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September 21, 2000

Commissioner Michael Powell
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C.

Re: Applications Of America Online, Inc., and Time Warner Inc. for Transfers of Control (CS Docket No. 00-30) *Ex Parte* Meetings

Dear Commissioner Powell:

At our meeting on Tuesday, September 19, to discuss Instant Messaging in the context of the AOL-Time Warner merger, you requested information concerning the business model that underlies the IM industry. The attached article dated September 19, entitled "Why IM Matters So Much," addresses this question:

> Instant messaging might seem like nothing more than a touchy-feely service for teen-agers now, but it's one of the stickiest applications on the Web, and in the future there are potential revenue streams that could yield billions of dollars.
>
> IM can drive up a site's traffic and brand awareness. It will be an important feature of interactive television; it has the potential to be used as a killer direct marketing tool, and can add real-time customer services to a site.

In addition, a Lehman Bros. report issued June 29, 2000 (investment thesis and page 42 attached) assessed the value of AOL's IM assets at $5.8 billion, a startlingly high valuation for a "free" service. This multi-billion dollar value was based explicitly on the stickiness of IM and its ability to drive traffic and brand awareness The Lehman Bros. report concluded:

> AOL has only just begun to monetize these services by introducing convenience-type service applications such as free web-based e-mail, calendars, greeting cards and IP Telephony to its users. In less than six months, ICQ now boasts a backlog in excess of $100 million.

All of these features dramatically reduce customer churn and the cost of customer acquisition. These effects have a tremendous impact, as documented by Lehman Bros., on the bottom-line of AOL and other Internet companies.

Sincerely,

Gerard J. Waldron /ax

Gerard J. Waldron

GJW/ls

cc: Ms. Magalie Roman Salas
Mr. Kyle Dixon

UpsideToday
THE TECH INSIDER

Why IM matters so much
by Louise Rosen
September 19, 2000

NEW YORK -- Since federal regulators began their review of the **America Online** (AOL)-**Time Warner** (TWX) merger, most attention has focused on the issues surrounding open access to the merged company's cable pipes and interactive services.

Now instant messaging has jumped to the fore. And all of a sudden, AOL's openness, or lack thereof, to a standard that all instant messaging services could subscribe to, has suddenly emerged as a hot-button issue.

The *Wall Street Journal* reported last week that "federal regulators could force AOL to open up its instant messaging service to rivals as a condition of approving its acquisition of Time Warner." Although several observers doubt that IM will prove a deal breaker, the issue is under the microscope of the Federal Communications Commission.

In recent weeks regulators have spent more time talking to AOL's IM competitors to learn the issues. "[The regulators] have gone to great lengths to see the future of IM and the implications surrounding it as it moves onto wireless devices and television," says Alex Diamandis, vice president of marketing for IM provider **Odigo**.

Company	Number of members
AOL AIM & AOL ICQ	130 million
MSN Messenger	18 million
Tribal Voice	8 million
Odigo	1.5 million

Sticky, sticky, sticky

Instant messaging might seem like nothing more than a touchy-feely service for teen-agers now, but it's one of the stickiest applications on the Web, and in the future there are potential revenue streams that could yield billions of dollars.

IM can drive up a site's traffic and brand awareness. It will be an important feature of interactive television; it has the potential to be used as a killer direct marketing tool, and can add real-time customer services to a site.

"IM has come to represent a killer application to attract users," says Lydia Loizides, Web technology analyst for **Jupiter Communications**. This is the reason AOL's competitors want interoperability among different services.

IM the beginning

In 1996, AOL introduced its subscribers to the "Buddy List," which allowed AOL members to see when their friends were online and available for instant chats.

A year later AOL introduced the AOL Instant Messenger (AIM), a free service that enables Internet users to communicate with AOL members and other AIM users. The Internet availability opened up the user base, and the technology was later licensed to other companies, including **Netscape** in 1997 -- before AOL acquired the company.

