Figure 21. AOL Time Warner Free Cash Flow Composition, 1999E

($ in millions, except per-share data)

	AOL	TWX	Combined
Revenue	$5,718	$27,333	$33,051
Net Income	668	470	1,138
Depr. & Amort.	240	2,529	2,769
Cash Earnings	$908	$2,999	$3,907
Capital Exp.	(489)	(2,043)	(2,532)
Non-Cash WC Change	736	1,000	1,736
Free Cash Flow	**$1,155**	**$1,956**	**$3,111**
Per Share Amounts:			
Net Income	$0.27	$0.34	$0.25
Depr. & Amort.	0.10	1.81	0.61
Cash Earnings	$0.37	$2.15	$0.86
Capital Exp.	(0.20)	(1.46)	(0.56)
Non-Cash WC Change	0.30	0.72	0.38
Free Cash Flow	**$0.47**	**$1.40**	**$0.69**
Shares Outst. (MM)	2,435	1,398	4,532

Source: Company reports and Salomon Smith Barney

Already well valued on an absolute FCF basis...

Turning to more direct valuation, we note that the nine comparable companies we have isolated at currently trading at an average of roughly 30 times estimated 2001 free cash flow, as illustrated in Figure A. The high-flier in the group is Cisco at over 100x projected free cash flow, although Lucent's projected negative free cash flow in 2001 technically makes that company the most expensive by this measure. On the lower end, General Electric is trading at 15x estimated 2001 free cash flow, probably reflecting GE's lower underlying earnings growth. At 56x estimated 2001 free cash flow, AOL Time Warner would have the third-highest free cash flow multiple in the group, excluding Lucent with its negative projected free cash flow.

...but an inexpensive way to buy FCF quality and growth.

A comparison of absolute free cash flow multiples only goes so far however, as the group of peers occupies a relatively wide range of free cash flow growth expectations. On the low end, we see General Electric, Intel, and Wal-Mart with mid-teens free cash flow growth and Oracle, IBM and Cisco each north of 30% free cash flow growth in 2001. The obvious way in which to adjust for varying free cash flow growth rates is to draw up a relationship between those growth rates and the free cash flow multiples implied by the valuations investors have assigned each one of these companies.

In the column at far right in Figure 19, we have presented the ratio of free cash flow multiple to free cash flow growth, using estimated 2001 free cash flow and the 2000 to 2001 growth rate. Compared to the absolute free cash flow multiples, the multiple to growth rate calculations seem to be slightly less widely dispersed. The group average is currently a multiple to growth rate ratio of 1.2x, with a high end just under 3x for Oracle and a low end of 0.6x for IBM. However, our peer group and the straight average calculations are still muddied by a few outliers, even on the multiple to growth rate basis. First, Exxon-Mobil's free cash flow is lower in 2001 than in 2000, producing a negative number in our model which skews the results. Similarly, the tabulations for Lucent are distorted by a projected free cash flow loss in 2001. To clean up these numbers for application to our valuation of AOL we can go in nay of several directions.

Adjusting the peer group.

If we exclude those companies with free cash flow growth rates that are either high-side anomalies or low-end numbers reflecting relatively maturity, we probably come closer to a group median that is more appropriate for valuing a combined AOL Time Warner. Excluding companies with free cash flow growth in 2001 in excess of 100% (Cisco) as well as those below 10% (Exxon, Lucent), we arrive at an average multiple to growth rate ratio of 2x. Alternatively, we could focus only on the peers with subjectively determined high-quality free cash flow growth (as explained above), and using Microsoft, Cisco, General Electric, Intel, and Oracle we would arrive at and average multiple to growth rate ratio of 1.86x. Paring the group down to center on only the most technologically-oriented companies — Microsoft, Cisco, Intel, and Oracle — we determine an average ratio of just over 2x. Using only the cream of the crop from a free cash flow quality standpoint — Microsoft and Oracle — the average would be just over 2x.

AOL Time Warner target: 2x FCF growth of 50%=$115 per share.

Given the foregoing discussion, we believe a highly reasonable valuation for AOL Time Warner on free cash flow is a multiple of estimated 2001 free cash equal to 2x the 50% free cash flow growth we anticipate for the company over the next several years. We note that while our figures show multiple to growth rate comparisons that use 2000–01 free cash flow growth for the peers, we propose using a forward-looking growth rate on AOL Time Warner. The result actually yields a more conservative valuation for AOL Time Warner since the multiple to growth rate comparisons for the peers would rise even higher if slowing, forward-looking free cash flow growth rates were used in peer company calculations. Nonetheless, at 100x projected 2001 free cash flow of $1.15 per share, our 12-month price target for a combined AOL Time Warner is $115 per share.

Execution is a risk not to be captured in a simple multiple.

Since a combined AOL Time Warner is a newly merging entity, whereas Microsoft, Cisco, GE, Intel, and Oracle are all well-established operating companies with existing track records, a case could be made for the application of an integration risk or uncertainty discount to AOL Time Warner's free cash flow multiple. However, we believe that the demonstrated commitment of AOL and Time Warner to begin working together and joining forces, both tactically and strategically, well before the closing of the merger reduces some of the normal merger-related valuation risk. Furthermore, we believe that in building a valuation case for a merger that will create as many advantages and opportunities as we believe the AOL Time Warner transaction does, investors who have reached the conclusion, as we have, that the new company will represent an attractive and unique investment vehicle should approach the valuation process with conviction, rather than timidity. Thus, instead of haircutting our valuation target to fold in a margin of safety or to discount integration risk, we prefer to set our price target using the most appropriate financial yardstick at a fair level relative to what we believe are the correct comparables and leave it at that.

Sum-of-the-Parts Analysis

In order to complete our sum-of-the-parts analysis, we had to go through several phases of analysis, beginning by deciding what was the most appropriate base financial projection to use in our analysis. We then needed to determine what the appropriate multiple range was for each of the combined companies' myriad of businesses.

What Is the Appropriate Base Projection?

We look to revenue multiples for online media companies and EBITDA multiples for traditional media companies.

Given that the online media companies are in the earliest phases of their growth stage, concentrating on growing revenues at the same time as making heavy investments in building the necessary infrastructure and brands necessary to help forge these companies into profitable businesses, many of these companies are not yet EBITDA positive. Thus, the online media companies are generally valued on a revenue multiple basis, which allows for a broader range of comparison among companies. So, for AOL's Online services, Advertising and E-commerce, and Enterprise Software businesses as well as Time Warner's Digital Media business, we've projected 2001 revenues (including the anticipated synergies) for each of these separate businesses and applied the appropriate Revenue multiple.

On the other hand, traditional media companies, which have already pushed through the infrastructure and brand building stages and have been consistently producing profits, are more appropriately valued on an EBITDA multiple basis. Thus, for Time Warner's Broadcasting, Cable Networks, Cable Systems, Filmed Entertainment, Music, and Publishing businesses, we've projected 2001 EBITDA (including the anticipated synergies) for each of these separate businesses and applied the appropriate EBITDA multiple.

What Is the Appropriate Multiple?

AOL's three distinct businesses warrant different multiples.

AOL operates in the following three main types of online related businesses: 1) Internet Service Provider business; 2) Online Media Portal business, and 3) Enterprise Software business. Each of these businesses operate under different business models, with different revenue drivers, different target margins, etc.; thus, it is understandable why they elicit different trading multiples. The very highest multiples are accorded to the online media portal businesses, which trade anywhere from the mid-single digits to the high double digits. This is not surprising given the high operating margin and marginal profitability potential of these types of companies. Further, many of these companies have low variable costs, including low cost of content, which helps to continually elevate their operating margins. We expect AOL to continue to be a leader in this space and, therefore, entitled to a multiple surrounding the top end of the range of comparable companies of 91.9x, thus we have chosen a range of 73.5x–110.3x (which equates to 20% above and below the top end of the range).

