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AOL: In Search of a New Strategy

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America Online is once again the center of Time Warner's growth strategy, and this go around there are a number of potential partners -- ranging from Microsoft and Google to Yahoo and Comcast -- reportedly interested in buying a minority stake. Yet to be determined is how the latest AOL business model, which includes both dial-up Internet access and advertising, will evolve.

So why is Time Warner looking to sell a stake in AOL? Time Warner CEO Richard Parsons stated in remarks on September 21 that the company wants to get more credit for AOL's advertising business, which is growing quickly but is dwarfed in revenue by its waning dial-up Internet access business. If AOL can become primarily advertising supported -- and move away from its identify as an Internet access provider -- then it has the potential to be seen as "high growth, just like Yahoo, just like Google," said Parsons.

To back up Parson's contention that AOL is valuable, Time Warner is soliciting bids to put a dollar figure on the online service's value, currently estimated to be anywhere from $10 billion to $15 billion, according to Wall Street analysts. Meanwhile, soliciting a partner could allow Time Warner to decouple AOL's Internet access and advertising businesses to create a more nimble joint venture similar to Yahoo.

The interest in AOL is quite a turnabout. Since the AOL and Time Warner merger closed on January 11, 2001, AOL has gone from the alleged growth engine of a media empire to a property of such low value that its name was dropped from the corporate moniker. Today, AOL is once again the focus of its parent's affections amid a rebirth in Internet advertising. Yet while AOL's standing has improved, its future remains uncertain as it tries to find a business model that will stick, say experts at Wharton, who also note that it's not too late to fix AOL, especially when you consider its 20 million subscribers and $1 billion in annual online advertising revenues.

"AOL's dial-up business is a classic cash cow -- hugely profitable today but inexorably declining," says Wharton legal studies and business ethics professor Kevin Werbach. "Take out AOL's Internet access business, and you still have a new-media powerhouse."

And although AOL's market heft has diminished somewhat, Wharton legal studies and business ethics professor Dan Hunter describes the online service as a survivor. "AOL has been a basket case for so long," he says. "First it was going to die, but it continued and maintained most of its previous position."

Now, Time Warner CEO Richard Parsons wants to take AOL to the next level. "The big value accretion opportunity for us is in AOL," he stated on September 21. "It's the number one point of focus." His strategy will be to keep AOL's dial-up business because "it generates too much money," but concentrate on "building the audience or advertising-based side of the business." Initially the plan involves developing the AOL.com portal into one that can go toe-to-toe with Yahoo.

Wharton business and public policy professor Gerald Faulhaber has heard this spiel before. "AOL is an enormous asset, but it has a management problem," says Faulhaber. "AOL has the audience, but Time Warner has demonstrated that it doesn't know how to take advantage of it." There are plenty of unanswered questions about AOL, Faulhaber adds. For example, what does AOL have to become in the future? What can AOL create that's unique? How can it garner profits from its instant messaging dominance? How will it convince its customers to stick with AOL as broadband Internet access grows in popularity?

Faulhaber isn't the only observer who doubts that Time Warner can figure out the AOL puzzle. Investor Carl Icahn has been pestering Time Warner to generate better shareholder returns. On October 11, Icahn, along with a handful of money management firms, wrote an open letter to Time Warner shareholders that blasted Parsons and company for failing to migrate AOL subscribers to broadband and failing to compete with Yahoo and Google. If management had only "demonstrated a commitment to the driving principle behind the merger (synergies between AOL and the Time Warner businesses)" it "could have preserved at least some of the shareholder value," he wrote. "Recently top management has begun highlighting AOL as a valuable asset and growth opportunity: Where have they been since 2000?"

Bailing Out for Broadband

Despite doubts about Time Warner's ability to deliver on the promise of AOL, Internet leaders are lining up to invest. "We think the recent spate of news regarding a potential deal between AOL and various interested parties highlights the growing perception of the implicit value in the AOL advertising business," said Bear Stearns analyst Raymond Lee Katz in a research note.

Why would companies like Microsoft and Comcast bother with AOL? Hunter says it's a simple matter of audience: It is still a primary way to get to the Internet for many people. Despite all its failings, adds Werbach, "AOL remains one of the most popular sites on the Internet, and it's an accomplished and successful commerce and advertising engine. Any of the other leading Internet players would gain some heft by association with AOL's massive community, and they would gain by preventing their competitors from doing the same."

Indeed, Nielsen/NetRatings reports Microsoft had the biggest Internet reach among U.S. home users, with 90,718,000 unique users in September. Time Warner properties, which are dominated by AOL brands, were second with 82,113,000 unique users, followed by Yahoo with roughly the same total. Google was fourth with 65.3 million. These home users spent nearly four hours per person on Time Warner sites. Yahoo was the only company that came close, with users spending 2 hours 28 minutes per person. However, AOL's audience is eroding as customers move to broadband. AOL lost 917,000 subscribers in the second quarter to fall to a total of 20.8 million members as of June 30. Revenue declined 4% in the second quarter to $2.1 billion.

To stem those declines, Parsons has focused on growing AOL's advertising business. So far, ads have helped offset the loss in dial-up subscribers. In the second quarter, AOL reported operating income of $368 million, up from $276 million the prior year, primarily due to increased advertising spending. For the six months ending June 30, AOL reported revenue of $4.23 billion, down from $4.37 billion a year earlier. Operating income was $692 million, up from $553 million the prior year. Time Warner will provide the latest AOL results on November 2 when it reports its third quarter earnings. Meanwhile, AOL's advertising revenue is expected to surge. In 2004, the total was $1 billion, a figure which should hit $1.8 billion in 2006, according to Merrill Lynch estimates.

