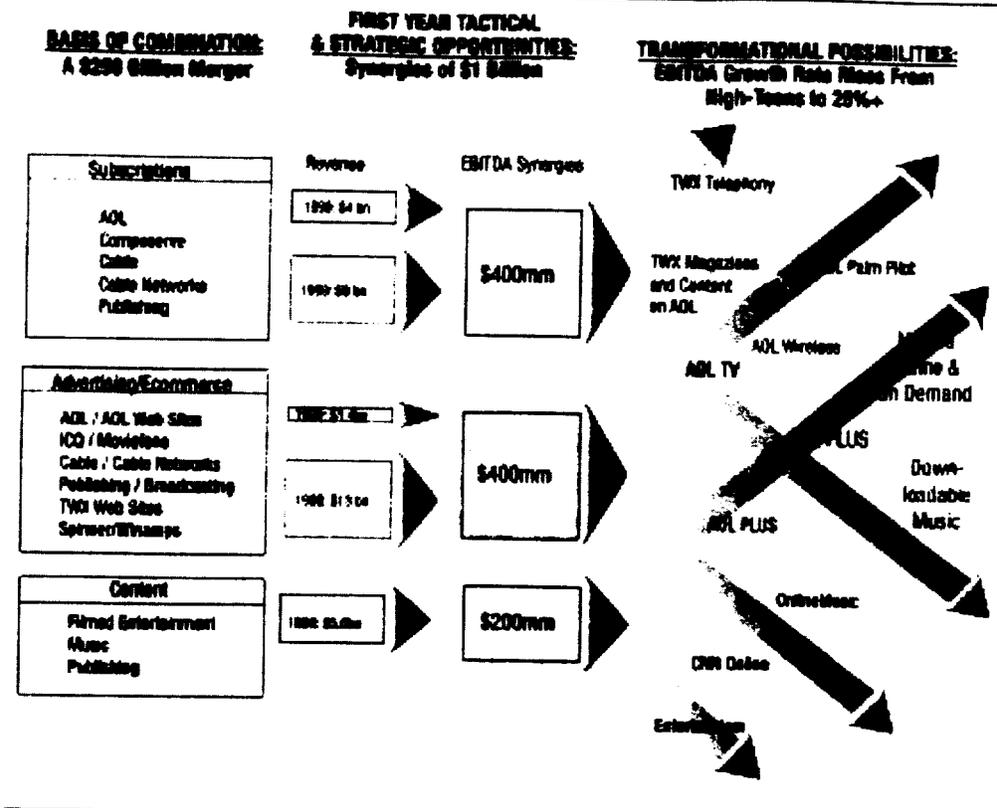
Analysis by Industry

In each of the relatively brief business unit discussions below, we attempt to describe both the upside potential and the risks that will lie ahead for AOL Time Warner's operating divisions. At the same time, we present our own analytical conclusions about what investors should expect from the new company on a fairly granular level. By no means are these comments and conclusions exhaustive, but, taken together, the following sections of this report are designed to put meat to the thematic skeleton assembled above.

From a broad perspective, we see the AOL/Time Warner proposed merger as a joining of two industry-leading companies that actually have fairly similar operational structures. Both companies are built around delivering content, entertainment, and communications to vast consumer audiences under the flags of some of the most widely-respected media brands in the world. Flanking that content core, both AOL and Time Warner have enormous subscription bases and rapidly growing advertising and marketing revenue sources.

As AOL and Time Warner come together, we see these three central businesses — Content, Subscriptions, and Advertising/Marketing Services — leveraging off of each other to create tactical synergies, expanded strategic opportunities, and in the long term, potentially transformative new business ideas. Figure 6 below, in many ways, encapsulates each of these core areas of operation and the effect that combining AOL and Time Warner will have on the company's products, cash flow, and growth rates.