Then there is AOL's Online services business, which is the clear leader in this industry by a wide margin. With over 20.5 million members for the core AOL and together with its other brands, the company's total membership is at more than 23.8 million, AOL has over seven times as many subscribers as its next closest competitor, EarthLink. Additionally, with its brand dominance, unmatched infrastructure, and superior management, as well as its access to a superior set of cable system assets, AOL should be able to continue to maintain its remarkable leadership position within the ISP arena through the upcoming broadband era. Given that AOL is the category leader, we believe that AOL should, at a minimum, be accorded the highest revenue multiple among other ISPs, 8.5x. It is our view that, as the indisputable leader in its field, AOL should in fact be accorded an even higher multiple; however, in order to err on the conservative side, we will take a revenue multiple of 8.5x as the top-side case as well.

Finally, there is AOL's Enterprise Solutions business, which currently represents a relatively small portion of its revenues. However, while this operation is small relative to the rest of AOL, this business has been strategically structured to scale as the inevitable demand for e-commerce solutions arises. Through AOL's strategic e-commerce alliance with Sun Microsystems, AOL is able to offer top quality e-commerce software and services, and to effectively and competitively run the e-commerce side of their business. On the one hand, you have the combined top-notch experience and brand power of AOL and Sun Microsystems in this sector; however, on the other hand, you have what is currently a relatively small player in this broadly defined area. Thus, we have taken a conservative approach and chosen multiples of 10.5x–13.5x, which evenly surround the mean revenue multiple for Enterprise Software companies.

Figure 22. America Online Revenue Multiple Analysis

	Ticker	Share Price[a]	Number of Shares	Market Cap	Net Cash	Firm Value	2001 Revenue	FV/ Revenue
Online Service Providers								
Excite @ Home	ATHM	$28.50	380	$10,839	$118	10,721	$1,258	8.5x
EarthLink	ELNK	$21.50	116	2,500	320	2,181	1,564	1.4x
Prodigy	PRGY	$18.56	64	1,190	32	1,158	413	2.8x
LOW								**1.4x**
MEDIAN								**2.8x**
MEAN								**4.2x**
HIGH								**8.5x**
Portals								
Yahoo	YHOO	$171.13	616	$105,413	$787	$104,626	$1,147	91.9x
Lycos	LCOS	$71.00	108	$7,675	150	7,525	392	19.6x
StarMedia	STRM	$34.50	64	$2,218	131	2,088	80	27.7x
Go.com	GO	$22.50	147	$3,308	75	3,233	688	4.8x
AskJeeves	ASKJ	$73.06	28	$2,080	17	2,063	85	24.6x
China.com	CHINA	$112.00	22.906	$2,565	12	2,554	62	41.4x
LOW								**4.8x**
MEDIAN								**26.2x**
MEAN								**35.0x**
HIGH								**91.9x**
Enterprise Software								
BEA Systems	BEAS	$106.06	152.1	$16,134	($360)	$15,774	$859	18.4x
Oracle Corporation	ORCL	$79.81	1,543.8	$123,212	(6,958)	116,254	13,446	8.6x
PeopleSoft	PSFT	$24.31	313.7	$7,627	(746)	6,881	1,655	4.2x
Microsoft	MSFT	$98.00	6,073.5	$595,208	(32,111)	563,097	31,042	18.1x
LOW								**4.2x**
MEDIAN								**13.4x**
MEAN								**12.3x**
HIGH								**18.4x**
America Online	**AOL**	**$64.75**	**2,610**	**168,998**	**1,472**	**167,526**	**9,788**	**17.1x**

Source: Company documents and Salomon Smith Barney

The diversified nature of media companies makes comparable analysis of single business lines challenging.

Many of the public media companies tend to operate like Time Warner, with a diversified line of business, making public comparable analysis of a singular business line somewhat limited. Further, given that Time Warner's various businesses are all part of a larger consolidated company, in some sense it would seem to be more reasonable that in separately evaluating each individual business, private company comparisons might be more relevant. Therefore, in evaluating Time Warner's separate businesses, we performed both acquisition comparable analysis as well as public trading comparable analysis, in most cases focusing primarily on our acquisition analysis to develop the most appropriate EBITDA multiples.

With respect to the Music business, we focused primarily on comparable acquisitions, given that there are no significant public companies that are exclusively focused on the music business. While EMI's purchase of Virgin Records was done at 26.5x EBITDA, we feel that this is not the best comparison, given that Virgin Records was a significantly smaller business and the transaction was announced back in 1992. On the other end of the spectrum is the acquisition of

PolyGram by Seagram, which was done at 13x EBITDA. While this transaction is a much stronger comparison, we believe that Time Warner's business should trade at an even higher multiple. Time Warner's music business, together with EMI, will be the world's largest music company (in terms of revenue) with a world-wide market share of 20%. Further, given the prospects of the digital transmission of music through the Internet and the boost that this should give to the cash flow of music businesses, we expect there to be multiple expansion. Thus we feel that a multiple range of 14x–16x on Time Warner's music is appropriate.

With respect to Time Warner's two separate Filmed Entertainment businesses (TBS and Warner Brothers), we again focused primarily on acquisition comps given the limited number of public pure-play filmed entertainment companies. We looked at past acquisitions of Diversified Filmed Entertainment companies (whose valuation multiples ranged from 11x–47x EBITDA), as well as acquisitions of pure play Independent Film Entertainment companies (whose valuation multiples ranged from 8x–23x EBITDA). We believe Time Warner's Filmed Entertainment businesses, which themselves each contain a variety of types of filmed entertainment, are a closer match with other Diversified Filmed Entertainment companies. We find the most relevant acquisitions among the recent Diversified Filmed Entertainment acquisitions to be the acquisition of Turner Broadcasting at 20.2x EBITDA, of Columbia Pictures at 19.4x EBITDA, of Paramount Communications at 18.3x EBITDA, and of MCA at 16.1x EBITDA, resulting in a mean multiple of 18.5x EBITDA. Given the differences between Time Warner's two separate Filmed Entertainment businesses, we felt it appropriate to look at each of them separately. Time Warner's TBS Filmed Entertainment business is smaller in size, has no TV production business, and is prone to more volatile earnings; therefore, we chose a multiple range below the mean of 16x–18x for this business. On the other hand, Time Warner's Warner Brothers Filmed Entertainment business is one of the top seven major studios, is a consistent box office leader, has a profitable TV production business and is one of the leaders in the industry well poised to take advantage of any multiple expansion that may be experienced in the Filmed Entertainment business. Thus, we believe a range slightly above the mean of 19x–21x EBITDA is appropriate.

Regarding Time Warner's Cable Network business (including TBS and HBO), we examined 15 different acquisitions spanning from 1994–99 and calculated a range of multiples spanning from 10.2x–30.1x, with a mean of 17.8x. In selecting the appropriate multiple range, we took into consideration that fully distributed analog cable networks are an even scarcer asset today compared with the period when the acquisitions we reviewed took place. Additionally, another competitive advantage for Time Warner's cable business is that it has almost fully upgraded its plants. Further, both HBO and TBS represent name brand premium cable assets. Thus, we believe a range of 22.0x–24.0x (slightly above the mean but well below the maximum) is reasonable.

