Online Advertising/E-commerce

AOL's advertising, e-commerce and other revenue stream will account for roughly 29% of AOL's overall revenue in calendar year 2000, or 6% of AOL Time Warner's pro forma sales. The bulk of AOL's advertising and e-commerce revenue comes from long-term marketing and sponsorship agreements that run within the AOL service, rather than from traditional banner ad sales on AOL Web sites. The nature of AOL's ad and e-commerce sales has historically been highly strategic in nature, multi-year, multi-million dollar deals struck between AOL's sales team and senior management groups at customer accounts. The "other" piece of AOL's revenue stream comes from direct sales of AOL branded merchandise, as well as from other fees such as credit card licensing fees and added charges for personal check payment plans.

The Upside

The clear leader with room to gain share.

AOL is the leader in the production of online media advertising revenue by a wide margin: AOL by itself captured an estimated 20% of all online advertising and marketing revenue in 1999, and AOL's fourth quarter 1999 total was 75% greater than Yahoo!'s revenue total in the same period. However, AOL's 1999 advertising and e-commerce revenue of $1.1 billion represents only a 0.5% market share of all ad spending in the United States last year. We believe that the merger with Time Warner will position AOL to significantly increase its advertising and e-commerce revenue, relative to where it would have been if AOL were to remain independent of a major media partner.

AOL's annualized advertising and e-commerce revenue stream of $1.75 billion is currently 35% the size of Time Warner's advertising business. However, AOL currently has more than $2.4 billion in its advertising and e-commerce backlog, contracts signed and in place but not yet earned and recognized. Going forward, if AOL Time Warner could sell an additional $0.05-$0.10 in advertising service on AOL for every $1.00 sold across Time Warner's network of properties, the result would be an additional $250–$500 million in ad revenue for AOL. With packaged ad sales and studied sales force cross-selling by Time Warner's extensive ad sales team, we believe this kind of fillip to AOL's advertising and e-commerce line is well within reach. Importantly, because AOL's advertising deals tend to be very strategic and long-term in nature, whereas Time Warner is better equipped and more successful in shorter-term, tactical advertising sales, we believe AOL has not yet fully tapped into the advertising budgets on which Time Warner concentrates. Importantly, AOL and Time Warner do not have precisely overlapping advertiser relationships at present — AOL sells more often to the CEO, while Time Warner depends more upon entrenched and long-standing relationships with brand managers and marketing directors — so the cross-pollination opportunities are probably larger than would be expected at first glance.

It's all about usage.

In the longer term, the primary advertising and e-commerce revenue opportunity that may arise from the merger is likely to be driven by increased AOL usage. At present, the average AOL member is on the service for just over one hour per day.

Meanwhile, Nielsen reports that the average American household watches more than seven hours of television each day. Likewise, television penetration stands at 99%% of all U.S. households, while AOL's core service has a penetration of roughly 20%. With a relatively limited amount of daily usage in comparison to television, and with lower overall household penetration, it is no wonder that AOL and the Internet at large are only capturing about 3% as much ad revenue as is the television industry.

However, we believe that one of the primary factors behind the AOL Time Warner merger is AOL's desire to improve its service, expand its membership base, roll out cable-delivered broadband access, and increase the amount of owned and controlled content on the service, all in the name of capturing a greater share of U.S. consumers' aggregate media consumption. If the steps taken by AOL Time Warner after the merger are successful in increasing AOL's overall hours of use (more members, more time per person), then it stands to reason that AOL will be able to command a greater share of the overall advertising pie, since it is any company's share of the audience's attention that most directly influences that company's ability to generate advertising revenue over the long haul.

AOL could rival the ad revenue big TV networks soon.

Could AOL become a \$5-\$7 billion property in terms of advertising revenue over the next several years? We believe that, with the merger, such a figure is within reason over a three- to five-year time horizon. Looking across the media landscape, there are a few other media franchises already at that ad revenue scale: The ABC, NBC, CBS, and FOX television networks are all in that range, or higher, if we include both network and local affiliate ad revenue. For AOL to enter the league of these franchises, however, the service will need to capture a significantly higher proportion of consumers' media diet. In our opinion, the most powerful tool for AOL to employ in trying to increase its share of the audience's attention is clearly that of content. E-mail , chat, instant messaging, and personal stock portfolio services will only get AOL so far up the media ladder in term of audience share. This is precisely where Time Warner's content resources and libraries can have the greatest impact on AOL: increasing the amount of time users spend gleaning information and being entertained on the AOL service.

The Risks

Online ad growth is highly predictable and rapid.

Finding risks that threaten the growth of AOL's advertising and e-commerce revenue is a challenge. We tend to agree with Jerry Levin's view that the growth of online advertising dollars is highly predictable, perhaps even the most certain trend within the entire media landscape. Today, only about 40% of all U.S. households are connected to the Internet, and the average U.S. household still spends something less than one hour per day online. However, we believe that one hour of daily online time within 40 million households probably represents something on the order of 4%-5% of overall media consumption in the United States. Yet, even though that percentage is clearly on the rise over the next several years, online media captures only a little over 2% of all advertising spending in the United States at present.

Other media show upside for AOL.

For AOL specifically, the trends look similarly favorable and the risks equally scarce. AOL currently generates only \$6 in advertising and e-commerce revenue per member per month, even though the average newspaper generates $45-$50 in monthly ad revenue per circulation unit, and television delivers more than $50 per month in advertising to each household using the medium. From these numbers, it seems AOL ought to have no problem working its way toward $10-plus in advertising and e-commerce revenue per member per month over the next few years. Remember, AOL has an e-commerce revenue angle that television and newspapers do not enjoy, and this should also help AOL close the gap relative to other media.

"Does online advertising work?" — yesterday's question.

The most likely concern that investors might have about AOL's advertising and e-commerce revenue — and, for that matter, about online media in general — is whether or not online advertising really works. Typically, falling banner ad click-through rates, and anecdotes about smaller sites declining to renew expensive portal or AOL anchor tenancy agreements, are cited as the hard evidence of online advertising's possible ineffectiveness. In reality, though, the online ad market has surpassed a $4 billion annual run rate, more than half the size of the cable television ad market and three times the size of the outdoor advertising industry. If online advertising did not work, we doubt the medium's advertiser support would either be as big or growing as rapidly as it is at present.

Our Expectations

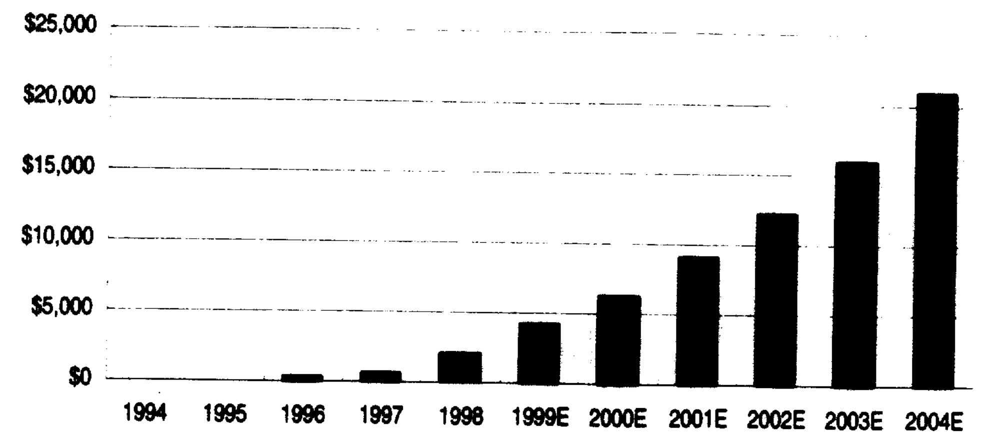
We project that AOL's advertising and e-commerce revenue will rise from $1.4 billion in calendar 1999 to $2.1 billion in 2000, suggesting roughly 50% year-over-year growth. However, in calendar 1999, AOL's advertising and e-commerce revenue rose by nearly 88%; thus, our projections currently call for a fairly material slowdown in growth that may prove too conservative when the year is done. Behind the 2000 projections, we have estimated that AOL's monthly ad and e-commerce revenue per member could rise from just under $6 in 4Q99 to something over $8 by the end of the current year.