Figure 6. America Online/Time Warner Opportunities



Source: Company reports and Salomon Smith Barney

Publishing

The Upside

Time Warner's core publishing operations (Time, Inc.) should benefit from the AOL merger as its stable of popular magazines such as *Time*, *People*, and *In Style* are marketed to AOL's subscribers. We estimate that subscriber acquisition expenses for Time, Inc. currently amount to about 14%-18% of publishing revenue, using industry statistical data as our point of reference. On an estimated \$3 billion in magazine revenue, these marketing costs probably approximate \$300-\$550 million per year. Meanwhile, industry data also suggest that as much as 60% of Time, Inc.'s consumer magazine subscriptions must be renewed each year.

At first blush, the opportunity to use AOL as a marketing channel for Time, Inc.'s titles is the most obvious upside opportunity unlocked by the merger. In the magazine business at large, publishers have been plagued by the declining effectiveness of timeworn subscriber marketing techniques. The traditional "stamp-sheet" and sweepstakes marketing tools used by magazine publishers have suffered several years of overuse, with a resulting decay in their productivity and efficiency. Meanwhile, normal direct mail appeals are costly, time-consuming, and relatively unproductive.

Assuming that the cross-promotion of Time, Inc. magazines over AOL's services reduces subscriber acquisition costs by 10%-15%, we estimate that AOL Time Warner could save \$40-\$80 million per year. However, beyond the basic marketing synergy, we note that there is the potential for Time Warner to move from its traditional annual renewal subscription model to the evergreen "credit card-on-file" structure favored by AOL. Currently, American Express Publishing is the only magazine group that has made the transition to the "bill to account on file" model, as that company has been able to draw upon its presence in the consumer credit business to establish the alternative billing model. However, industry anecdotal evidence indicates that customer retention on credit card-on-file subscriptions is closer to 70% at the end of the first year than the 40% retention rate common under the annual renewal model. Thus, if Time Warner were able to bundle its subscription sales into the existing AOL billing relationships, Time Warner's retention rate might increase and marketing costs could be reduced even more sharply in the magazine business.

Time Warner's ten largest magazines combined have 20 million subscribers, and on that base, the difference between 40% retention and 70% retention is 6 million subscriptions per year. Since we estimate that Time Warner spends about \$25 per year for each unit of circulation that must be replaced to maintain its rate base, a full switchover to "account on file" relationships might save the company \$150 million per year. Of course, a complete transition in subscriber billing is unlikely even in the longer term, but the cost savings from such a move would be considerable nonetheless.

Similar to Time Warner's other advertising-driven business units, Time, Inc.'s key relationships with advertisers tend to be deeper and of longer standing than those of

AOL. We believe that AOL Time Warner will be able to leverage those relationships with the top 50 advertisers to generate incremental advertising revenue for AOL. Factoring in the fact that Time, Inc.'s magazines generate an estimated \$2 billion in ad revenue per year, a 10% sell-through onto AOL against that Time, Inc. ad revenue base would yield an incremental \$200 million in ad dollars flowing through to AOL.

From the AOL perspective, the Time, Inc. content derived from its magazines should provide a deeper and broader proprietary content resource, which should, in turn, add stickiness to AOL's service. On AOL's 20 million-plus subscriber base, a 3%-5% improvement in AOL's annual member retention would offer a quickly compounding 600,000–1 million net additions. While Time, Inc. content alone might not be enough to precipitate this kind of uplift, enhanced online content, special member privileges, and bundled magazine/online subscription packages might be enough to do the trick and provide the retention bonus to AOL described above.

Meanwhile, the merger also affords Time, Inc. some proprietary advantages relative to other magazine publishing families. In the past, Time Warner has used AOL to promote and advertise its magazines, and the AOL service and audience profile proved valuable to Time Warner in the launch of its *Teen People* magazine. Going forward, Time, Inc. will likely be able to use AOL not only as a marketing outlet, but also as a research test bed guiding new-product decisions by the publishing house.

AOL Time Warner will also have an ability to offer "stunt" events to make AOL subscribers feel special and create good word of mouth. One recent example of this was an early look at Sports Illustrated's swimsuit cover, which was available only on AOL before the magazine actually hit the stands. AOL Time Warner will have an ability to do special promotions like this for all of its event magazines (*People: The Sexiest Man Alive; Fortune 500; etc.*). While on the surface this may not appear dramatic, when you consider the breadth of Time Warner's publishing division coupled with the power of AOL's "captive" audience, the ability to improve customer retention, advertising sales and brand awareness is only just the beginning.