For Time Warner's Cable Systems business, we examined both public trading comps (since there are several singularly focused public cable companies) as well as several recent cable system acquisitions. The cable system companies currently trade at a EBITDA multiple of 11x–21x. The relevant cable acquisitions produced EBITDA multiples in the range of 10x–21x EBITDA. However, we note that Time Warner's Cable System business has size and scale that the other comparable companies do not. Additionally, Time Warner's cable system runs through premium metro areas, such as New York, which should be accorded incremental value. Additionally, looking over the past few years, fueled in part by the prospects of the Internet, we notice a strong trend toward multiple expansion with regard to cable system businesses and we expect this trend to continue. For all these reasons, we believe Time Warner's Cable Systems business should trade at a premium and have set a EBITDA multiple range of 22x–24x. As a sanity check, we analyzed the resulting Firm Value per subscriber for Time Warner's Cable Systems created by these multiples. The resulting Cable Systems valuation (including the portion owned by Time Warner alone and the portion owned through the TWE partnership) is $70.6–$77.0 billion, which translates into $5,600–$6,100 per cable subscriber, which we deem to be reasonable.

Then there is Time Warner's Broadcasting business (consisting of the WB Network), which is currently in its start-up phase and not yet generating a net profit. Thus, we have taken a conservative approach and valued this business at $1.0 billion, which we believe to be a very deep discount to other network valuations.

Time Warner's Digital Media business should also be valued on online revenue multiples.

Finally, there is Time Warner's Digital Media business which is currently in the start-up phase and therefore not yet generating positive EBITDA. We believe Time Warner's Digital Media business should appropriately be valued on a revenue multiple basis like AOL and other Online Media businesses. We would also argue that with the help of AOL's deep online media management experience and solid infrastructure, Time Warner's Digital Media business should be valued using comps similar to AOL's Online Media business (at the upper half of the comparable company revenue multiple universe). However, given the yet unproven nature of Time Warner's Digital Media business, we have opted to be conservative and value this business based on the lower half of the comparable company revenue multiple universe of 4.8x–35.0x.

What Are the Non-Consolidated Assets?

In our analysis of a combined AOL Time Warner, we have also placed value on certain hidden or non-consolidated assets. Overall, on a combined basis, we estimate AOL Time Warner carries hidden assets worth anywhere from $39–$74 billion. Of the mix, we estimate that Time Warner's hidden assets (primarily Time Warner Telecom, RoadRunner, and non-consolidated cable joint ventures) account for $9 billion, or 12%–23% of the total.

Figure 23. Time Warner Non-Consolidated Assets

($ in millions, except per-share data)

	Asset Value[a]	TWX Stake	Attributable to TWX
Road Runner	$1,990	74%	$1,483
Unconsolidated Cable Joint Ventures[b]	2,367	74%	1,763
Time Warner Telecom [c]	4,029	100%	4,029
Comedy Central & Court TV[d]	747	74%	556
Total Non-consolidated Investments	**$9,134**		**$7,832**

Notes:

(a) We did not include any value for AT&T Joint Venture due to lack of definative agreement to date.

(b) Represents value of 50% stake in each of TX JV of $1,474, of KS JV of 591 and Other JVs of $1,588.

(c) Based on 48.2% ownership of TWTC at public market valuation of TWTC

(d) Valuation based on 2000 EBITDA Subscriber Data

Source: Company reports and Salomon Smith Barney

At over $9 billion, Time Warner's off-balance sheet assets are substantial.

Time Warner's 48% stake in Time Warner Telecom (TWTC), a publicly traded competitive local exchange carrier, is currently valued at approximately $4 billion by the public market. We estimate that RoadRunner is worth approximately $2 billion, based on Excite@Home's public market valuation. Currently, Excite@Home trades at $510 per current homes passed (about 21 million) and at $149 per projected homes passed (72 million). Applying these multiples to RoadRunner, we arrive at a value for RoadRunner of $2.3 billion at the high end and $1.6 billion at the low end. Averaging these two values, we arrive at our $2.0 billion value for Time Warner's 37% ownership of Road Runner. We value Time Warner's pro rata share of non-consolidated cable assets at about $2.4 billion, net of debt, based on a per-subscriber value of about $4,000. For Time Warner's 50% stake in both the Comedy Central and Court TV cable networks, we ascribe a total value of about $750 million, with Comedy Central accounting for about $550 million (assuming about $18 per subscriber and 61 million subscribers at year-end 1999). For Court TV, based on a $12 per-subscriber value (given Court TV's lower distribution), we estimate a value of about $200 million for Time Warner's 50% stake. We currently assume no value from Time Warner and AT&T's previously announced venture to deliver residential telephony, given the lack of a definitive agreement and uncertainty in timing of deployment.

Figure 24. Valuation of Time Warner's Share of RoadRunner

($ in millions, except per-share data)

	Current	**Projected**
ATHM Shares	380	380
ATHM Stock Price	$28	$28
ATHM Market Capitalization	$10,648	$10,648
Net Debt	$72	$72
ATHM Firm Value	$10,720	$10,720
ATHM Homes Passed	21,000,000	72,000,000
FV/Homes Passed	$510	$149
Road Runner Homes Passed	12,500,000	30,000,000
Road Runner Firm Value	$6,381	$4,467
Average of Current & Proj. Firm Value	5,424	
Value of TWX's 36.7% of RoadRunner	**$2,341**	**$1,639**
Avg. of TWX 36.7% at Curr. & Proj.	**1,990**	

Source: Company reports and Salomon Smith Barney

America Online's primary non-consolidated assets are its strategic investments in other private and publicly traded companies (such as China.com), its international businesses (many of which are operated through 50/50 joint ventures), and its strategic alliance with Hughes Electronics Corporation. It is difficult to put a value on AOL's strategic investments—as we saw with China.com, the value of investments in private companies could quickly rise as these companies go public. Additionally, AOL's investments in publicly traded companies could rise or fall markedly given the volatility of Internet stocks.

AOL's international businesses could deliver significant valuation upside, given the public valuations placed on other international online companies.

It is equally difficult to assess the value of AOL's international businesses; however, one could argue that the value should be significant given the strong valuations placed on companies such as Yahoo! Japan and Terra Networks. Further, the valuation of AOL's international operations could be unleashed as AOL and its partners contemplate bringing some of its international businesses public. One way to put this into a valuation context is to look at AOL's international properties is on a value-per-subscriber basis. If we value the more than 4 million international subscribers predicted by the end of calendar year 2000 and multiply that by a conservative $8,000 per-subscriber value (at the bottom end at which the leading international online media public companies currently trade), we arrive at $32 billion, of which AOL owns 50% (except for AOL Europe which AOL will own 100%), which results in a valuation of significantly greater than $16 billion (depending on the portion ascribed to AOL Europe).

Then there is the strategic alliance with Hughes, formed in an effort to develop and market integrated entertainment and Internet services, including development of a set-top box for DirecTV and AOL TV, as well as Internet delivery over DirectPC satellite. It is not hard to see the potential value that could be realized from this alliance.

Finally, there is potential upside to our current revenue projections from AOL's ICQ property. In just six months, ICQ has been able to accumulate a $125 million advertising backlog. With over 50 million registered users, and over 18 million users utilizing ICQ each month, the potential profit power of ICQ is remarkable. However, since ICQ has only recently begun to monetize its assets and generate advertising revenues, we have not yet modeled any significant upside from ICQ into our current projections.

The potential value of AOL's non-consolidated assets could be staggering. However, due to the uncertainty involved in valuing the off-balance sheet assets, we have placed a fairly wide range on the valuation of AOL's total off-balance sheet assets of $30 billion on the low end of the range and up to $65 billion for the upper limit of the range.

What Price Target Does the Sum-of-the-Parts Analysis Suggest?

Our analysis brings us to a $115 price target.

Our sum-of-the-parts analysis produced a total firm value for AOL in the range of $328 to $465 billion. While our analysis for Time Warner produced a tighter range for firm value of $167 to $191 billion. We then added the firm values of the separate entities together, and subtracted out Combined Net Debt and Minority Interest, to arrive at a range for Total Equity Value for the Combined Firm. Finally, we divided the Total Equity Value of the Combined Firm by total shares expected to be outstanding, to arrive at a share price range for the combined company of $102 to $143. Thus, our price target for a combined AOL Time Warner, at $115 per share, sits squarely in the middle of our calculated equity value range.