Twenty other application providers have since licensed the technology from AOL, including **Apple** (AAPL), **IBM** (IBM)/Lotus Notes and **EarthLink** (ELNK)/**Mindspring**.

With its Buddy List, AIM and another IM service -- **ICQ** -- acquired by America Online, the company now has about 130 million IM users, vastly outnumbering its competitors' numbers. MSN Messenger, for example, has 18 million users and Tribal Voice 8 million. Since it first introduced the service, AOL estimates that about 40 other companies have begun offering similar services.

Last year AOL blocked users of competing IM software from contacting its members, citing concerns for its members' security and privacy. It continues to use that argument as a reason for not adopting interoperability. Since the merger review began, AOL has assured regulators it is working toward creating a standard that does not compromise the security or privacy of its service.

The Internet Engineering Task Force, an Internet standards body, is trying to establish a set of standards that would allow all users of competing IM providers to communicate with each other. AOL has submitted its recommendations to this body, but other providers have accused the company of foot-dragging, and have formed their own panel to create a standard to facilitate interoperability called **IMUnified**.

Among the members of IMUnified are **Yahoo** (YHOO), **Aamp;T&T** (T) and **Excite@Home** (ATHM). At the beginning of September the group announced that it had completed the development of standards that will enable interoperability across the different IM services. (See "IMUnified develops IM interoperability standard.")

"We brought together many disparate companies and still managed to create an open protocol," says Diamandis.

AOL continues to maintain that it will review the standards but will ensure that its members' security and privacy are protected before it opens up its service. In the meantime, it's working on its own standards.

Not in any hurry

But observers are skeptical that AOL, even with regulators breathing down its backs, will open up its system anytime soon. "AOL is going to drag its feet as long as it can, especially since this is not going to be a derailing factor for the merger," says Ken Kiarash, Internet analyst at **Buckingham Research Group**.

The competition wants interoperability, and the motivation is not as simple as merely allowing members to communicate in real time with one another. There may not be any revenue streams worth noting now, but there will be in the future. And that is what they have been trying to make the regulators see.

So what does the future hold for IM? Voice, streaming media, advertising messages, files, interactive television and potential revenue are but a few of the things that are beckoning.

Microsoft's (MSFT) MSN Messenger 3.0 already can carry voice over the Internet, and Loizides believes that this feature "brings a new dimension to the IM market" that "will surely heat up the already fiery rivalry between Microsoft and AOL." This VoIP feature enables users to make free long-distance calls.

IM will be an important feature of the new AOLTV, already in some test markets, a settop box that will converge the television with the Internet. Viewers will be able to chat to one another online while watching their favorite shows.

But perhaps one of the most compelling arguments for opening up the system -- and the most compelling reason for AOL to keep it closed -- is the potential revenue stream.

"Revenue potentials are coming from ASP user fees, advertising on the windows, and the potential for it to be used by group buyers," says Diamandis.

Real-time promotions

Marketers are salivating for an open system. They envision sending real-time promotions to IM users. E-commerce sites, for example, which need to clear inventory with a sell-by date, might alert customers to specials. A link could direct customers to the site instantly.

This will become even more important as the use of Web-enabled wireless devices proliferates.

Another potential IM use, according to Loizides, is in real-time customer-service features. "The real potential to monetize the service comes when it's included to add value to a site," says Ross Bagully, chief executive of AOL IM rival **Tribal Voice**.

AOL's IM competitors are hoping that these issues will compel the regulators to force AOL to open up its system. But the analysts are not so sure that AOL will do so within a year.

"The IM feature has been important to AOL as part of its e-commerce and advertising strategies," says Kiarash. "The company could be hurt if the growth in users slows down as rivals gain access to its users."

Regulators have another month before they wrap up their review and put it to a vote.