The Risks

In our view, the main challenges surrounding the publishing division in the wake of the merger will pertain to how Time, Inc. franchises are positioned within the AOL service. While we do not expect AOL Time Warner to play strict favorites with its internal content brands as the company programs the content within AOL, there is risk that the company might succumb to these temptations and replace compelling third-party content with less widely appealing captive franchises.

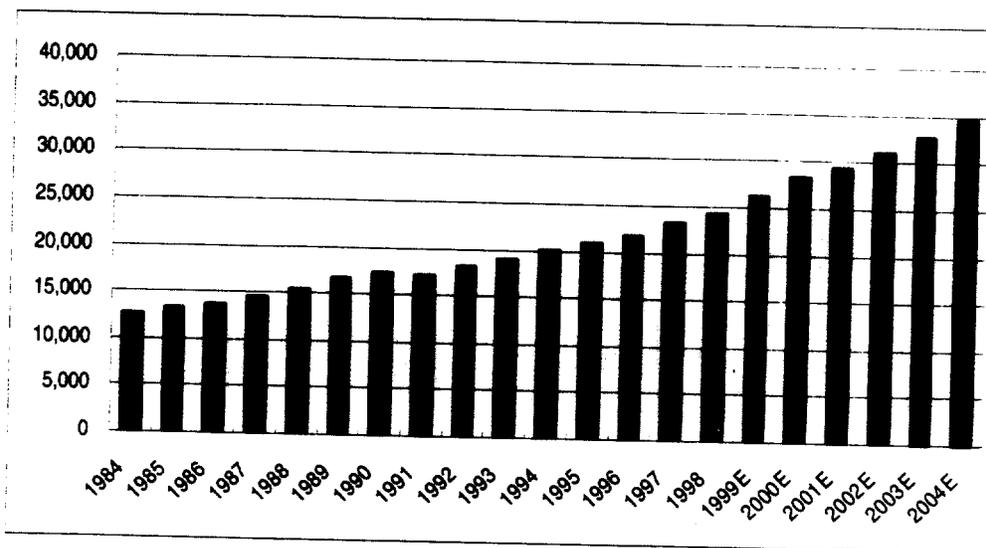
Our Expectations

As we look at AOL Time Warner's publishing division going forward, we believe that the merger will likely bring improved subscription marketing economics and shared increases in advertising market share with the introduction of new multi-property advertising sales packaging. In our view, the subscription opportunities

could rack up cost savings, retention improvements, and new subscriber relationships with a value of \$200 million in annual EBITDA over several years. Relative to current publishing division cash flows, an improvement in segment EBITDA of this magnitude would represent a 25% uplift. Clearly, it will take some time for the full potential of these opportunities to be realized, but the opportunity to transform the economics of Time, Inc.'s activities will surely be one of the merged company's priorities.

Figure 7. U.S. Magazine Publishing Revenue Projections

\$ in Millions



Notes: Includes advertising and circulation revenues.

Source: McCann-Erickson, Magazine Publishers of America, BPA International, and Salomon Smith Barney

Cable Systems

Filling the "pipe" with data, voice, video, and interactivity.

The Upside

A key underpinning of the AOL and Time Warner merger centers around Time Warner's cable systems, reaffirming our view that cable is a highly attractive means by which to reach consumers and deliver an array of broadband services. Already, Time Warner, through its 40% ownership of RoadRunner, has begun to commercially deploy high-speed Internet service over its cable systems. RoadRunner already boasts a subscriber base of 550,000 (of which 330,000 subs are attributable to Time Warner). In one market (Portland, Maine), RoadRunner penetration has reached an impressive 21% of homes passed. By branding RoadRunner with the ubiquitous AOL name, which is essentially synonymous with the Internet, and incorporating AOL's proprietary online content, we expect AOL Time Warner's high-speed access business to achieve deeper penetration. Assuming that penetration reaches 10% of homes passed from about 4.4% at year-end 1999 and an average monthly revenue of \$40 (assuming all incremental subs are Time Warner Cable subscribers), we estimate an incremental \$600 million in annual revenue by 2002-03.