Figure 25. AOL Time Warner Sum-of-the-Parts Analysis

($ in millions, except per-share data)

		Public Market Valuation Method		Value	
America Online	**Revenue 2001E**	**Low**	**High**	**Low**	**High**
Online Services	$5,866	8.5x	8.5x	$50,012	$50,012
Advertising, Commerce & Other	3,697	73.5x	110.3x	271,796	407,693
Enterprise Solutions	575	10.5x	13.5x	6,053	7,778
Total Firm Value				**$327,861**	**$465,483**
TWX	**EBITDA 2001E**				
Publishing	$988	14.0x	16.0x	$13,825	$15,800
Cable Networks -TBS	1,411	22.0x	24.0x	31,040	33,862
Music	599	14.0x	16.0x	8,380	9,577
Filmed Entertainment-TBS	215	16.0x	18.0x	3,444	3,875
Cable Systems	545	22.0x	24.0x	11,997	13,088
Intersegment and Corporate Expense	(90)			(90)	(90)
	Revenue 2001E				
Digital Media	260	4.8x	35.0x	1,250	9,101
TWX Total Firm Value				**$69,846**	**$85,212**
TWE	**EBITDA 2001E**				
Cable Systems	$2,863	22.0x	24.0x	$62,984	$68,710
Filmed Entertainment -WB	861	19.0x	21.0x	16,359	18,081
Cable Networks - HBO	760	22.0x	24.0x	16,714	18,233
Broadcasting - The WB Network	0	NM	NM	1,000	1,000
TWE Total Firm Value				**$97,057**	**$106,024**
Add: AOL Off Balance Sheet Assets				$30,000	$65,000
Add: TWX Off-Balance Sheet Assets				9,134	9,134
Combined AOL TWX Total Firm Value				**$533,897**	**$730,853**
Less: Net Debt				(16,528)	(16,528)
Less: Minority Interest[a]				(29,059)	(31,347)
Combined AOL TWX Total Equity Value				**$488,310**	**$682,979**
Diluted Shares owned by Former AOL Shareholders				2,765	2,765
Diluted Shares owned by FormerTWX Shareholders				2,021	2,021
Total Diluted Shares for AOL TWX Combined Entity				**4,786**	**4,786**
Implied Share Price for AOL TWX Combined Entity				**$102**	**$143**

Notes:
(a) Minority interest represents Media One's 25.51% ownership of Time Warner Entertainment Partnership and Advance/Newhouse's interest in the TWE-A/N Partnership value at $4,300 million)

Source: Company reports and Salomon Smith Barney

Discounted Cash Flow Analysis

Our DCF analysis lends support to our $115 price target.

We have also performed a five-year discounted cash flow (DCF) analysis on AOL Time Warner to help triangulate a value for the new entity. Overall, our DCF model indicates a price target approaching $115 for AOL Time Warner, which supports our sum-of-the-parts and firm value/EBITDA analysis.

Based on our pro forma AOL Time Warner model, we project the company will generate unlevered free cash flow of about $8.6 billion in 2001, $12.1 billion in 2002, $16.0 billion in 2003, $21.3 billion in 2004, and $27.3 billion in 2005. Our DCF incorporates a 15% discount rate, which approximates AOL and Time Warner's blended cost of capital.

As in all DCF models, the majority of value is derived from the terminal value. For AOL Time Warner, we have applied a 35x terminal multiple to 2005 estimated EBITDA. While this terminal multiple assumption may, at first glance, appear lofty, we note that this multiple implies a 14x terminal value/2005 revenue multiple, which we view as relatively conservative for *the* Internet company with leading market share in all of its businesses. From another perspective, our terminal multiple implies a 12.1% perpetual growth rate. Compared with our 25% long-term EBITDA growth forecast for AOL Time Warner, we believe that this perpetual growth rate assumption and, hence, the associated 35x terminal multiple is justifiable.

Our DCF implies a $539 billion firm value.

Taking all the pieces together, our DCF implies a $539 billion firm value for a combined AOL Time Warner. Adjusting for about $56.6 billion in off balance sheet assets (which assumes the midpoint of our estimates) and deducting $16.5 billion in net debt and minority interest of roughly $30 billion, we arrive at an estimated equity value of approximately $549 billion, or $115 per share.

Figure 26. AOL Time Warner Discounted Free Cash Flow Analysis

($ in millions, except per-share data)

	2001	2002	2003	2004	2005
EBITDA	$11,588	$14,254	$17,818	$22,272	$27,841
Corporate Expense	(230)	(240)	(252)	(265)	(278)
Cash Taxes	(500)	(563)	(625)	(688)	(750)
Unlevered Cash Flows	**$10,858**	**$13,451**	**$16,941**	**$21,320**	**$26,813**
Capital Expenditures	(3,000)	(2,400)	(2,200)	(2,000)	(2,000)
Change in Non-Cash Working Capital	740	1,000	1,250	2,000	2,500
Unlevered Free Cash Flow	**$8,598**	**$12,051**	**$15,991**	**$21,320**	**$27,313**
Interest Expense, Net	(1,300)	(1,300)	(1,300)		
Minority Interest	(535)	(600)	(700)		
Other Adjustments	(1,263)	(1,639)	(1,685)		
True Free Cash Flow	$5,500	$8,512	$12,306		
Free Cash Flow Per Share	$1.15	$1.73	$2.42		
Shares Outst. (MM)	4,786	4,933	5,081		
Net Present Value of Unlevered FCF	**$7,480**	**$9,120**	**$10,528**	**$12,211**	**$13,609**
Terminal Value		At EBITDA Multiple of:	35.0x		975,532
Present Value of Terminal Value	486,067	Discounted @ WACC of:	15.0%		
Implied Firm Value	**$539,016**				
Balance Sheet Adjustments:					
Off Balance Sheet Assets	56,634				
Value of Minority Interest	(30,203)				
Net Debt	(16,528)				
Adjusted Equity Value	$548,918				
Equity Value Per Share	**$115**				
Shares Outstanding	4,786				

Source: Company reports and Salomon Smith Barney

Firm Value/EBITDA

In addition to our sum-of-the-parts and DCF analyses, we have also benchmarked AOL Time Warner based on traditional firm value to EBITDA multiples. Using our forecasts, we estimate that AOL Time Warner is currently trading at a 24.2x firm value/EBITDA multiple, assuming an equity market capitalization of $294 billion (based on AOL's stock price of $66 7/8 on March 20 and 4.8 billion in pro forma shares outstanding) and $17 billion in projected net debt at year-end 2000, $57 billion in off-balance sheet assets (assuming the midpoint of our assumptions), and $11.6 billion in EBITDA in 2001.

Although at first blush our valuation may seem lofty...

Compared with other traditional media companies (such as Walt Disney, Viacom [pro forma for the merger with CBS], News Corp., Seagram, and Fox Entertainment), current valuation for a combined AOL Time Warner represents a 52% premium to its peer group. Although, at first blush, valuation may appear lofty, AOL Time Warner's firm value/EBITDA multiple is essentially at parity to its long-term 25% EBITDA growth rate, actually below the 5% premium to growth assessed to comparable diversified entertainment names.

...upon closer inspection, our analysis shows our valuation to be quite appropriate.