The bottom line, says Wharton marketing professor Peter Fader, is that AOL "still has assets others want, notably a base of customers that are locked in through thick and thin, content from Time Warner, a leading instant messaging position and properties like Mapquest and Moviefone."

Accessing the Globe

With its strong advertising growth, AOL is planning to milk the dial-up business and focus on advertising to become a media player on the web. Parsons' other objective is to make AOL an international player. For instance, Yahoo and Google are already dominant internationally. AOL isn't. "Where we fall short is overseas," said Parsons. "One of the reasons for moving to the portal strategy was you unlock yourself from your subscription or your access footprint, and you can access the entire globe."

Experts at Wharton question whether that strategy will be enough in the long run. In the short term, it makes sense, says Hunter. "It's the only bet they can make right now so they have to do it." Faulhaber, however, suggests that AOL's current strategy sounds a lot like Yahoo's old one and that AOL may be trying to hit a target that keeps moving. "AOL, with its portal strategy, is trying to compete with someone (Yahoo) that has already built a dominant model," says Faulhaber. "I don't see the model making it. If you don't know how to do something well, nothing else matters."

Meanwhile, Yahoo and Google have been moving toward offering communication services with instant messaging, PC-to-PC calling, blogging software and friend networking sites, says Hunter. Even News Corp., which lags its rivals on the Internet, sees the trend. It recently acquired the parent of peer-networking site MySpace. "The models are increasingly moving toward social software," says Hunter. "As these social models grow, AOL could be left in the cold again."

He advises AOL to move toward becoming more of a communications platform. It has the leading position in instant messaging, but has yet to find a way to make money from it. In retrospect, AOL could have created a service such as Skype, the software application that allows people to talk and instant message for free using PC-to-PC connections.

In Parsons' recent speeches and conference calls, he has primarily focused on advertising rather than the importance of social networking. Nevertheless, AOL has already taken steps in this direction. On October 6, it acquired Weblogs Inc., a blogging site, and on August 4, it bought Xdrive, which provides storage services on the web.

The Most Likely Suitors

For the record, Time Warner hasn't confirmed any of the various press reports in *The Wall Street Journal* and *New York Times* about selling a stake in AOL. However, Parsons did note that the company was looking at "both structural and strategic approaches to accelerating" AOL's new strategy.

Among the most likely AOL partners, in order:

> Microsoft: Faulhaber ranks the software giant as the most likely partner for AOL. The company and Yahoo recently agreed to make their instant messaging interoperable, and a deal with AOL could eventually mean that all instant-messaging services would be compatible. Microsoft could get Time Warner content for its MSN portal and find another customer for its search technology. The two companies could also combine their dial-up customers. "MSN seems like it's plodding, but it's always in the mix," says Faulhaber.

Morgan Stanley analyst Spencer Wang says combining MSN and AOL would "create a very legitimate third portal competitor to Google and Yahoo."

> Comcast: An AOL partnership with Comcast on the surface is a no-brainer. Comcast's cable outlet would give AOL customers a migration path to broadband service. Comcast could use AOL as the home page for its high-speed services. Meanwhile, Time Warner and

> Comcast work together frequently in the cable business. The one hang-up: the price of an AOL stake. "AOL would command a premium and it is unclear Comcast would be willing to pay," says Faulhaber. "Comcast will back out of a deal if the price isn't right."
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> Google: A deal with AOL would be a bit of a departure for Google, which has focused on building tools that manage information instead of acquiring content, says Hunter. A deal with AOL could give Google rights to Time Warner movies and music content in exchange for search technology and other tools.

Merrill Lynch analyst Lauren Rich Fine also notes that Google's interest is largely defensive. Google currently provides search tools to AOL and a venture with Yahoo or Microsoft would end that arrangement.

> Yaho As the leading portal on the web, Yahoo wouldn't gain much from a deal with AOL. However, Yahoo could become a search partner for AOL and nudge rival Google out of the mix.

Of course, none of these deals may actually happen. Katz said that no deal is definite, given significant "sticking points," namely the valuation and control of AOL. In addition it's unclear whether AOL will be publicly traded separately from Time Warner.

Fader also notes that the winning bidder for AOL will probably have buyer's remorse later. "There are multiple bidders, so it's likely that someone will pay too much for it. It's the winner's curse. The customer base is valuable but half of it will evaporate as people move to broadband." He also expresses surprise that Time Warner isn't going to sell AOL outright to one of its suitors. "They are probably leaving money on the table by not doing that."

What will really be interesting is what happens to AOL once the dealing is done, say observers. Managing an AOL venture is bound to get complicated, considering Time Warner wants to remain dominant. "Time Warner is the biggest challenge for any buyer," Fader says, adding that it's unlikely Time Warner, which shoulders most of the blame for AOL's demise, can successfully manage the online service and be nimble enough to compete with companies like Yahoo and Google.

Yet to be determined is what AOL business model will ultimately emerge. Can the Internet access and advertising businesses be separated? How will AOL adapt to new technologies? Is the AOL brand worth saving? Werbach says no matter who buys a stake in AOL, the online business will have image problems. "AOL's biggest problem may be image and culture. People don't think of it as a top Internet media player, and it doesn't really think of itself that way."

It's quite possible, Fader suggests, that AOL will be dismantled and the brand will slowly fade as its customers are absorbed into other properties belonging to Microsoft, Comcast or any other of the bidders. "You may have to take the name and morph it into something else." Regardless, he adds, the next chapter of the AOL saga will be interesting. "Watching AOL will be a good spectator sport. Who will win is unclear, the business model is unclear and the Internet is just as much of a Wild West shootout now as it was years ago."