Open access logjam starts to break up.

In addition, as highlighted by the recent Memorandum of Understanding reached by AOL and Time Warner, the deal also paves the way for a resolution of the thorny open access issue. We view the agreement on open access as a positive development in helping to resolve differences between cable operators and ISPs, and in eliminating a potential roadblock to deploying high-speed Internet access. More important, however, investors should recognize that this type of agreement — surrounding an extremely complex issue — was clearly accelerated by the pending marriage of AOL and Time Warner.

Among the key points of the memorandum:

- 1 AOL Time Warner will provide open access to its cable systems, making them available to competing ISPs. AOL and Time Warner intend to enter into a binding definitive agreement to provide AOL service on Time Warner cable systems, which will be used as a model for commercial arrangements to be struck with other ISPs. We would not be surprised to see at least one third-party ISP deal before the merger closes.
- 2 Consumers will not be required to purchase service from an ISP that is affiliated with AOL Time Warner. As such, AOL Time Warner will negotiate commercial arrangements with unaffiliated ISPs. In addition, AOL Time Warner will not operate its cable systems in a way that discriminates among traffic based on affiliation with AOL Time Warner
- 3 AOL Time Warner will not place a fixed limit on the number of ISPs with which it may enter into commercial arrangements. However, limitations may arise based on AOL Time Warner preserving the integrity and quality of the consumer experience and any technological restraints that arise from offering multiple ISPs over cable. ISPs offering service on its cable lines will be allowed to partner on a

- national, regional, or local level with Time Warner Cable, which should enhance consumer choice.
- 4 Both AOL Time Warner and other ISPs will be allowed to have direct relationships with the consumer. As a result, AOL Time Warner and ISPs will have the opportunity to market and sell broadband services to the consumer. ISPs will also have the option of billing and collecting directly from the customer.
 - 5 AOL Time Warner will allow ISPs to provide video streaming, a provision that is treated far more tentatively and with limitations in Excite@Home's cable agreements. The more accommodative stance of AOL Time Warner is a hallmark of the benefits of putting the interactive company and media company together under one roof, where turf battles become irrelevant.

There has been much discussion about what is the "true" motivation behind AOL and Time Warner's push toward open access. The simple answer to this question is that they believe the combined company will be able to generate more incremental revenues (and thus more shareholder value) through an open access system. The company believes that its leading brand and top-notch product and service offerings stack up well against any of the other ISPs or portals. Thus, it follows that AOL Time Warner does not need to try to maintain exclusivity of its systems in order to maintain its leading position. In fact, AOL Time Warner will be in a better financial position from pursuing open access and thus creating the opportunity to charge other ISPs (e.g., EarthLink and MindSpring) a fee for use of the company's extensive cable systems. Thus, it is simple to see that the open access issue is one which AOL and Time Warner have considered from a financial viewpoint, ultimately determining that open access is the solution which will generate the most incremental revenue and overall value for the combined company.

The Risks

Regulatory foot dragging and intrusion.

While we view the cable opportunity as one with great potential for AOL Time Warner, this business arguably poses the most uncertainty as well. Cable remains a highly regulated industry and the open access matter remains very prickly. While we believe that AOL's combination with Time Warner and the subsequent Memorandum of Understanding will coax other cable operators to sign similar deals with AOL Time Warner, the ultimate outcome still remains difficult to predict. Should the open access issue reach an impasse, the dissemination of broadband services could be slowed.

Our Expectations

Cooperation will unlock new opportunity.