Our $115 price target for AOL Time Warner implies a 44x firm value/EBITDA multiple based on our 2001 projection of $11.6 billion. Although our price target for AOL Time Warner implies a significant premium to traditional media companies, we note that the premise behind the merger of AOL and Time Warner is to establish the preeminent media company that is uniquely positioned to capitalize on the Internet opportunity. As a result, we believe that this valuation is appropriate for a combined AOL Time Warner given our expectation that the combined entity will be able to sustain annual free cash flow growth of 40% to 50%-plus, double its peer group's average sustainable cash flow growth rate of 13%. Furthermore, as a point of reference, we note that Yahoo! currently sells at a 202x firm value/EBITDA multiple, underscoring our belief that a 44x firm value/EBITDA multiple is attainable for AOL Time Warner.

Figure 27. Entertainment Industry — Comparative EBITDA Valuations

($ in millions[a])

	Walt Disney# (b)	News Corp.# (c)	Time Warner# (d)	AOL#	TWX + AOL (e)	Viacom (f)	Viacom + CBS Corp.	Seagram# (g)	Fox Entertainment Group# (h)	Group Average (i)
[illegible]	1M	2M	1H	1H	1H	1H	1H	1M	2M	
[illegible]	DIS	NWS	TWX	AOL	AOL	VIAB	VIAB	VO	FOX	
[illegible]	$39 7/16	$62	$93 13/16	$66 7/8	$66 7/8	$55 7/8	$55 7/8	$60 1/16	$26 5/16	
[illegible]	2,083	534	1,347	2,765	4,786	710	1,551	436	722	
[illegible]	$82,158	$54,133	$126,389	$184,909	$320,055	$39,653	$86,637	$26,190	$18,984	
[illegible]	---	---	438	-	438	---	---	---	---	
[illegible]	11,279	6,600	18,000	(1,472)	16,528	3,799	7,570	6,988	3,251	
[illegible]	93,437	60,733	144,827	183,437	337,021	43,452	94,207	33,178	22,236	
[illegible]	(1,918)	(31,200)	(9,134)	(47,500)	(56,634)	(3,000)	(4,000)	(7,063)	(6,461)	
[illegible]	$91,519	$29,533	$135,693	$135,937	$280,388	$40,452	$90,207	$26,115	15,774	
[illegible]	4,859	1,991	4,894	495	5,982	1,953	3,004	1,486	NAV	
[illegible]	4,635	1,994	5,453	1,099	7,363	2,162	3,920	1,540	1,046	
[illegible]	5,054	2,223	5,934	1,888	8,849	2,378	4,457	1,771	1,151	
[illegible]	5,559	2,430	6,726	3,128	11,588	2,764	5,056	2,054	1,324	
[illegible]	18.8	14.8	27.7	274.6	46.9	20.7	30.0	17.6	NAV	16.6
[illegible]	19.7	14.8	24.9	123.7	38.1	18.7	23.0	17.0	15.1	18.4
[illegible]	18.1	13.3	22.9	72.0	31.7	17.0	20.2	14.7	13.7	16.6
[illegible]	16.5	12.2	20.2	43.5	24.2	14.6	17.8	12.7	11.9	14.7
[illegible] EBITDA growth rate	10%-12%	9%-11%	12%-14%	35%-50%	25%-30%	14%-16%	15%-17%	14%-16%	12%-14%	

[illegible]
[illegible] Pro forma Disney estimates have been calendarized
[illegible] year end
[illegible] EBITDA [illegible] calendarized June fiscal year end. Equity market cap includes preferred.
[illegible] Time Warner [illegible] economic interest in Time Warner Entertainment
[illegible] PERCS. Shares Outstanding include 74 million
[illegible] preferred stock
[illegible]
[illegible] the sale of Educational and Reference Publishing in 4Q98. Does not factor in CBS merger
[illegible] acquisition of PolyGram, USA Networks, and sale of Tropicana as if all transactions had occurred at the beginning of fiscal 1998
[illegible] consolidated EBITDA only and does not include EBITDA from non-majority owned businesses
[illegible] for Seagram which has a June fiscal year
[illegible] estimates are calendarized and add back Fox News and FBC losses
[illegible] News Corp., Time Warner (stand alone), Viacom (stand alone), Seagram, and Fox Entertainment
[illegible] EBITDA Earnings before interest, taxes, depreciation and amortization. NAV Not available. NR Not rated
[illegible] Time Warner and Seagram are covered by Jill S. Krutick. AOL is covered by Lanny Baker. News Corporation is covered by George Colman

Source: Company reports and Salomon Smith Barney

Merger Mileposts

Merger milepost events could serve as catalysts for the stock.

We believe that the merger announced on January 10 will close sometime during the fourth quarter of 2000. However, in the interim period, we anticipate about a dozen key events that could be called "merger mileposts." These events and accomplishments could become intermediate-term catalysts for AOL's share price when and if they transpire. At the same time, long delays or inaction on some of these fronts could raise a cautionary flag about timing, integration, cooperation, and strategic direction at the new company. We have briefly described the most important "merger mileposts" for which investors should watch over the next three to nine months. Our "mileposts" are arranged in order of importance to AOL Time Warner and discussed below.

Strategic Discussions with AT&T

More than ever, we feel an alliance between AOL and AT&T is inevitable.

Our long-held belief that AOL and AT&T will eventually work together as partners becomes reinforced in light of the AOL Time Warner merger. We believe AOL Time Warner and AT&T will be drawn into strategic discussions during 2000, if for no other reason than because both companies have so much to offer to the other. A closer partnership and new commercial agreements between AOL Time Warner and AT&T are likely to be seen as further evidence of the strategic merit of the AOL Time Warner merger, and could provide another catalyst for the stock.

Prior to the merger, AOL's strategic desire to market and deliver its services over all communications platforms, including a broadband version of AOL over the AT&T/TCI cable systems, has been balanced in our mind with AT&T's strategic desire to increase data traffic on its network and build its cable telephony penetration. Historically, we have believed that a "win-win" relationship between AOL — with its loyal Internet subscribers and enormous data traffic volume — and AT&T — with its recently acquired and upgraded cable footprint and need for expanded services and increased traffic — was an inevitability, at risk only to corporate hubris or miscalculation.

However, with Time Warner added to the mix, we believe that the likelihood of strategic developments or alliances between AOL Time Warner and AT&T only increases, breaking the logjam that has been in place for a year or two. The number of negotiating points between the two companies now increases far beyond just broadband distribution of AOL on the AT&T cable systems, to include the delivery of AT&T telephony service over the Time Warner cable systems, the ownership structure of RoadRunner, and the ownership of Time Warner Entertainment. We believe that with all these balls in the air and with each side eager to resolve many of the open questions, fruitful negotiations between AOL Time Warner and AT&T almost cannot help but happen.

In fact, on March 8, AT&T and Time Warner announced a joint marketing agreement under which the two companies will co-promote Time Warner's cable television and AT&T's communication services. The joint efforts will begin in spring 2000 in Albany and Syracuse, New York, and will provide incentives to customers who subscribe to both Time Warner Cable and AT&T calling services.

Eventually, the plan is to expand the joint marketing efforts into other markets as well. Although AT&T and Time Warner have been down the co-marketing path once before, only to stall out along the way, we believe that the larger business opportunities that now linger in the wings for both AOL Time Warner and AT&T will propel a gathering cycle of negotiations and strategic cooperation that will ultimately benefit both sides.

Resolution i˜ AOL Europe

AOL has a 50%/50% joint venture with Bertelsmann Group in Europe that is likely to be reorganized in the wake of the AOL Time Warner merger. Formed in 1995, AOL Europe is equally owned by AOL and German media giant Bertelsmann. AOL Europe currently has 3.1 million subscribers, with heavy concentrations in the United Kingdom and Germany. Media Metrix ranked the AOL services in Europe No. 1 in online usage during the last quarter. Although the European Internet service marketplace is becoming more competitive, AOL Europe has recently shown strengthening subscriber growth and now stands as the second-largest Internet access provider in Europe, behind Deutsche Telekom's T Online in terms of numbers of subscribers. However, AOL Europe ranks No. 1 in terms of hours of usage.