A post-merger acceleration is in the cards.

After the merger is completed, we believe Time Warner will likely be able to help AOL ramp up its advertising revenue even more quickly. Looking to 2001, we believe AOL should be able to tack on another $1 billion or more in advertising and e-commerce revenue, surpassing $3 billion in advertising revenue in that year. The projected increases stem from a rising membership base, continued gains in hours of use, and the ongoing attraction of additional new advertising and marketing partners. Our expectations for 2001 include some help from Time Warner, but the merger adds the possibility of AOL generating up to another $200 million in ad revenue in 2001 that we had not previously factored into our projections. In the longer term, say, three to five years, we believe AOL will be able to move toward the $5-$7 billion threshold in terms of advertising and e-commerce revenue. In our opinion, AOL is highly likely to become the world's leader in terms of advertising and marketing revenue produced by a single media franchise, because of: 1) AOL's leadership within the fastest-growing medium; 2) Time Warner's ability to help increase hours of use and draw in advertisers; 3) the Internet's unique capacity to tap both advertising and e-commerce revenue streams, and 4) AOL is poised to be one of the very few truly global advertising and communications franchises.

Figure 10. U.S. Online Advertising Expenditures

$ in Millions



Source: Salomon Smith Barney

Online Content

The Upside

A rich mixture of new content formats.

One of the key visions behind the AOL Time Warner merger is the combined company's ability to produce an array of entirely new content, by mixing together AOL's interactive, multimedia platform and Time Warner's deep content resources and familiar, respected media brands. We can envision an environment in which consumers bookmark not only Web pages, but also television programs, radio shows and more through the AOL service. Likewise, it seems likely that consumers will be able to e-mail programs and songs to friends, family, and associates via AOL, not to mention the AOL TV promise of being able to chat and instant message with others while all parties are simultaneously experiencing the same television programming.

Of course, Time Warner content such as CNN, *Sports Illustrated,* Warner Music, and The WB television programs will be mixed into the AOL service, Netscape, ICQ, and other interactive franchises over time, as well. While we do not expect AOL Time Warner to veer in the direction of using Time Warner content exclusively throughout the online services, we believe that the merger positions AOL Time Warner best to be the media company that truly breaks new ground in developing and delivering entirely new forms of media and entertainment. We believe AOL will likely continue to depend upon and employ high-quality content from non-Time Warner sources, just as the major television networks air programming from both their sister production companies and third-party sources.

Above all, we believe AOL Time Warner's goal will be to make AOL as essential as the telephone and as entertaining as the television. To get there on the entertainment side, AOL will have to invent new forms of media that rival the incredible audience-drawing power of television. As technologies like digital music players and storage devices become more common, we expect AOL Time Warner to change the way music, and perhaps videos, are packaged, delivered and consumed. Suffice it to say that the upside to the AOL Time Warner merger, from a content perspective, will be constrained only by the creative imaginations of the company's content people, the technical capabilities of its software employees, and the limitations infrastructure of AOL and the Internet.

The Risks

A walled garden can block out growth.

When the fin-syn rules governing the television industry were relaxed a few years ago and a couple of the television networks merged with programming studios, a loud hue and cry went up that each network would wind up airing only its in-house programming. At the time, the fear was that programming choice and quality would be impaired by the economic interests of the integrated studio-network giants. In fact, the success of both of these businesses depends more on consumer tastes and general acceptance of programming decisions than it does on the ability of either to have a captive supply or captive distribution channel. Likewise, although there is risk that AOL Time Warner could unwisely favor its own content over potentially more popular content from outside sources, we believe the consumer market in which AOL Time Warner operates will exert its own corrective influences upon such a practice.

Our Expectations

Integration and cooperation will define success.

Over the next 18 months — as indeed has already begun — we expect to see AOL and Time Warner work more closely to improve the Internet readiness of Time Warner's content and online franchises, while also integrating more of the Time Warner resources into the AOL service and its other online brands. Already, AOL has produced "skinned" versions of its new Netscape browser software that are branded with the leading Time Warner brands — i.e., *Time* magazine, Warner Bros. cartoons — and deeply infused with Time Warner content. In many ways, the new Netscape browser product is a harbinger of the content synergy that we believe will help define the merger: A new technology being introduced by AOL has been reshaped and improved by the addition of Time Warner content. Products like this, which make simple sense from a consumer and marketing perspective, would formerly have required tedious inter-company negotiations and avidly contested financial arrangements. With AOL and Time Warner under a common roof, the mixing of technology with content to generate new products can be done much more quickly and successfully, in our opinion.

While we believe that AOL Plus will probably be a showcase for the way that AOL's services can be improved by the addition of Time Warner's content, AOL TV is likely to represent an early proving ground for this theory. AOL TV will be launched in early summer 2000, and it will be interesting to see how Time Warner franchises are incorporated into that new product. AOL has talked about carving out anchor programming locations within AOL TV that will allow certain content partners to reserve preeminent positions with AOL TV's channel pages. Time Warner is likely to occupy more than one of these potentially valuable anchor slots, enabling the company to capture value not only as the provider of the AOL TV service, but also as owner of one or more of the primary media franchises that are featured within that service. We believe a leading Time Warner role in AOL TV is likely, if for no other reason than the fact AOL Time Warner will be able to work without conflict — between service provider and content source — to produce the ideal programming experience for the new service.

Television Distribution

The Upside

Cross-promotion and packaged selling.

Time Warner's impressive array of television networks (including HBO, TNT, TBS, CNN, the WB Network, and Cartoon Network, among others) provide a solid distribution and promotional platform, which should prove to be a powerful force in promoting AOL's businesses. In addition, the cable networks' strong relationships with advertisers should help to boost AOL's blossoming advertising sales. Time Warner's cable networks also provide a potent source of content for AOL: For example, CNN's unsurpassed news resources could provide attractive online content, which could be incorporated into AOL's subscription business. As a result, AOL may be able to wean itself away from some of its more expensive licensed content by utilizing Time Warner's proprietary content. Furthermore, by incorporating Time Warner's content, we believe that AOL should be able to reduce churn and increase customer retention.

The Turner Networks have enjoyed excellent operating momentum before the AOL transaction. The raw power of the AOL Time Warner combination should allow this momentum to at least be maintained or even notch upward despite increasingly difficult comparisons. Several positive dynamics have been driving this business, but the most critical driver has been a robust advertising model. Cable networks have been a major beneficiary of the shift in advertising dollars from traditional broadcast outlets to cable networks. The company has done an exceptional job of educating the advertising community about the merits of cable networks and the ability of advertisers to grab the same reach and frequency based on a more concentrated purchase of generally more cost efficient cable networks in their media budget. By offering advertisers a much more highly integrated media buy with the scope of AOL Time Warner, we think the shift in advertising dollars will only accelerate. Joint sales meetings are already beginning to take place.

Advertisers are becoming increasingly reliant on using a computer-driven optimization strategy to more efficiently hit their reach and frequency targets. Based on surveys conducted, Turner Networks has found that consumer recall is no different for an ad seen on a broadcast network or cable network. This notion coupled with the enhanced media mix offered by the combined entity will help to keep the dollars flowing towards cable networks rapidly. We estimate about $1 billion in incremental ad dollars will accrue to cable networks in 2000, a similar increase to 1999's performance.