While we acknowledge the risks outlined above, we are encouraged by AOL and Time Warner's recent agreement on open access. In our view, the speed with which AOL and Time Warner have agreed upon initial terms for open access underscores the ability of the two management teams to act decisively. By setting this initial working relationship between cable MSO and ISP, we believe AOL Time Warner may help accelerate similar distribution agreements for AOL on other cable systems. Furthermore, we view this development as the first tangible sign of the synergy in

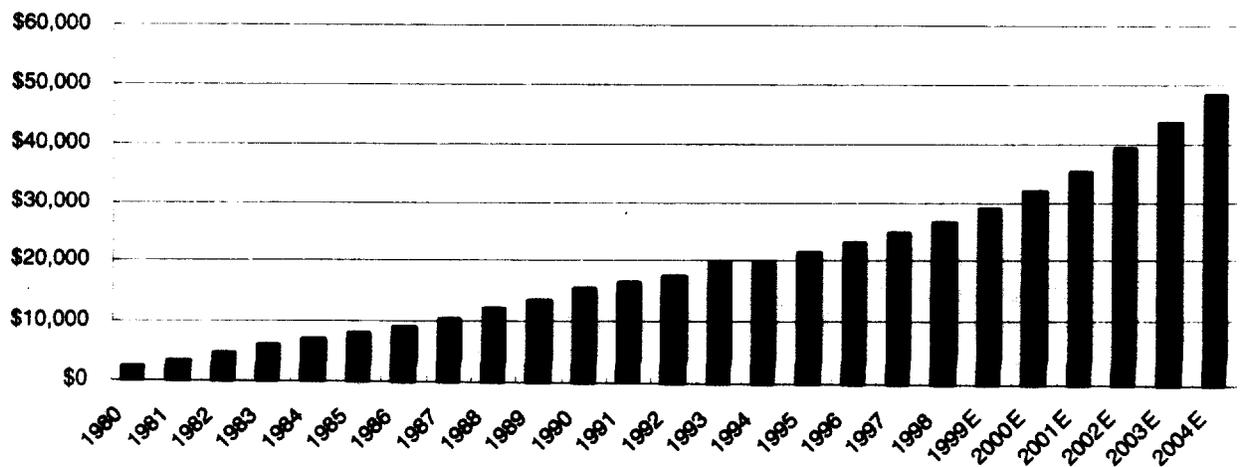
combining AOL and Time Warner. Without the companies' pending combination, we doubt that such a pact could have been reached as swiftly. In our view, this pact will likely be a harbinger of similar agreements, which will quickly and confidently address such perpetually thorny questions as content versus distribution, ISP versus cable, and manufacturer versus distributor.

Time Warner's cable plant remains on track to be fully upgraded by the end of 2000. Corresponding with the completion of Time Warner's transition to digital, we expect a host of new services ranging from digital video (increased channel offerings), high-speed Internet access, and, eventually, telephony, to accelerate cash flow growth for Time Warner Cable. Recognizing the initial warm consumer reception for its new cable offerings, Time Warner is expected to ramp up its cable capital spending to accelerate the rollout of new services. Time Warner is now expected to boost its cable CAPEX from \$1.6 billion in 2000 to \$2 billion, about \$400 million higher than our forecast. Of the incremental \$400 million in cable capital spending, we believe the entirety is variable or discretionary CAPEX. As these orders and installations come in, Time Warner is targeting an after-tax return on its digital and Road Runner services in excess of 30%. As the AOL brand equity and subscriber base is leveraged through the merger, we expect growth will be further propelled.

As noted above, digital technology will transform television, making it an increasingly interactive medium. As the country's second-largest cable operator, leading Internet service and content provider, and top purveyor of traditional entertainment, AOL Time Warner is uniquely positioned to capitalize on this trend. In particular, Time Warner's cable systems provide an attractive test bed and critical distribution platform for new interactive television services that could evolve.

Figure 8. U.S. Cable Subscription Projections

\$ in Millions



Source: Paul Kagan Associates and Salomon Smith Barney

Online Access

AOL's Internet access subscription revenue stream should account for roughly 65% of AOL's overall revenue in calendar year 2000, or 13% of AOL Time Warner's pro forma sales. AOL generates the bulk of its subscription revenue from the flagship AOL service at an average of about \$20 per member per month, which provides users with unlimited hours of use. However, the AOL service is also offered under alternative pricing plans, such as a plan of \$4.95 for three hours of use and \$2.50 for each hour thereafter, or \$12.95 for 20 hours of use and \$0.99 for each hour thereafter. Furthermore, the CompuServe brand also contributes to AOL's subscription revenue stream, although it tends to generate slightly less revenue per member per month, due to discounted service plans and other incentive offers.