Because Bertelsmann and Time Warner are frequent competitors with each other across several lines of business, we believe Bertelsmann could look to remove itself from the AOL Europe partnership and seek an alternative route to an online presence. Bertelsmann CEO Thomas Middelhoff already has resigned from AOL's board of directors. In time, we would expect Time Warner's media divisions to take up many of the roles formerly filled by Bertelsmann within AOL Europe, especially in marketing and in the provision of content to the service.

The most likely scenario is for AOL to bring in a new joint venture partner in Europe.

Although AOL Time Warner certainly has the financial resources to take full control of and responsibility for AOL Europe, we believe the addition of a new joint venture partner in the place of Bertelsmann is a more likely outcome. Given the high level of wireless telephone penetration throughout Europe, and in light of AOL's increased focus on expanding its wireless services everywhere, we would not be surprised to see AOL Time Warner bring in a large European wireless company as a partner in AOL Europe.

The financial orchestrations that might be behind reorganizing AOL Europe are hard to predict, but the range of possibilities extends from an outright AOL Time Warner buyout of Bertelsmann's stake in the JV to all kinds of asset swaps, partnerships, and new commercial agreements between the companies involved. AOL does not currently consolidate the financials of AOL Europe, but rather runs the JV's results through the Equity Income line on its income statement, so the reorganization might not necessarily prompt any major changes in AOL's cash flow or near term earnings. AOL Europe is just about profitable, with a revenue run rate of $600 million.

Resolution of RoadRunner

It is likely that Time Warner will push to restructure RoadRunner.

Time Warner's ownership interest (roughly 36%) in broadband-Internet-over-cable provider RoadRunner stands in competitive conflict with AOL, and we would expect Time Warner to push for a restructuring of RoadRunner during 2000. Clearly, it now makes more sense for Time Warner to put its broadband efforts behind AOL rather than RoadRunner, particularly given the merger and AOL's significant and well-established strategic and operational advantages over RoadRunner. Additionally, AT&T will soon become a 35% owner in RoadRunner (once AT&T's acquisition of MediaOne closes), and we believe AT&T will be interested in restructuring RoadRunner given AT&T's control of and focus upon rival broadband provider Excite@Home. At the very least, a recent "open access" announcement by AOL and Time Warner commits the new company to allowing multiple Internet access providers to deliver broadband Internet service over the Time Warner cable system infrastructure, suggesting that AOL would be available alongside RoadRunner even if RoadRunner was not restructured.

At present, RoadRunner enjoys a two-year exclusive in the marketing and provision of broadband Internet access services on Time Warner. However, RoadRunner's exclusive licenses begin to expire on June 4, 2002. RoadRunner was established by the above-mentioned cable system partners to be their cooperative broadband Internet vehicle, and the company is owned 36% by Time Warner, 35% by MediaOne (soon to be AT&T), 10% by Microsoft, 10% by Compaq Computer, and 9% by Advance Newhouse. Currently, RoadRunner claims about 550,000 subscribers, growing sequentially by 130,000 for 4Q99 (an average of approximately 1,450 daily additions). Roughly 60% of RoadRunner's current subscribers are Time Warner cable system households. At the same kind of per-subscriber valuation accorded to the other cable-sponsored broadband service provider, Excite@Home, RoadRunner might be worth $2–$3 billion.

Figure 28. Time Warner Stake in RoadRunner

	Stake in Road Runner	Time Warner Ownership	TWX Stake in Road Runner
Time Warner Inc. (Cable)	8.6%	100.0%	8.6%
Time Warner Entertainment[a]	20.0%	74.5%	14.9%
TWE/AN[b]	26.3%	50.2%	13.2%
Time Warner Stake in RoadRunner			**36.7%**

Notes:
(a) Time Warner owns 74.5% of Time Warner Entertainment
(b) Time Warner owns 74.5% of TWE's 64.85% stake in TWE/AN Ptnrshp, and 100% of TWI Cable's 1.9% interest in the TWE/AN Partnership

Source: Company reports and Salomon Smith Barney

Ultimately, the combined company's broadband play will reside under the AOL brand name.

Although the unwinding or reorganization of RoadRunner could follow any one of several paths, we believe the eventual outcome will be one that positions AOL Time Warner to focus on the AOL brand as the company's broadband flagship. Since the RoadRunner brand is built largely on Time Warner franchises (both the cable systems and the brand imagery), we would not expect RoadRunner to continue without AOL Time Warner's support. It is possible that RoadRunner could be dissolved, with AOL Time Warner merging its RoadRunner subscribers into a broadband AOL offering, and with MediaOne/AT&T rebranding its RoadRunner operations under the Excite@Home service. Whatever the mechanics, we believe RoadRunner's current ownership profile will be updated and altered to reflect the new interests of AOL Time Warner and of AT&T/Media One, neither of which is likely to prefer to support RoadRunner in addition to its own competing primary broadband services.

Expanded Wireless Alliances and Activity

Wireless initiatives will be given increased priority in the new combined company.

AOL has recently stepped up its pace of strategic progress on the wireless front, naming Dennis Patrick to the new position of president of AOL Wireless and announcing new wireless initiatives with Sprint, Nokia, Motorola, Research in Motion, BellSouth, and Arch Communications. AOL's wireless activities are part and parcel of the company's AOL Anywhere strategy, which aims to make the AOL services available and ubiquitous across all Internet access technologies. AOL's "anywhere" objective has been to deliver the communications, content, and interactivity of the AOL service on cell phones, pagers, handheld computers, and wireless devices of all kinds. Now, with the merger with Time Warner, the "anywhere" strategy takes on a new opportunity in the distribution of Time Warner content and information over these same platforms. Time Warner can provide deep news and financial information that can be bundled into AOL's wireless service, and music and entertainment content might also be distributed over the wireless channel. We believe that wireless will be a priority for the combined company, simply because the combination of AOL's communications services and Time Warner's content resources could easily produce one of the most compelling wireless Internet service offerings available in the market. Furthermore, the wireless efforts will play into AOL's subscription strategy, which we believe will increasingly focus on enhanced value, new pricing packages, and expanded premium-priced levels of service.

Commercial Introduction of AOL TV

Upon reaching scale, AOL TV will introduce incremental revenue streams.

Recently introduced and with an expected early summer 2000 launch, AOL TV is an entirely new product and service that mixes the interactivity of AOL into the popular and familiar environment of television viewing. AOL TV is likely to be marketed as a premium service and an extension of the core AOL online service, and we would expect AOL TV to generate subscription and advertising revenue of its own once it is introduced and grown to a reasonable scale. Operating on a set-top box attached to a return telephone line, AOL TV decodes information sent to the box in the vertical blanking interval alongside traditional television signals and presents several of the most popular features of AOL as an overlay on traditional television. AOL TV offers an easy-to-navigate on-screen programming guide that organizes and simplifies the increasingly complex television channel lineup. AOL TV also gives the user the ability to chat, send and receive e-mail s and instant messages, and read news stories, all while watching regular television programming.

Although AOL TV is expected to be introduced and marketed to consumers as early as this summer, we believe that the rollout may be constrained by the availability of the required consumer hardware, the set-top box. On the other hand, AOL will be able to market AOL TV to an already loyal user base right through the AOL service. In fact, AOL must look no further than its own membership to find the choicest AOL TV potential customer list — AOL's heaviest users have already bought into the company's interactive services and made networked communications a part of their lives. Based upon what we have seen of the product, we believe that the initial demand for AOL TV could surprise even AOL.

AOL TV will serve as a bridge between the PC and the TV.