Time Warner's suite of cable network offerings is unmatched in the market, for example, from CNN to the Cartoon Network. The Cartoon Network is just one opportunity worth highlighting. About $50-$60 million will be invested ($15 million in infrastructure) over the next two years in fostering the creation of the Cartoon Network into a multimedia brand for animated entertainment, community and commerce on the Web. By building an animation community on AOL's Entertainment Channel and broadband service, this should increase on-line viewership of content, advertising revenues, potential for syndication and licensing/merchandising revenues and enhance the ability to attract and retain advertisers.

Cross-promotional, international, digital content and ad sales opportunities will also likely be major incremental growth drivers to the Cartoon Network. A few promotional examples include: signing up for AOL and get Cartoon merchandise, distributing AOL disks at Braves, Hawks and Thrashers games, etc.

The AOL Time Warner merger will likely continue to foster change in the way advertising is sold. By creating a new model for advertising, eventually cost per thousand will yield to different performance-based metrics. Whether its cost per sale, cost per new customer acquisition, or lifetime value of a customer, AOL Time Warner will be positioned to exploit this potential.

The Risks

In our opinion, the key challenge facing Time Warner's television distribution assets is fending off viewership erosion as surfing the Internet becomes an increasingly popular consumer pastime. However, should television viewership come under pressure from the Internet, we believe that the combined entity is well-positioned to capitalize on this shift given AOL's leading online presence.

Our Expectations

Overall, in the near term, we believe that Time Warner's television assets will represent a powerful tool for AOL to cross-promote its Internet service, while AOL's expertise should help to accelerate the transition of Time Warner's content to the Internet world. In addition, we estimate that AOL's advertising revenues (which have grown at a 176% rate from 1994–99) should also see a meaningful uplift as Time Warner's long-standing relationship with advertisers is applied to AOL's service.

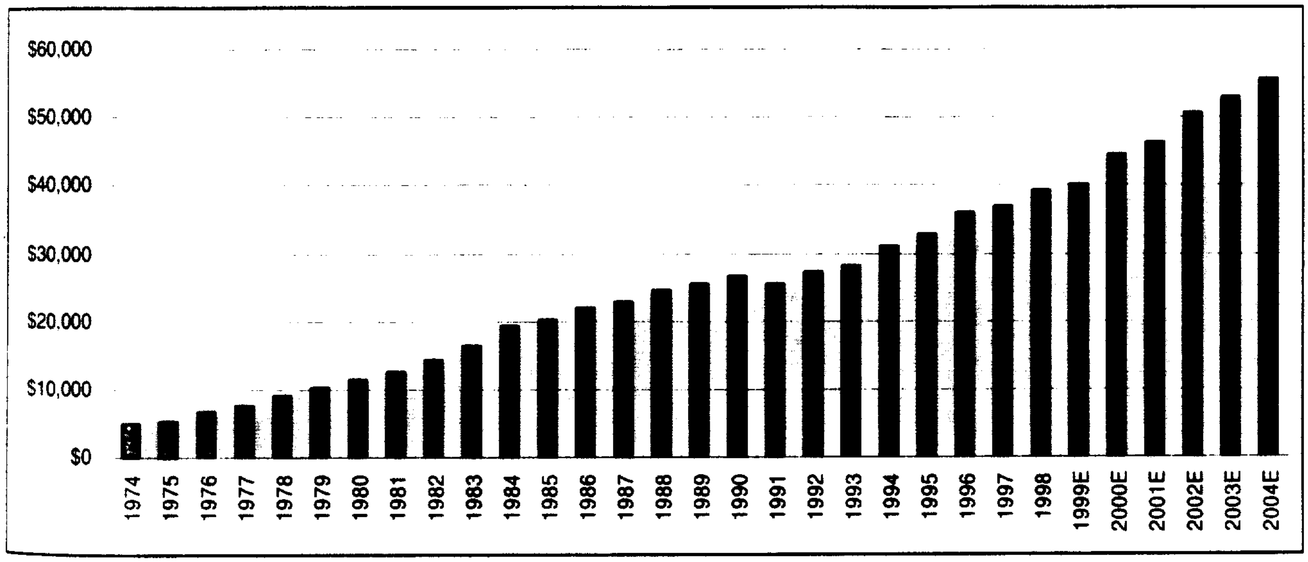
From a business strategy standpoint, we expect that AOL Time Warner will utilize the reach of its television distribution platforms (which reach 2.5 billion consumers monthly) to build on the AOL brand. In addition, as agreements with third-party content providers expire, the traditional Time Warner brands such as CNN and The Cartoon Network will likely migrate to the AOL service, increasing the stickiness of AOL's offerings and thus reducing customer churn.

Video streaming will become part of the picture eventually.

Longer term, we believe that video streaming could have meaningful implications for Time Warner's television businesses. As bandwidth increases, television programming could utilize the Internet as a new, global distribution platform, although challenges will arise in mitigating the cannibalization of traditional television viewing. AOL Time Warner will also be at the vanguard of the budding interactive television market, which is projected to reach $20 billion by 2004, according to Forrester Research. AOL TV, which is slated to launch in the second half of 2000, starts with a navigation overlay on conventional television programming that makes it easier and more convenient to surf and navigate the increasingly vast amount of programming available on television. In addition, AOL TV will bring to the TV set and the television experience several of the most compelling and habit-forming features of the core AOL service: Consumers will be able to access e-mail, chat with friends, and gather incremental news and information on their television screens, all while watching normal programs on TV. The complementary content that embodies AOL TV is delivered through the vertical blanking interval (or extra space) in the regular broadcast signal, through the cable line, or through a satellite dish. While the business model and pricing have not yet been set, we view AOL Time Warner, which boasts in-house distribution (Time Warner Cable), traditional content (Warner Bros., Turner Networks), and the No. 1 brand in interactive content (AOL), as uniquely positioned to benefit from the growth of interactive television.

Figure 11. U.S. Broadcast Television Advertising Projections

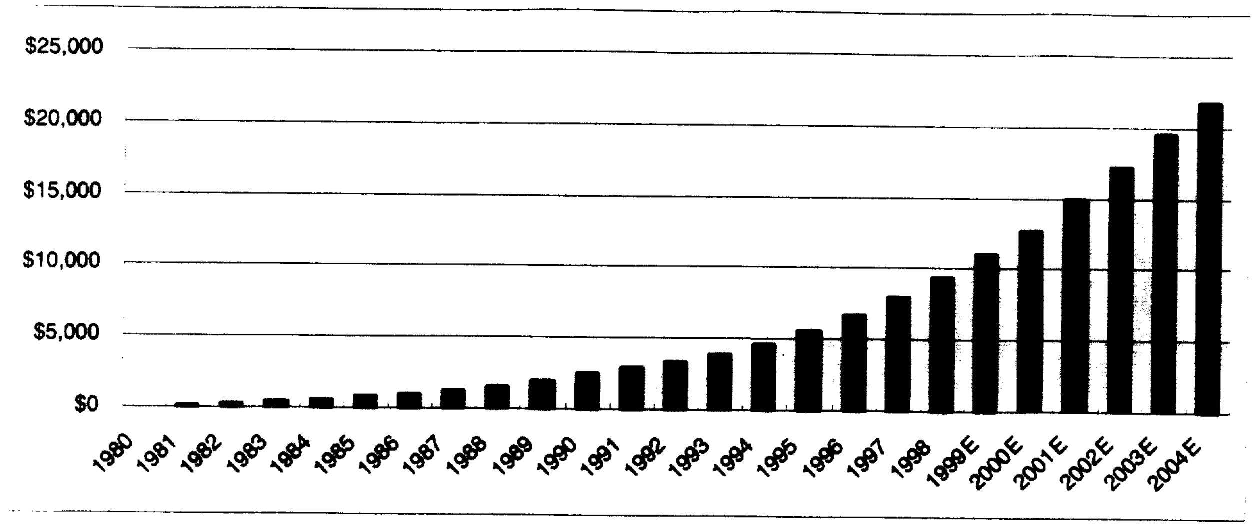
$ in Millions



Source: McCann-Erickson and Salomon Smith Barney

Figure 12. U.S. Cable/DBS Advertising Projections

$ in Millions



Source: Paul Kagan Associates and Salomon Smith Barney

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Music

The Upside

Market and business model will be improved.