The Upside

Deliver on cable broadband.

As AOL and Time Warner merge, there are several ways in which AOL's access business is likely to benefit. First, we expect AOL and Time Warner eventually to deliver AOL's broadband service, AOL Plus, over the Time Warner cable systems. Additionally, as AOL Plus begins to roll out across the Time Warner cable systems, we believe AOL Time Warner will work diligently to reach agreements with AT&T that will allow AOL Plus to be offered on AT&T's cable systems as well. AOL Plus is likely to be priced, at least initially, at a higher monthly rate than AOL's dial-up service, perhaps \$40 per month for broadband versus \$21.95 per month for regular AOL. With that kind of pricing, if only 10% of AOL's 20 million domestic subscribers upgraded to AOL Plus, a number equal to 15% of Time Warner's cable subscribers, the annualized revenue benefit to the company would be north of \$400 million. We believe this kind of lift is probable within the 2002-03 period, and the margin impact would be substantial, on the order of one-quarter billion dollars.

Narrow churn and increase loyalty.

Second, the addition of more Time Warner content and the introduction of new co-developed content areas on AOL may increase the usefulness of the AOL service and help lower AOL's membership churn. Likewise, bundling AOL Plus into consumer cable television subscription packages could also help increase member loyalty and retention. Finally, we note that dial-up ISP EarthLink recently stated that 40% of its subscriber churn was explained by customers upgrading away to alternative broadband services. As AOL Plus is introduced to the Time Warner (and perhaps other) cable systems, AOL should be able to recapture much of any broadband-related drain on membership that the company may be experiencing at present. On 20 million domestic members, even a quarter-point reduction in monthly churn would enable AOL to retain an extra half-million users annually. Since each AOL member is currently generating about \$300 in revenue per year, this kind of reduction in churn would be worth \$150 million in annual revenue even at the current monthly revenue rate (which, by the way, continues to climb).

A platform for new services.

Third, the merger between AOL and Time Warner is likely to improve AOL's ability to introduce and market other AOL services, such as AOL TV and, eventually, subscription-driven interactive music and entertainment packages. Quantifying the potential revenue and cash flow uplift from these new services is

difficult, as none of them have been launched yet and, outside of AOL TV, are probably still several years away. However, we can see how AOL TV could easily — and very quickly — become a \$200 million business, assuming 10% of Time Warner's subscribers took the service at a price of \$10-\$20 per month.

Time Warner could add \$1 billion in access revenue in three to four years.

In sum, we believe that the merger should afford AOL the opportunity to launch its broadband service more quickly, further reduce its already low membership churn, and begin to develop other premium subscription services. All told, we estimate an additional \$900 million–\$1 billion in annual subscription revenue that might come to AOL Time Warner through Internet access services over the course of the next three to four years.

The Risks

Reduced access pricing is a scary prospect...

Erosion of Internet access pricing power is the most obvious risk to AOL's subscription business in the years ahead. AOL's \$21.95 per-month basic membership fee is already one of the higher price points in the Internet access market. Many other Internet service providers (ISPs) offer much lower monthly prices, from \$10.95 per month all the way down to free, unlimited Internet access. If AOL were forced to slash its monthly fee to the \$10.95 per-month level (an event we do not see as likely), it would shave \$2.4 billion off of AOL's annual subscription revenue, assuming 20 million domestic accounts were affected.

...but an unlikely one, in our view.

However, over the past year and half, AOL has weathered the rising price competition storm well, tacking on an increasing number of new subscribers and gradually realizing ever greater net subscription revenue per member per month. We believe that AOL's easy-to-use, high-quality, feature-rich service has become the Internet access service of choice, with more than 50% of all U.S. consumer accounts subscribing to AOL. Furthermore, we believe that AOL's well-established brand can continue to attract a disproportionate share of the new user population and command a premium price for the service. Our analysis of AOL's recent Internet service agreement with Gateway is that the relationship is producing one AOL subscriber for every Gateway.net subscriber who is signing up with the PC manufacturer's ISP. We believe these numbers illustrate the branded cachet and drawing power of the AOL service, even as it is marketed alongside a cheaper bundled Gateway offering.