URL: http://www.upside.com/texis/mvm/ebiz/story?id=39c289380

LEHMAN BROTHERS

June 29, 2000

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AMERICA ONLINE

COVERAGE INITIATED

2 Outperform

AOL 51		**52-Wk Range 96-38**			**FY 6/30**		**S&P 500** 1454.8
	1Q	**2Q**	**3Q**	**4Q**	**Year**	**P/E**	**Div.**
2000E	0.07a	0.09a	0.11a	0.11	0.39	130.8	Nil
2001E	0.12	0.13	0.14	0.15	0.54	94.4	Nil
2002E	—	—	—	—	0.78	65.4	Nil
Shares Outstanding	2.5 Billion						**NASD** 3940.3

Excellent Fundamentals at a Compelling Price

- On June 21, 2000, we initiated research coverage of America Online with a 2 Outperform rating and a 6-12 month price target of $75 per share.

- AOL is the leading franchise in the rapidly growing online media sector. Its AOL, CompuServe and Netscape Online services have attracted a huge subscriber base of more than 26 million members. Additional online properties such as ICQ, Netscape Netcenter and Digital City combine to make AOL's portfolio of brands the most valuable on the Web.

- The new AOL Time Warner will be the largest Internet-media company in the world, with estimated proforma revenues of $37.3 billion in calendar 2000 and EBITDA of $8.9 billion. We believe that the combined entity is the best-positioned company to lead the industry through the next decade.

- The valuation of the combined company is quite compelling. AOL Time Warner currently trades at a discount to both its long-term EBITDA growth rate and the EBITDA-to-growth rate multiples of other major media and entertainment players. At 18.5 times our 2001 EBITDA estimate, investors can now buy AOL Time Warner at a Time Warner multiple.

INVESTMENT THESIS

AOL is the leading and, in our view, most valuable interactive services company in the world, with a paying member base that rivals the audience of any major media franchise and tens of millions of additional consumers through its portfolio of free Web-based services. The company's core strategy, which is the foundation of the world's No. 1 online service and most powerful Internet brand, has not changed over the years and is actually quite simple and seemingly easy to duplicate. However, most competitors continue to fail to execute, and AOL's leadership position continues to widen despite formidable threats. The company's maniacal focus on providing easy-to-use and invaluable services has made AOL "the Internet" for tens of millions of consumers.

The pending merger with Time Warner brings together the premier global media company with the leading Internet company, with estimated proforma revenue of $37.3 billion and EBITDA of $8.9 billion in calendar 2000. We believe the company has the audience reach, content, distribution capabilities and management team necessary to be ***the*** driving force behind the next wave of online consumer usage growth and the continued convergence of the Internet and television. Furthermore, valuation has become more attractive with the recent pullback in the stock. AOL Time Warner is now priced at 18.5x our 2001 EBITDA estimate, a discount to both its estimated long-term growth rate of 23% and the EBITDA-to-growth rate multiples of major media companies such as Viacom/CBS and Disney. We initiated coverage with a 2 Outperform rating and a $75 price target.

Investment Highlights

AOL's Leadership in Cyberspace is Insurmountable

AOL is the largest access service provider in the market, owning the No. 1 (flagship AOL) and No. 3 (CompuServe) services in the United States. Together, the company's worldwide base of 26 million-plus paying members is by far the largest in cyberspace, with more than five times as many subscribers as its nearest competitor, and almost double the next 10 providers combined. AOL has strengthened its position through the development and acquisitions of other leading interactive properties and services such as Digital City, Netscape Netcenter and ICQ. The company's multi-brand strategy creates meaningful competitive advantages relative to other consumer Internet companies, including unparalleled operating leverage, superior audience reach, flexibility in meeting the needs of distinct audiences, increased economies of scale, and a more diversified revenue mix. We believe AOL's existing family of services, many of which continue to be overshadowed by the success of the flagship AOL service, combine to make the most valuable portfolio of Internet properties on the Web.

Core Business Fundamentals Remain Strong

AOL's business fundamentals remain strong across all key operating metrics. The company has shown dramatic growth over the past three years, with sales experiencing 49% CAGR and estimated to exceed a staggering $9.1 billion next fiscal year. AOL's subscriber growth has increased by more than 17 million people over the same period, with average usage per member increasing from approximately six hours to more than 33 hours each month. Slowing domestic member growth at the premium AOL service should be offset by strong growth of AOL's "value" brands, international properties and new services (i.e., AOL TV and AOL Mobile services). We expect AOL to grow its paying member base by roughly 6 million per year across its family of brands over the next few years.