In our view, music is poised to be a prime beneficiary of the Internet. As a result, we believe that the prospects for Warner Music (which recently agreed to combine its music operations with EMI Group PLC) will be greatly enhanced by AOL's leading Internet presence. The Internet is reshaping the business model for music: E-commerce is proving to be a substantial new distribution channel for music, while digital downloading of music should further bolster top-line growth while potentially also lowering the cost structure longer term. By marketing Warner Music's offerings to AOL's 23 million and growing subscriber base, top-line growth will likely accelerate from about a 5% per-year pace to something in the high single digits in 2002-03. Assuming EBITDA margins improve 35% from lower cost of goods and distribution expenses linked to digital downloading, we estimate that music EBITDA would see an incremental uplift of $250 million. While the company could pass along some of the anticipated cost saves in the form of lower pricing and only a small proportion of the company's sales will actually be driven by a direct download model, the raw potential is apparent and over time can be quite material.

The Risks

Fundamentally, it is still a hit-driven business.

While the outlook for Warner Music is positive, the chief risks include the potential for Warner Music's recent lackluster performance to continue. Owing to soft international markets and a light release schedule, music EBITDA in 3Q99 and 4Q99 fell 17.4% and 13.5%, respectively. We now forecast that music will deliver a 10%-20% EBITDA decline in the first quarter of 2000 as a lack of hit titles carried over from last year. Music is still projected to see a modest EBITDA rise in 2000, but the quality of the second half product will be the key. In addition, the music business is inherently hit-driven and a drought in successful albums could also crimp performance. With regard to the development of online music, a key risk factor lies in the potential for increased piracy of music, while the global distribution platform of the Internet could allow artists to circumvent traditional record companies like Warner Music. Clearly, a whole new business model will be emerging, as the digital download of music becomes more commonplace. It is possible that there could be some short-term dislocations, which could have an impact on results.

Our Expectations

Despite the risk factors outlined above, we continue to believe that music and Warner Music will shine as the Internet continues to develop as a medium. Piracy is an age-old phenomenon in the music industry and is not unique to the Internet. In 1998, the IFPI estimated that global sales of pirate music CDs rose by 20% to 400 million units, costing the industry a total of US$4.2 billion. To put the current Internet piracy effect into context, the IFPI estimates that 0.5 million illegal music files are stored on the Web, or 0.1% of total pirate units. At the same time, Cahners In-Stat Group estimates that digital music sales amounted to US$150 million in 1998, or 0.4% of the total value of the music market. Together, these two statistics suggest that, despite the hype, Internet piracy is proportionally no more prevalent than the current levels experienced by the industry.

We believe that the risk of disintermediation of music companies is similarly overstated. Since many of the distribution and manufacturing costs disappear in e-commerce, there is a concern that artists will go directly on the Internet to sell their product, cutting out the role of the record company. We think that this oversimplifies the existing role of a record company. Not only do record companies "discover" new talent and finance the early years, but they also heavily market and push that new talent to radio stations (to secure airplay) and to consumers. This role is critical to the success of an artist in the existing model, given the quantity of content available. In an Internet environment, where it is arguably even more important to build a name given the difficulties in searching the Internet, the role of a record company continues to be of great importance for new acts. While a number of sites have been established to provide a forum for unsigned artists (such as mp3.com, musicmatch.com, and musicunsigned.com), these sites tend to be showcases, which still do not fulfill the marketing role of traditional music companies.

On the whole, we believe that the risk/reward scenario presented by the Internet to the music industry is exceedingly favorable. In this vein, AOL Time Warner is uniquely positioned to capitalize on this opportunity. As noted above, Warner Music, combined with EMI, is the world's leading music company with an impressive roster of proven talent as well as leading market share across the globe. In our opinion, leveraging AOL's captive subscriber base and dominant Internet presence will super-charge the combined companies' music business.

Online Promotions

In the near term, with bandwidth constraints, the scope of music on the Internet remains devoted to online promotions. Thousands of albums are released annually; of these, only a fraction receive exposure through television or radio. We believe that the largest opportunity from a promotional standpoint involves improved marketing of secondary artists who receive little air time from radio (which plays predominantly Top 40), while MTV plays approximately only 15% of the music videos produced. Marketing opportunities include the ability to e-mail song samples to fans or to offer free trials to stimulate interest. In addition, the online world offers music labels more direct contact with fans. As a result, we believe the Internet provides the potential for improved returns on artist development.

Currently, some music is available for digital downloading on a limited basis (again, due to bandwidth constraints), primarily for promotional purposes. Early evidence suggests that this alternative is helping to drive incremental music sales. Time Warner/CDNOW have indicated, for example, that offering promotional tracks from Sugar Ray's album *14:59* over a 30-day period fueled a 70% jump in CDNOW's sales of the album. Similarly, by allowing for the digital downloading of Todd Rundgren's new song "The Surf Talks," sales of his prior album *The Very Best of Todd Rundgren* (originally released in 1997) surged 110% month over month during the promotional period.

E-commerce
Music e-commerce will provide a powerful distribution platform on the computer, as the Internet provides a point-of-sale window for millions of consumers, versus traditional retail outlets, which are measured in the thousands. Pro forma for Time Warner's combination with EMI, AOL Time Warner will have a roster of more than 2,500 artists, and garner over 2 million song copyrights. AOL's more than 23 million subscribers will provide a powerful platform for this new venture to leverage as it expands its online presence. The Internet will allow Warner/EMI to potentially reach all consumers around the globe, instead of a small subset of typically 10- to 24-year-olds at retail stores. Furthermore, this new distribution platform will enable Warner/EMI to showcase and sell its huge inventory of products. We estimate that more than 10% of total music industry sales (e-commerce/digital downloading) will be achieved online by 2003-04.