While AOL TV may become the source of several new revenue streams and business opportunities for AOL Time Warner in the long term, we believe the introduction of AOL TV will be significant for other reasons in the nearer term. In many ways, AOL TV will present a visible bridge between the PC-oriented online world that AOL has dominated in the past and the new land of interactive media convergence. As the interrelationship between and the evolution of new media and old media is established in the form of AOL TV, we believe that the wisdom of merging AOL and Time Warner will become increasingly evident and obvious. As interactivity and traditional media start to truly converge, AOL Time Warner will not only sit at the forefront of that trend with its AOL TV product, but will also be uniquely and powerfully positioned to compete in a world where technology, content, interactivity, and programming expertise are all essentials for any major media company. In this way, we believe that the introduction of AOL TV could be a powerful catalyst in shifting perceptions about where the media business is headed, and about which companies are truly equipped to lead in that revolution.

Other Strategic Moves or Acquisitions

Further pre-closing acquisitions are likely (à la EMI).

From the start, AOL and Time Warner have indicated that their merger is not an end point, not a final coup de grace. Rather, both companies have described the merger as a starting point in the creation of an entirely new kind of Internet-ready global media company. To this end, we believe that other follow-on mergers, acquisitions, and partnerships are reasonably likely, even before this merger closes. The financial capacity of the combined company could easily support even a relatively large transaction, in our view. By our calculation, AOL Time Warner currently runs at $8–$9 billion in EBITDA and $3–$4 billion in free cash flow, and has $16.5 billion in combined net debt, leaving considerable buying power.

Already, Time Warner has gone ahead with a $23 billion merger of its music division with EMI, creating in the process the world's No. 1 recorded music company with a 26% share of the U.S. market. Although Time Warner probably had the EMI transaction in its sights without respect to the AOL merger, the move to scale up in music gains added logic once AOL enters the picture. The future of recorded music is one in which digital distribution of content via the Internet seems inevitable, and AOL is clearly positioned to be a major player in that market, first because of its large subscriber base, second because of its expertise at mainstreaming new technologies (e.g., You've Got Mail, You've Got Pictures), and third because AOL owns both Spinner and WinAmp — two of the leading online music properties and brands. We believe there may be other areas in which similar acquisitions or partnerships are possible for the AOL Time Warner.

Quarterly Financial Performance

We expect solid quarterly financial performance ahead.

In the interval between today and closing of the merger, the financial performance of AOL and Time Warner will be another important factor. Investors who doubt the intentions of AOL or Time Warner and who may fear that the merger is prompted by some weakness or anticipated softness in one or another of the companies' business lines will closely scrutinize the intervening quarterly financial reports. However, we have a high degree of conviction that near-term financial concerns were not the motivating factor behind the merger, and we would expect both companies to produce encouraging financial results in coming quarters.

AOL metrics to focus on: subscriber count, revenue per subscriber and operating margins.

For AOL, we believe that the three key numbers to watch over the next three quarters will be the subscriber count, revenue per subscriber (both subscription and ad/e-commerce), and operating margins. Taken together, these three measures will tell a fairly complete story about the health of AOL: Strong subscriber growth would indicate that the Internet/Online market is still expanding rapidly. Stable or rising per-member subscription revenue (particularly in combination with healthy subscriber growth) would suggest that fears about cheap or free Internet access providers impinging upon AOL's member growth and eroding AOL's pricing may have been misplaced. Growing per-subscriber advertising and e-commerce revenue points to the upside and leverage still inherent in AOL's business model. Finally, expanding operating margins demonstrate that all of the above is being achieved in a financially rewarding way. It is interesting to note that in the last year, AOL's margins have risen from 11% to 20%, even while the force of greatly increased competition ostensibly should have been clawing at AOL's growth, pricing, and margins. The reality, however, is that AOL's brand, scale, and operating leverage have continued to gather steam over the last year, so that AOL's already strong financial picture has steadily improved even as the competition has multiplied.

Cash flow is key for Time Warner.

For Time Warner, cash flow growth will remain the key yardstick to watch in the interim. With difficult comparisons in the first half of 2000, we expect EBITA growth for Time Warner on a stand-alone basis to be second-half weighted, although EBITA (before losses from digital media) should still attain a double-digit level in the first half of 2000. Among Time Warner's bevy of business units, we believe that the music operations, after posting a down year in 1999, needs to be monitored, although it represents only 10% of Time Warner's cash flow and an even lesser amount of the combined company's EBITDA. Second, Time Warner's advertising-driven units (i.e., Turner cable networks, The WB, Publishing, Cable Systems, etc.) will also be monitored in order to assess the relative strength of advertising. We also believe that the deployment of new cable services (high-speed Internet access, in particular) will also be scrutinized, given cable's dependence on new services to accelerate cash flow growth longer term. As always, the regulatory environment will also play an important role as it pertains to Time Warner's cable and television assets.

Shareholder Votes

A simple majority vote is required.

At some point, probably after AOL and Time Warner have received federal regulatory and legislative approval for their merger, the two companies will put the merger to a vote of their respective shareholders. Under the bylaws of each company, the merger will need to be affirmed by a simple majority of the shareholder votes outstanding with respect to the matter by each company's investor base.

Figure 29. Equity Ownership Table

	AOL	TWX	AOL TWX Combined
Executive Officers and Directors as a Group	1%	11%	5%
Institutional Investors	45%	72%	63%
Individual Investors	55%	17%	31%
Total Investors	**100%**	**100%**	**100%**

Source: Company documents, Spectrum Run dated December 31, 1999, America Online Proxy Statement dated September 22, 1999, and Time Warner Proxy Statement, dated March 30, 1999

We expect strong support from institutional investors and management.

In looking through the ownership of both AOL and Time Warner, it is relatively easy to see where many of the votes for the merger are likely to originate. At AOL, management and employees own 1% of the outstanding shares, and institutions hold another 45% or so of the equity. We would expect strong support for the merger from AOL's management shareholders as well as from most institutional investors. By deduction, perhaps 55% of AOL's shares are held by individual investors and we believe this constituency may be the swing vote in the process. Although AOL's share price has fallen 8% since the January 10 merger announcement, we believe most AOL investors, even price- and momentum-sensitive individual investors, see the strategic merit behind the combination. If we assume 75% of the institutional investors will vote in favor of the merger, AOL will probably need the support of less than one-sixth of its individual shareholder base in order to approve the merger. We believe that AOL's board of directors and management will likely stand behind the merger.

Figure 30. America Online Management and Director Ownership

	Shares Beneficially Owned[a]
Steve Case, Chairman and CEO	9,036,883
James L. Barkdale, Director	4,164,113
William N. Melton, Director	2,200,000
General Alexander M. Haig, Jr., Director	1,227,392
Francis J. Caufield, Director	1,067,586
Bob Pittman, President and COO	1,022,129
George Vrandenburg, III, Sr. VP Global and Strategic Policy	879,600
Michael J. Kelly, Sr. VP, CFO and Asst. Sec.	305,000
Kenneth Novack, Vice Chairman	199,259
Daniel F. Akerson, Director	144,000
General Colin L. Powell, Director	120,000
Franklin D. Raines, Director	108,000
Other	6,639,812
All Executive Officers and Directors as a Group (19 persons)	27,113,774

Notes: (a) Includes option shares.

Source: America Online Proxy Statement, dated September 22, 1999

On the Time Warner side, management owns 11% of the outstanding shares, while institutions own 72%, leaving individual investors with a 17% stake in the company. Within the Time Warner insider holdings, Vice Chairman Ted Turner has pledged to vote his 114 million shares (10% of the total) in favor of the transaction. On the institutional investor front, we believe that most of the investors who own Time Warner, or who will own it by the time of the shareholder vote, are likely to be in favor of the transaction. In the end, the shareholder vote process is a critical step in the process, but we believe AOL and Time Warner will easily garner the necessary votes.