AOL has been able to expand its EBITDA margins more than fivefold from 5% in 1997 to 27% today and is now generating free cash flow of more than $1 billion annually. Until recently, the Street has rewarded these results with AOL stock having appreciated more than 120-fold over the past three years, with its market cap growing from just $5 billion at the end of 1995 to $129 billion today.

Ad/Commerce is the Growth Engine behind Powerful Earnings and Cash Flow Growth

Ad/commerce continues to be the fastest-growing part of AOL's revenue mix and the engine behind the company's powerful earnings and cash flow growth. AOL has demonstrated the ability to effectively monetize its broad reach and loyal consumer following with an estimated $1.9 billion in advertising revenue in fiscal 2000. With more than 50% market share of U.S. online households and its members spending 85% of their time online within the service, AOL has become an online "must-buy" in media circles. Advertisers continue to consolidate their spending around the largest Web properties, with AOL's ad revenues often exceeding the combined total of other major Internet players. On a per-user basis, ad/commerce revenue has grown to $6.74 per member per month from only $2.74 in 1997. While we are encouraged that online advertising growth will prosper longer term, AOL and other online media companies must now transition their portfolio toward more traditional marketers to offset the drop-off that we expect in dot-com spending.

TWX's Content and Powerful Distribution Creates Unique Opportunities

The new AOL Time Warner will be a true "new" media powerhouse with diversified revenues from advertising and e-commerce (40% or total revenue), cable, magazine and ISP subscriptions (40%), and music and filmed entertainment content (20%). AOL Time Warner's unparalleled stable of consumer brands including, AOL, Time, CNN, TNT, TBS, HBO, CompuServe, Warner Bros., Netscape, Sports Illustrated, People, ICQ, Cartoon Network, Warner Music Group, and Looney Tunes will have more than 110 million paying subscribers and reach consumers worldwide more than 2.5 billion times each month.

AOL Time Warner will also emerge as a leader in the rapidly emerging consumer broadband landscape, with the ability to accelerate the sale of broadband cable services across each other's platforms. Time Warner's technologically advanced systems (more than 85% of TW Cable systems are already upgraded) rounds out AOL's comprehensive broadband strategy, allowing it to offer new and existing cable broadband services to its members. We believe gaining access to these systems will also set the stage for future agreements with additional cable system operators. For Time Warner, AOL offers the world's largest Web-enabled audience to market its digital cable and media services.

The Driving Force of the Evolution of the Internet and Media

We expect AOL Time Warner's deep management team to leverage this unique set of assets to deliver accelerated revenue growth and strong returns. Unlike mergers based primarily on cost-cutting synergies, we expect AOL Time Warner to drive growth through new revenue opportunities. The marriage of AOL and Time Warner creates tremendous opportunities for marketing efficiencies, increased advertising sales, new subscription growth and increased retention, accelerated broadband penetration, as well as shared infrastructure and overhead savings. Furthermore, by leveraging the assets, creative talent and financial power of the combined company, we anticipate the accelerated development of existing services (i.e., Time Warner digital music, AOL TV), and development of new businesses.

Valuation Is Compelling

With the recent sell-off in the stock, AOL's valuation has become compelling, in our opinion, offering an attractive entry point for investors looking to build positions in this dynamic company. The combined entity, AOL Time Warner, currently trades at only 18.5 times our proforma 2001 EBITDA estimate, representing a discount to our five-year EBITDA CAGR projection of 23% and well below the EBITDA-to-growth rate multiples of major media companies Viacom/CBS and Disney. Interestingly, Time Warner, on a stand-alone basis, historically traded at a premium to its peers, reflecting its higher long-term EBITDA growth rates, its non-EBITDA contributing properties, earnings predictability and leading market positions across many of its businesses. The market appears to be heavily discounting AOL Time Warner's growth trajectory, given the complexity in integrating these two enormous companies and the ability to realize the potential synergies. While the risks cannot be minimized, we expect AOL Time Warner to demonstrate excellent growth characteristics — providing investors an opportunity to purchase AOL Time Warner at a Time Warner multiple.