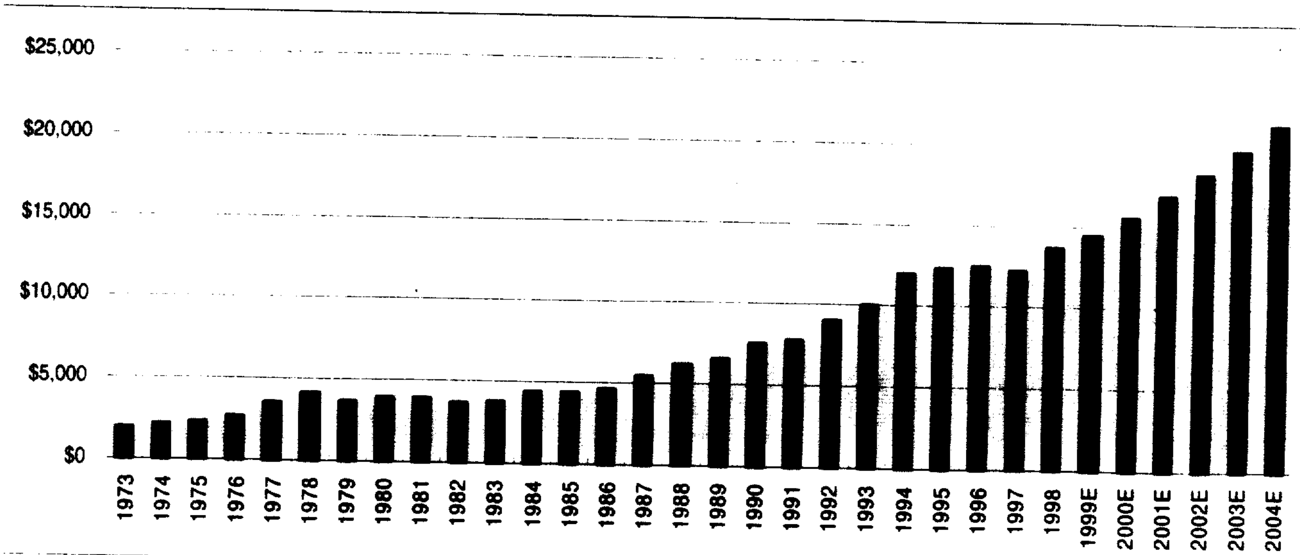
Digital Downloading
Longer term, as bandwidth increases, the Internet will bring to the music industry a complete shift in the distribution and format of recorded music, with consumers downloading content directly from the Internet to equipment in the home. Music downloading from the Internet is currently possible using MP3 software and hardware, a standard that has evolved mainly outside the sphere of influence of the "majors," which have been slow in defining their own industry standards. However, with a proliferation of pirate recordings (it is not difficult to convert a CD into a compressed MP3 file) and strong growth in MP3 sales, the major music companies have now agreed upon a standard format (SDMI—the secure digital music initiative), which they hope to launch by year-end 2000.

Much depends on an agreed-upon standard becoming accepted by and marketed to consumers, as this will prompt manufacturers to mass-produce the necessary hardware and drive product acceptance. The choice of "winning" technology will affect the exact structure of the music industry and the extent to which the existing majors can benefit from the likely changes. Clearly, however, the ability to download music via the Internet represents a significant shift in the structure of the music industry. On the cost side, manufacturing (i.e., pressing CDs, recording tapes, etc.) and distribution costs almost disappear, although other rights, management, database, and marketing costs will surely offset a portion of these savings. On the revenue side, there is potential for a sales boost as consumers upgrade their existing collections to the new format, as happened during the shift from vinyl to CD. Interestingly, the ability to create one's own compilation is likely to re-emphasize the importance of singles, the market for which has seen a rapid decline, with a recent Music & Copyright survey showing a first half 1999 drop in singles sales of 37% in Japan, 24% in the United States, and 6% in the United Kingdom.

We also believe that other future developments could serve to super charge AOL Time Warner's music business. The music industry continues to consolidate (as evidenced by Seagram's acquisition of PolyGram and the above-mentioned merger of Time Warner and EMI); thus, future music acquisitions could further bolster AOL Time Warner's music presence. In addition, technology has historically reshaped the music business by providing new distribution outlets. In this vein, using mobile units (such as wireless phones or personal digital assistants) to listen to music could further accelerate music growth for AOL Time Warner longer term.

Figure 13. U.S. Recorded Music Projections

$ in Millions



Source: RIAA and Salomon Smith Barney

Filmed Entertainment

The Upside

Internet and AOL as another distribution channel longer term.

Historically, technology has created new distribution platforms through which filmed entertainment can be leveraged, allowing incremental revenue streams to develop. For instance, the evolution of video began with motion pictures in the early portion of the 20th century. By the 1950s, the advent of television provided a new format for consumers to view feature films, with Hollywood studios garnering license fees from television outlets to complement ticket sales at the theatrical exhibition level. Similarly, technology led to the birth of the VCR in the 1970s, which spawned the home video market, a major profit driver for movie studios. In addition, new technology and distribution formats allow media companies to leverage their core competency in creating content to attack new entertainment markets. Once again using television as an example, Hollywood studios, by utilizing their production assets and relationships with creative talents, to this day remain the No. 1 supplier of television programming, reaping the financial rewards from network television production to off-network syndication.

The merger with AOL should squarely place Time Warner's filmed entertainment assets (Warner Bros. and TBS Film) at the forefront of the budding online entertainment business. In the near term, we believe that AOL's 23 million-plus subscribers will be an attractive cross-promotional vehicle for Time Warner's movies and television shows. As the Internet transitions to broadband technology, the Internet and AOL's subscription service should provide a substantial market for the direct distribution of Time Warner content. In addition, as interactive features become an increasingly important component of entertainment, Warner Bros.' content development expertise should also prove invaluable in developing new forms of entertainment.

The Risks

The risk, in our view, is that AOL Time Warner fails to develop content for the online world that resonates with consumers. This challenge is underscored by the inherent hit-driven nature of the entertainment business and fickle consumer tastes. Should AOL Time Warner prove unsuccessful in capitalizing on the online entertainment opportunity, Time Warner's traditional filmed entertainment will remain mired in challenging fundamentals — namely, a mature market and rapidly rising production and marketing costs.

Our Expectations

Although success in the field of entertainment is inherently difficult to predict, we believe that Time Warner's track record in developing "hits" provides some level of confidence that the combined company will take advantage of the Internet as a medium for entertainment. Coupled with AOL's experience in developing compelling online applications (which have already attracted 23 million paying subscribers), we believe that the risk of AOL Time Warner failing in this arena is low.

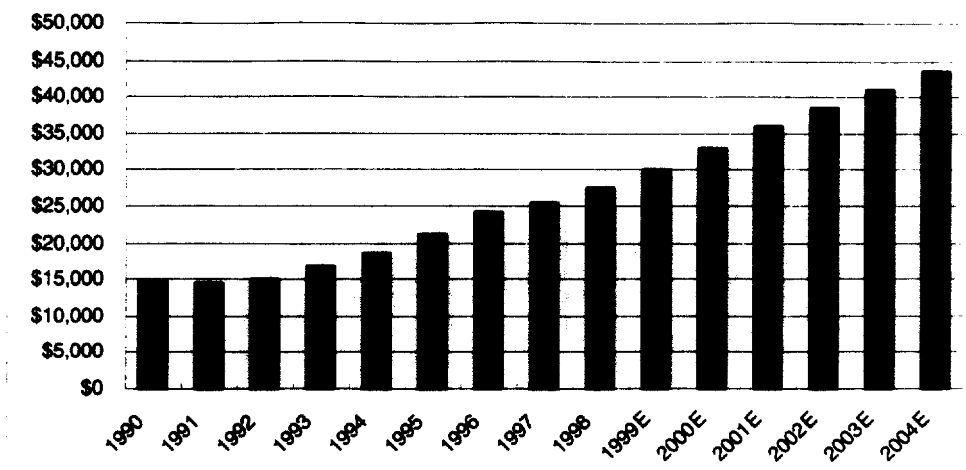
The development of Internet distribution for filmed entertainment will likely hinge on the deployment of broadband technologies and in-home media storage devices. With greater bandwidth, consumers could ultimately download films and television programs for their personal consumption, lending new meaning to video-on-demand. For AOL Time Warner and other content creators, this new avenue would be tantamount to adding a new window to its distribution cycle, allowing for an incremental new, high-margin revenue stream. It is important to note that content companies are poised to benefit from any form of broadband rollout, irrespective of which technology becomes entrenched as the standard (cable modems, DSL, satellite, etc.).