Figure 31. Time Warner Management and Director Ownership

	Shares Beneficially Owned[a]
R.E. "Ted" Turner, Vice Chairman	114,210,853
Gerald M. Levin, Chairman and CEO	6,753,033
Peter R. Haje, Executive VP and General Counsel	1,450,004
Richard D. Parsons, President and Director	1,422,623
Merv Adelson, Director	1,405,376
Richard J. Bressler, Exec. VP TWI & Chair. and CEO TW Dig. Med.	670,156
Beverly Sills Greenough, Director	49,264
Francis T. Vincent, Jr., Director	42,564
Reuben Mark, Director	27,464
Michael A. Miles, Director	25,158
Gerald Greenwald, Director	19,890
Carla A. Hills, Director	12,664
J. Carter Bacot, Director	10,090
John C. Danforth, Director	7,010
Stephen F. Bollenbach, Director	3,090
Other	358,588
All Executive Officers and Directors as a Group (18 persons)	126,467,827

Notes: (a) Includes option shares.

Source: Time Warner Proxy Statement, dated March 30, 1999

Achievement of $1 Billion Synergy Target

A combined AOL Time Warner should easily meet its $1 billion EBITDA synergy target.

Beyond the closing of the merger, one of the litmus tests for the wisdom of the transaction will be AOL Time Warner's ability to achieve the $1 billion extra lift in first-year EBITDA that the companies have discussed. From our perspective, looking at a combined company with roughly $40 billion in revenue and $30 billion in cash operating costs, we do not believe $1 billion in incremental EBITDA should be overly daunting.

For instance, from a top-down perspective, if AOL Time Warner can cut 1%-2% out of the combined companies' cash operating costs in year one, the result would be $300-$600 million in additional EBITDA. Although the two companies do not have many direct overlaps, we believe these kinds of savings are achievable in the Web site development, marketing, back office, and network infrastructure areas alone. At the same time, if AOL Time Warner can produce 2.0%-3.0% more revenue growth in combination than they would individually, the result would be an additional $800-$1,200 million in revenue. If the combined companies were able to add that revenue at a reasonable marginal cost, perhaps 30%-40% of the newfound revenue, or $300-$500 million, could drop to the EBITDA line.

Elsewhere in this report, we have more specifically quantified the likely sources of cash flow uplift or synergy in the first year of combination, but our 2001 baseline calls for 60% of the uplift to come from cost savings and 40% from revenue gains. Looking further out, that mix ought to flip-flop toward one-third cost savings, two-thirds revenue gains. Likewise, in the near term, more of the EBITDA bump may come from Time Warner operations than from AOL operations, while accelerated Internet and interactive revenue becomes more important over time.

Federal Regulatory and Legislative Approval

We believe AOL and Time Warner will likely receive all necessary regulatory approvals.

The merger between AOL and Time Warner will be subject to the regular federal government approval processes: The FTC and the FCC, as well as approval from the European Commission and various Canadian governmental entities. Although AOL Time Warner will be the leading media company of the Internet age, and the combination will bring together assets and resources that can leverage off of each other in significant ways, we do not believe the AOL Time Warner merger should cross any free trade, antitrust, or regulatory lines. The combination brings together very few overlapping businesses and does not by itself lead to any excessive concentrations in any of the combined company's areas of operations.

Although AOL recently spoke before Congress, Congress has no formal role in the merger approval process. The FTC is the entity which is currently reviewing the proposed merger to ensure that it complies with federal antitrust laws. In fact, merger reviews performed by the FTC are supposed to be free from all political considerations. However, it is important to note that several House and Senate committees have broad legislative and oversight responsibilities for issues that affect the industry, such as privacy concerns and open access.

Local Approvals and Cable Franchise Transfers

Beyond the federal review process, AOL and Time Warner will also have to gain local approvals, particularly with respect to cable franchise transfers, in some areas. In the recent past, one sticky issue around cable transfers has been the Internet "open access" debate. In a few cities — notably Portland, San Francisco, and Los Angeles, among others — local or municipal governments have recently held up cable franchise transfers as they evaluated and deliberated over how Internet access would be offered over those cable systems. However, AOL and Time Warner recently signed a letter of understanding between the two companies that pledges them to "open access" on Time Warner's cable systems, putting the companies on the "right" side of the issue from the perspective of those cities and towns that have been holding up cable franchise transfers. In other words, AOL and Time Warner have already stated that they intend to allow other ISPs beyond AOL to serve their customers over the Time Warner cable infrastructure, and this is exactly what cities like Portland have recently been fighting for in the courts. We believe the cable franchise transfer process will likely be completed by the end of 2000.

Organizational and Management Decisions

At some point along the way to completing the merger, AOL and Time Warner will clarify and solidify the management and organizational structure of the combined company. However, both companies are comfortable leaving many of these decisions up in the air for the time being. The rationale for postponing the finalization of AOL Time Warner's organizational chart arises from senior management's desire to mix and intertwine the companies' people and operations as fully as possible before drawing up the new management model. We believe AOL Time Warner is aiming for a highly integrated corporate profile, one where warring fiefdoms and jealous divisional rivalries are uncommon, and where interaction, cooperation, and mutual reinforcement typify the way units work with each other.

By not yet setting a firm organizational structure — a single firm culture can more readily develop.

Obviously, AOL Time Warner takes on some degree of near-term risk by delaying these organizational decisions, as a sense of strategic direction and operational leadership could become lost or obscured. On the other hand, we believe that AOL and Time Warner are both currently enjoying a liberating period of heightened creativity and internal excitement, which is directly related to the fact that few rigid rules or segmentations have been imposed from the top down. Instead, people at Netscape are free to cross-pollinate with Time Warner, creating several "skinned" versions of the new Netscape browser; *Time*'s editors are free to put "AOL Keyword: TIME" on the cover of the magazine at their discretion; and AOL and Time Warner cable can sit on the same side of the table and knock out an open access agreement on the basis of the benefits to the merged company. As a result of delaying some of these organizational choices, an environment of integration and the culture of a single company may be better able to take hold.

In our conversations with Jerry Levin, he has suggested that it was possible, although highly improbable, that the new AOL Time Warner might be organized into a Content group, a Subscriptions group, and an Advertising/Direct Marketing group. While such a structure is unlikely, Mr. Levin's point is that the new company seeks to look at the possibilities ahead of it with as open a mind as possible. AOL Time Warner is focused on finding new business opportunities and inventing new markets; protecting existing kingdoms and bowing to existing corporate customs is not part of the plan. Among other ideas, we could envision AOL Time Warner organizing the online service and the cable systems as parallel business platforms, into which each of the other divisions would be plugged. In the end, though, a new organizational framework should gradually start to emerge, and investors should keep an eye out for how management authority and responsibility will be divided up within the new company. In the process, some executive departures may be inevitable, but as long as Levin, Case, Pittman, and Kelly remain on board, as well as Parsons and Bressler, we believe that the business will remain in the hands of one of the best-equipped teams in the rapidly changing world of the media industry.

Further Commercial Agreements

At the time the merger was announced, AOL and Time Warner simultaneously announced a series of commercial agreements between the two companies. Since January, the two companies have followed up with additional commercial agreements as well as some more strategic moves, including Time Warner's EMI acquisition and the letter of understanding regarding cable broadband "open access." In many ways, AOL and Time Warner are already operating as one "virtual company," and we anticipate a continued stream of commercial agreements and strategic interoperation between the two companies. Although a company with $40 billion in merged revenue is unlikely to get much near-term financial bang out of one or two (or ten) of the kind of deals that AOL and Time Warner have recently been launching, we believe the momentum established by these pre-merger alliances will carry over into the early days of the new company.