Near-Term Catalysts Will Help Drive Stock

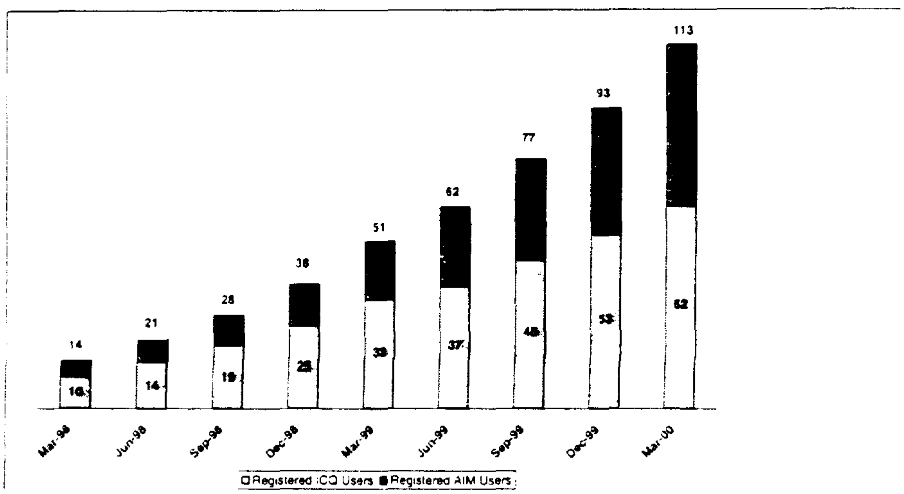
We believe there are several near-term catalysts that should help propel the stock higher, including, 1) strong expected calendar second-quarter results for both AOL and Time Warner; 2) positive news on regulatory front; 3) new product launches (AOL TV, AOL Mobile Services, and next generation AOL 6.0 software later this fall); and 4) the announcement of an open-access deal with Time Warner Cable.

AIM/ICQ

AOL Instant Messenger (AIM) and ICQ are among the company's most valuable and under-appreciated assets. ICQ ("I Seek You"), purchased in June 1998 for $287 million, has been a home run, and we estimate that it is worth as much as $5.8 billion today. We look for these properties to begin to generate a healthy stream of revenues in fiscal 2001.

- AOL Instant Messenger (AIM) is the company's homegrown Web-based real-time communications tool, which enables users to send personalized electronic text messages and files. AIM currently has more than 51 million registered members.
- ICQ, similar to AIM, is a Web-based communications portal. ICQ expanded AOL's reach worldwide with only 6% of its users overlapping with AOL. ICQ serves a distinct segment of the market, with two-thirds of its users outside the United States, and two-thirds ages 18 and 34.
- ICQ currently has more than 65 million registered users (+465% since the acquisition), an active population of more than 20 million and 1.4 million simultaneous users (up 350% since the acquisition), making it the most popular messaging service on the web in spite of no marketing support to date. ICQ remains the No. 1 download application on CNET's Download.com.
- AOL continues to expand the breadth and depth of the AIM service. The company has added streaming stock quotes and news and, more recently, the ability to talk among users and exchange images/pictures and sounds. In April 2000, AOL launched the latest version of ICQ 2000a, featuring enhanced community features and navigation, new instant messaging and communications functionality, multi-lingual capabilities and corporate firewall compatibility.
- AOL has only just begun to monetize these services by introducing convenience-type service applications such as free web-based e-mail, calendars, greeting cards and IP Telephony to its users. In less than six months, ICQ now boasts a backlog in excess of $100 million.

Figure 28: America Online
AIM/ICQ Registered Member Growth (in millions)



Source: Company documents and Lehman Brothers.