In addition to providing a new distribution format for traditional entertainment goods, the Internet should also become a new breeding ground for specialized online content. In our view, for consumers to truly gravitate to the Internet as a form of entertainment, media players must also develop online content to take advantage of the Internet's interactivity. Yet, this process is dependent on creative forces, and it is difficult to predict how online entertainment will evolve. Some players have begun to experiment with new online entertainment concepts. Showtime (a unit of Viacom), for instance, has created "WhirlGirl," a new online animated series, at its showtimeonline.com Web site. "WhirlGirl" is a short-form animation with new free episodes available every week. In addition, consumers can also play related games online at the "WhirlGirl" site with the lead character. While still somewhat crude in execution (and not likely to threaten Disney's animated products in the near future), it is clear that entertainment companies are still finding their way through the myriad of entertainment options offered by the Internet. Prior to the announced merger with AOL, Time Warner was also in the throes of defining the entertainment of tomorrow at its recently revamped entertaindom.com Web site. This online destination promised a new era of entertainment, composed of four domains: 1) video-based entertainment; 2) animation-based entertainment; 3) music-based entertainment, and 4) game-based entertainment.

Clearly, the evolution of filmed entertainment online remains cloudy. As history has suggested, content creators will need time to explore and understand what new entertainment ideas will work with technological advancements and new media. While we can only guess what will capture the public's imagination to become the new "Seinfeld" or *Titanic* of the Internet, we firmly believe that media companies must break the accepted mold of creating passive entertainment experiences. To succeed online, these players must ultimately embrace the interactivity that the Internet offers and deliver an exciting new experience for consumers. In our view, AOL Time Warner, with its unique blend of content development expertise, potent brands, and AOL's ingenuity in developing online applications, will lead the charge on this front.

Figure 14. U.S Theatrical Film Distribution Revenue Projections

$ in Millions



Note: Includes Theatrical Exhibition, Home Video and TV Distribution of Films

Source: Adams Media Research. EDI, Paul Kagan Associates, and Salomon Smith Barney

Financial Models

Figure 15. AOL Time Warner: Historical and Projected Earnings, 1999-2002E (without Synergy line item)
($ in millions, except per-share data)

	F1999	F2000E	F2001E	F2002E
Revenue				
Cable Systems	$5,374	$6,038	$6,641	$7,239
Online	5,718	7,606	9,788	11,739
Cable Networks	6,111	6,976	7,857	8,772
Filmed Entertainment	8,075	8,442	8,864	9,202
Publishing	4,663	4,943	5,190	5,398
Music	3,834	3,987	4,187	4,438
Broadcasting	384	518	622	728
Digital Media	1	50	60	70
InterSegment Elimination	(1,109)	(1,331)	(1,464)	(1,611)
Total Revenue	**$33,061**	**$37,229**	**$41,744**	**$45,976**
EBITDA				
Cable Systems	2,491	2,840	3,097	3,484
Online	1,253	1,966	3,162	4,384
Cable Networks	1,529	1,817	2,095	2,426
Filmed Entertainment	947	982	1,040	1,143
Publishing	760	855	941	1,049
Music	526	546	574	637
Broadcasting	(91)	(35)	0	15
Digital Media	(16)	(221)	(220)	(195)
InterSegment Elimination	(36)	(60)	(90)	(95)
Total EBITDA Without Synergies	**$7,363**	**$8,691**	**$10,598**	**$12,847**
EBITDA (Withouth Synergies) Growth Rate	(13.2%)	18.0%	22.0%	21.2%
Synergies	0	158	990	1,407
Total EBITDA With Synergies	**$7,363**	**$8,849**	**$11,588**	**$14,254**
EBITDA (With Synergies) Growth Rate	23.1%	20.2%	31.0%	23.0%
Depreciation	(1,170)	(1,460)	(1,630)	(1,780)
Amortization	(1,397)	(1,330)	(8,430)	(8,430)
Total Operating Income	**$4,796**	**$6,059**	**$1,529**	**$4,045**
Interest and Other, Net	(1,844)	(1,965)	(1,300)	(1,300)
Minority Interest	(400)	(475)	(535)	(600)
Corporate Expense	(248)	(260)	(230)	(240)
Income (Loss) Before Income Taxes	**$2,304**	**$3,359**	**($536)**	**$1,904**
Income Taxes	(1,033)	(1,950)	(1,764)	(2,779)
Tax Rate	45%	58%	(329%)	146%
Recurring Earnings	**$1,271**	**$1,408**	**($2,300)**	**($875)**
Preferred Dividend	(52)	(14)	0	0
Recurring Earnings to Common	**$1,219**	**$1,394**	**($2,300)**	**($875)**
Extraordinary Items	1,374	0	0	0
Reported Net Income to Common	**$2,593**	**$1,394**	**($2,300)**	**($875)**
Per Share Data:				
Recurring Earnings to Common	**$0.27**	**$0.30**	**($0.48)**	**($0.18)**
Extraordinary Items	$0.31	$0.00	$0.00	$0.00
Reported Net Income to Common	**$0.58**	**$0.30**	**($0.48)**	**($0.18)**
Avg. Shares Outst. (MM)	4,474	4,701	4,786	4,933

Source: Company reports and Salomon Smith Barney

Figure 16. AOL Time Warner: Historical and Projected Earnings, 1999-2002E (with Synergy line item)

($ in millions, except per-share data)

	F1999	F2000E	F2001E	F2002E
Revenue				
Cable Systems	$5,374	$6,038	$6,943	$7,985
Online	5,718	7,806	10,138	11,939
Cable Networks	6,111	6,976	8,093	9,387
Filmed Entertainment	8,075	8,442	8,864	9,528
Publishing	4,663	4,943	5,338	5,872
Music	3,834	3,987	4,266	4,693
Broadcasting	384	518	622	728
Digital Media	1	50	260	500
InterSegment Elimination	(1,109)	(1,331)	(1,464)	(1,611)
Total Revenue	**$33,051**	**$37,429**	**$43,059**	**$49,022**
EBITDA				
Cable Systems	2,491	2,852	3,408	4,124
Online	1,253	2,066	3,512	4,584
Cable Networks	1,529	1,817	2,171	2,627
Filmed Entertainment	947	982	1,076	1,179
Publishing	760	855	988	1,141
Music	526	546	599	665
Broadcasting	(91)	(35)	0	30
Digital Media	(16)	(175)	(75)	0
InterSegment Elimination	(36)	(60)	(90)	(95)
Total EBITDA	**$7,363**	**$8,849**	**$11,588**	**$14,254**
EBITDA Growth Rate	23.1%	20.2%	31.0%	23.0%
Depreciation	(1,170)	(1,460)	(1,630)	(1,780)
Amortization	(1,397)	(1,330)	(8,430)	(8,430)
Total Operating Income	**$4,796**	**$6,059**	**$1,529**	**$4,045**
Interest and Other, Net	(1,844)	(1,965)	(1,300)	(1,300)
Minority Interest	(400)	(475)	(535)	(600)
Corporate Expense	(248)	(260)	(230)	(240)
Income (Loss) Before Income Taxes	**$2,304**	**$3,359**	**($536)**	**$1,904**
Income Taxes	(1,033)	(1,950)	(1,764)	(2,779)
Tax Rate	45%	58%	(329%)	146%
Recurring Earnings	**$1,271**	**$1,408**	**($2,300)**	**($875)**
Preferred Dividend	(52)	(14)	0	0
Recurring Earnings to Common	**$1,219**	**$1,394**	**($2,300)**	**($875)**
Extraordinary Items	1,374	0	0	0
Reported Net Income to Common	**$2,593**	**$1,394**	**($2,300)**	**($875)**
Per Share Data:				
Recurring Earnings to Common	**$0.27**	**$0.30**	**($0.48)**	**($0.18)**
Extraordinary Items	$0.31	$0.00	$0.00	$0.00
Reported Net Income to Common	**$0.58**	**$0.30**	**($0.48)**	**($0.18)**
Avg. Shares Outst. (MM)	4,474	4,701	4,786	4,933

Source: Company reports and Salomon Smith Barney

An Alternative View: Jerry Levin's "Three Buckets"

Levin 's three buckets: Subscriptions, Content, and Ad/E-Commerce revenues.