Another backstop to AOL's pricing is its multi-brand, multi-price-point partnership service model. The core AOL brand is the premium brand in the marketplace, with the best service and best price. However, AOL also has a strong brand in CompuServe, which has been marched forward as the company's brand to address the needs of the value segment. Finally, AOL has co-opted potential competitors and gained the leverage of other uniquely positioned partners to leverage its Internet access infrastructure. Specifically, Gateway helps puts AOL in the device business, Wal-Mart Stores helps it reach the rural community, and Sears, Roebuck puts AOL in touch with a company focused on domestic customer service to the home.

The risk of reduced subscription pricing at AOL is clearly one with material consequences for the company if it should become a reality. However, we believe that history shows — and analysis suggests — that AOL has successfully carved out

a premium position in the Internet marketplace that supports its current pricing. Investors worried about AOL's pricing should keep an eye on the company's subscriber growth, subscription revenue per member, marketing expenses, and overall margin. Over the past year, however, these fundamental gauges have continued to move in the right direction.

The membership march continues.

Our Expectations

We currently project that AOL will add roughly 4.0 million new members to its core domestic service during calendar 2000, tacking on another 4.5 million in 2001. By the end of 2001, we believe the core AOL service will boast roughly 26 million total members. Outside the United States, AOL currently has 3 million members, and we project 4.1 million overseas members by year-end 2000 and 5.0 million by year-end 2001. Meanwhile, AOL's CompuServe 2000 service has grown to 2.5 million members as of December 1999, and we project another 1.7 million additions to CompuServe in each of the next two years.

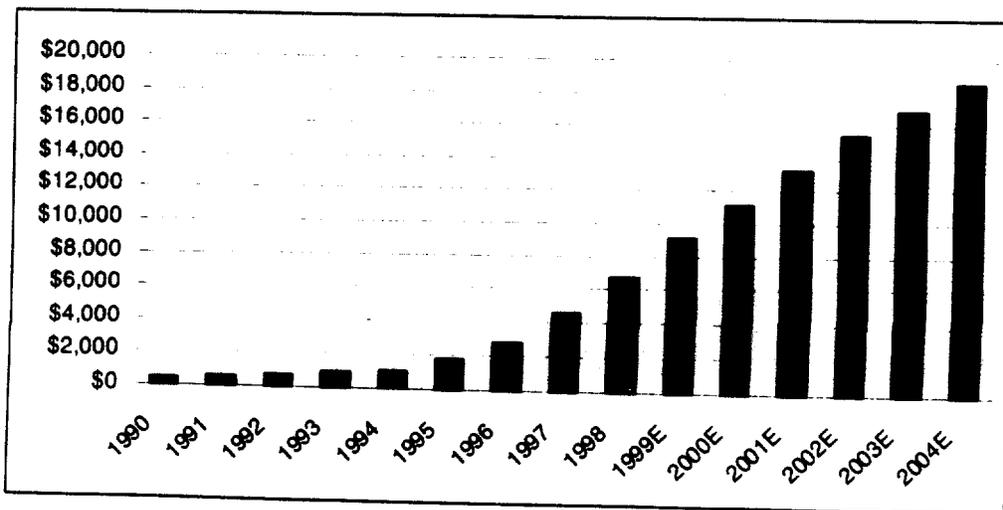
On the pricing front, our model currently projects no further increase in revenue per member per month, even though AOL's monthly net subscription revenue per member has grown by 3% over the past year.

With time, and upon the completion of the merger, it will become easier to factor the impact of the combination into our projections for AOL's access business.

However, we do believe that our existing estimates could be low in two key areas: First, we have historically underestimated AOL's subscriber growth, as the adoption of the Internet has proceeded more quickly than we have anticipated. Second, as noted above, we believe that within three years, the combination with Time Warner could easily add another \$500 million or more per year to our access revenue projections.

Figure 9. U.S Internet Access Expenditures

\$ in Millions



Source: Company reports, ActivMedia, eStats, Forrester Research, Jupiter Communications, Simba Information, and Salomon Smith Barney