In explaining how the businesses of the new AOL Time Warner fit together, and in an effort to present the engines of the combined company's growth in a straightforward manner, Time Warner CEO Jerry Levin speaks of "three buckets" of revenue: Subscriptions, Content, and Advertising/E-Commerce. Mr. Levin's simplified characterization of the new company's business and financial structure is interesting and useful, as it helps draw out the similarities between AOL and Time Warner. Both companies have significant subscription and advertising revenue streams, and content plays a key role in each.

Speaking generally, Mr. Levin has stated that the combined company's business initially will break down as 40% of revenue from Subscriptions, 40% from Content, and 20% from Advertising/E-Commerce. Then, putting this reorganized view of the company in context, the Time Warner CEO has suggested that the Subscription businesses are a steady source of revenue and cash flow, provide the "customer touch" base of the new company, and should provide tactical integration and strategic leverage opportunities. The Content business is positioned as the creative heart of the new company and the repository of significant and unique long-term value. As the Internet transforms the media business, the Content portion of the company stands to be energized by new content formats and widening distribution channels, with accelerated long-term revenue and cash flow growth rates being central to that outlook. The Advertising/E-Commerce streams are currently the smallest contributors to overall results for the combined company, but these are positioned on the crest of a highly predictable and powerful wave of growth as cable television revenues catch up with viewership, and as audience attention to and consumer usage of the Internet rises, pulling along explosive gains in online advertising/e-commerce revenue.

Pittman's three layers: Tactical Synergies, Strategic Opportunities, and Transformational Possibilities.

In some ways, Mr. Levin's conceptualization corresponds with that of AOL President Bob Pittman. For his part, Mr. Pittman also describes three layers to the combination: Tactical Synergies, Strategic Opportunities, and Transformational Possibilities. The tactical merits of combining AOL and Time Warner should yield $1 billion in incremental EBITDA in the first year of combination, on the back of easy-to-realize revenue enhancements and immediate cost savings. The strategic elements of the merger include integration efforts that would put AOL services onto Time Warner's cable television distribution platform, infuse AOL services with Time Warner content, bundle together various products and services of the two firms, and allow a new level of strategic momentum in areas such as cable-Internet open access, broadband AOL, e-commerce sales of Time Warner entertainment content, and new-product development. On the transformational front, it is a bit harder to speak precisely of what the merger will bring, but as traditional media and the Internet continue to converge upon new forms of interactivity, entertainment and communication, it is safe to say that AOL Time Warner will be uniquely positioned to invent, define and deliver entirely new services and products in the future.

In a loose way, Mr. Levin's Subscription category maps to Mr. Pittman's Tactical Synergies focus, as many of the cross-selling, cross-promotion and cost-saving ideas fall into these two classifications. Similarly, the Advertising/E-Commerce "bucket" will be home to many of the strategic benefits of the merger, as mixing the two companies' brands, audiences, distribution networks, and respective areas of expertise together should provide headroom for AOL Time Warner to accelerate the already-rapid growth in high-margin advertising and e-commerce revenue. Finally, the Content side of AOL Time Warner is likely to be the element most transformed over time, where entirely new businesses and products can emerge as the companies and their online/offline media businesses converge.

Model rebuilt using the "three-bucket" approach.

Leveraging off of Mr. Levin's Subscription/Advertising/Content framework, we took a crack at examining AOL Time Warner through that alternative lens. While we do not expect the company to divide its business or report its results in this manner in the future, it does provide a worthwhile and revealing glimpse of the merger from another perspective. Briefly, we rebuilt our financial model for AOL Time Warner at a high level as follows: Into Subscriptions, we put AOL's monthly access revenue, along with our estimates of Time Warner's cable service revenue, cable network subscriber revenue and magazine subscription revenue. The Advertising/E-Commerce "bucket" is filled with AOL's revenue in these areas, together with Time Warner's ad revenue from local cable system media sales, the cable networks, magazines, broadcasting, and its Web sites. Finally, the Content piece is composed of Time Warner's filmed entertainment, music and book publishing revenue. We also drew up an Other category, into which we put AOL's Enterprise Services revenue and our best guess at Time Warner's store revenue. We are the first to admit that we've taken some very rough estimates in building our "three-bucket" model, but we are encouraged by the outcome, which is acceptably close to Mr. Levin's 40%/40%/20% percentages. We also broke down the combined company's EBITDA as best we could, using the categories and classifications detailed here (see Figure 17).

Figure 17. AOL Time Warner: A Look at Jerry Levin's "Three Buckets," 1999-2004E

($ in billions, except per-share data)

	1999	2000E	2001E	2002E	2003E	2004E	CAGR
Revenue							
Subscriptions	$13	$15	$17	$19	$21	$23	+12%
Content	13	13	14	15	16	18	+7%
Advertising/E-Commerce	7	8	11	15	20	25	+30%
Other	1	1	1	1	1	1	(1%)
Total	$33	$37	$43	$50	$58	$67	+15%
EBITDA							
Subscriptions	3	4	4	5	6	6	+14%
Content	2	2	2	2	3	3	+12%
Advertising/E-Commerce	2	3	4	6	8	11	+38%
Other	0	0	0	0	0	0	+38%
Total	$7	$9	$11	$13	$17	$21	+23%
EBITDA Margin							
Subscriptions	26%	27%	27%	27%	28%	29%	
Content	13%	13%	13%	14%	15%	17%	
Advertising/E-Commerce	34%	35%	36%	38%	42%	45%	
Other	3%	12%	12%	13%	14%	15%	
Total	22%	23%	25%	27%	29%	31%	
Revenue Mix Analysis							
Subscriptions	39%	39%	39%	37%	36%	34%	
Content	38%	36%	33%	30%	29%	27%	
Advertising/E-Commerce	20%	23%	27%	31%	34%	38%	
Other	3%	2%	2%	2%	1%	1%	
Total	100%	100%	100%	100%	100%	100%	
EBITDA Mix Analysis							
Subscriptions	46%	45%	42%	38%	35%	31%	
Content	23%	20%	18%	16%	15%	14%	
Advertising/E-Commerce	31%	34%	39%	44%	49%	54%	
Other	0%	1%	1%	1%	1%	1%	
Total	100%	100%	100%	100%	100%	100%	

Note: Subscription category includes figures from AOL, Time Warner Cable, Cable Networks, and Publishing, with estimated intersegment eliminations. Content category includes figures from Filmed Entertainment, Music and Publishing, with estimated intersegment eliminations. Advertising and E-Commerce category includes figures from AOL, Time Warner Cable, Cable Networks, Publishing, Broadcasting, and Digital Media, with intersegment eliminations. Other category includes figures from AOL and Filmed Entertainment, with eliminations.

Source: Company reports and Salomon Smith Barney

In 1999, the combined company would have had roughly $33 billion in revenue, with about $7 billion in EBITDA before corporate expenses, for a 22% cash flow margin. Looking to the future, we projected the "three-bucket" model primarily according to the top level considerations that both Levin and Pittman have articulated. The results are interesting.

Subscription revenue growth rate boosted by combination.

On the Subscription line, we project revenue growth in the mid- to lower teens in the next two years, as AOL's supercharged subscriber revenue growth rate is layered on top of more muted subscription revenue growth rates in Time Warner's cable and publishing businesses. However, toward the tail end of a five-year horizon, we would not expect to see the combined company's subscription growth rate tail off the way that it might if the two companies were looked at independently in isolation. We believe that new services, such as AOL Plus, AOL TV, and perhaps even some music or movie subscription businesses that we cannot entirely envision right now, should be incorporated into the combined company's subscription revenue outlook to a degree that they might not necessarily see without the merger. Accordingly, we do not see annual subscription revenue growth falling below the 10% threshold through 2004.

On the Advertising/E-Commerce front, a simple combination of the two companies' 2000 outlook would point to revenue growth of slightly better than 25% in 2000 versus 1999. Clearly, AOL's advertising and e-commerce revenue will climb at a rate several times as great as 25%, and Time Warner's local cable ad sales are currently growing at better than 30% per year. The WB is also on a pace far outstripping the combined company average. However, Time Warner's magazine and cable network ad revenue, which would account for roughly two-thirds of the combined company's overall revenue in this category, are growing at about half the 25% rate.

Rapid ad/e-commerce revenue growth is certain.

Beyond the current year, however, we would expect the combination of AOL and Time Warner to help supercharge the companies' advertising and e-commerce revenue. Importantly, as the Internet grows to become a larger part of the combined company's ad revenue stream, the growth of that medium will buoy the overall ad revenue growth rate for the company, even before the benefit of any tactical or strategic enhancements. For instance, while the Internet accounted for less than one-fifth of the combined company's ad/e-commerce revenue in 1999, our pre-existing projections for both companies show the Internet at more than one-quarter of that category's revenue in 2000. In 2001, as AOL and Time Warner work together, cross-pollinate and cross-sell each other's media inventory, we believe a 35% jump in ad/e-commerce sales is within reason. From that pace, the law of large numbers should gradually pull AOL Time Warner's advertising/e-commerce revenue back downward, but we recognize that unseen e-commerce opportunities and the inexorable rise of online audience time will continue to make this the fastest-growing revenue "bucket" in the new company. On this point, we would also argue that rapid ad/e-commerce revenue growth is probably the most predictable financial attribute of the new company, given background industry forces and the enhanced position of the merged company within that environment.

Content revenue growth will rise to double digits by the end of our projections.

On the Content side, the new company will start with 40% of its revenue coming from its slowest-growth category. However, the direct cash flows coming from businesses such as filmed entertainment, music, and book publishing are smaller relative to the cash flows of the company's other, higher-margin businesses. To wit, we estimated that the Content "bucket" produced a cash flow margin in the vicinity of 13% in 1999 and accounted for only 20%-25% of overall cash flow last year. Furthermore, if the new company is successful along the "transformational" lines that both Levin and Pittman have articulated, we believe that the revenue growth rate in the Content business is poised to creep upward over time. We believe that the digital distribution of content over the Internet and the convergence of the truly massive distribution power of television and cable television with the interactive and on-demand capacities of online media promise expanded Content opportunities over a five-year period. In our top-down "bucket" model, we have forecasted Content revenue growth that starts in the mid-single digits in 1999 and 2000, and will likely then rise to 10% per year by the end of our projection period.

Turning to cash flows, there are two ways to project how the revenue trends described above might affect EBITDA over time: First, we can make category-by-category assessments of margin trends into the future and roll up these numbers to produce a company-wide estimate; alternatively, we can take a more general but nonetheless indicative approach using an overall marginal rate of profitability applied against projected revenue growth to forecast the change in EBITDA. With a model as approximate as our "bucket," we prefer the latter approach in order to avoid the presumption of really knowing how the company's cash flows will correspond with the revenue categories.

Marginal profitability rates are expected to mushroom.

In general, media businesses in growth mode are characterized by appealingly high levels of marginal profitability. Initial investments in content and distribution networks tend not to escalate in tandem with the revenue potential as audience scale grows. Think of how a hit movie or album can produce rising profit returns as revenue grows when a title goes from popular to hit to blockbuster (of course, sometimes it is the artist, rather than the producer, that captures the sweetening back-end profits). Or, consider how AOL's margins have mushroomed as its audience has sailed beyond a critical mass and advertising revenue per member has surged. The same is true in any well-managed magazine, broadcasting, or cable network business: Once the basic operating cost nut is covered, incremental revenue tends to have incrementally higher profit associated with it. In our analysis of both traditional and online media businesses, we have repeatedly seen marginal rates of profitability in the 30%–50% range.

Going back to our "bucket" revenue model, we believe a 15% compound annual revenue growth rate is achievable for AOL Time Warner over the next five years, leaving combined company revenue above $65 billion in the terminal year of our current forecast. Starting with $7 billion in EBITDA in 1999, if we apply a 30%–50% margin to the increase in revenue that we have described between 1999-2004, our projections drop out $10-$17 billion in incremental cash flow on top of the base $7 billion by 2004. At the midpoint of that range — equivalent to a 40% rate of marginal EBITDA profitability on a $34 billion increase in annual revenue from 1999-2004 — we arrive at an EBITDA estimate of $21 billion for AOL Time Warner in 2004, triple the 1999 level.

Figure 18. AOL Time Warner: Marginal Profitability Matrix and Valuation Summary

($ in billions, except per-share data)

			EBITDA Marginal Profitability to 2004E				
	1999	2001E	30%	35%	40%	45%	50%
EBITDA	$7	$11	$17	$19	$21	$23	$24
Implied EBITDA Margin	22%	26%	26%	29%	31%	34%	36%
Five-Year EBITDA CAGR			+19%	+21%	+23%	+25%	+27%
Per Share Target Price on 2001 EBIDTA at Multiple-to-5 Year Growth Rate ratio of:							
		1.50x	$68	$76	$83	$90	$96
		1.75x	79	88	97	105	112
		2.00x	90	101	110	119	128
		2.25x	101	113	124	134	144

Source. Company reports and Salomon Smith Barney

Viewed in the more detailed, category-by-category margin format, we also see $21 billion in 2004 EBITDA as a fair estimate. In Figure 17, we have projected that AOL Time Warner's Subscription stream goes from a starting EBITDA margin in the mid-20% range to the upper 20% level by 2004, as subscriber marketing efforts become more efficient and retention rates rise as products are cross-marketed and bundled together. Likewise, we project that the Content businesses might tack on 400 basis points of EBITDA margin over the next five years, as new distribution channels lower costs and new products, pricing models, and packaging for content expand the overall market size. Finally, we believe that AOL Time Warner's Advertising/E-Commerce revenue stream will enjoy steadily increasing profitability, moving from an estimated mid-30% EBITDA margin level in 1999 toward a mid-40% level by 2004, in line with the profitability of other "pure" advertising revenue models with which we are familiar (e.g., ,the radio and television broadcasting business and Yahoo!). Applying these EBITDA margin assumptions to our "bucket" revenue model, we arrive at the same $21 billion in 2004 EBITDA that we forecast under the more macro-oriented marginal profitability method detailed above.

AOL is poised to deliver the strongest growth rates and cash flows seen in traditional media and online businesses.

In the end, projecting a combined AOL Time Warner's revenue and cash flow out five years is a task that we believe can be accomplished with only a limited amount of accuracy. Historically, investors and analysts evaluating Time Warner have frequently used such long-term models, and with a reasonable degree of accuracy. However, on the AOL side, looking out beyond the next five quarters has been somewhat difficult in the past, as new business opportunities, unforeseen market growth, and ongoing strategic expansions in AOL's scope of activity have challenged the forecaster to include the full potential in any point-in-time projections. As AOL and Time Warner merge, the new company's growth, revenue, and cash flows will surely be more easily projected than have been AOL's in the past; however, the likelihood and magnitude of upside surprises relative to prevailing expectations should also be far greater than what has historically been the case with Time Warner's numbers. Nonetheless, we are comfortable making one strong and broad conclusion about the new company's future: a combined AOL Time Warner will be poised to deliver some of the strongest growth rates and the highest overall levels of revenue and cash flow that will be seen in either the traditional media business or the Internet marketplace, respectively.