



## The Mega-media Business Model: Doomed to Fail, or Just Ahead of its Time?

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It's now AOL Time Warner's turn to take center stage as the latest poster child of America's mega-corporate meltdown.

Last week, on the day the world's largest mega-media company posted its first quarterly net profit since completing its mega-merger, the Securities and Exchange Commission (SEC) announced it was investigating AOL Time Warner for questionable bookkeeping – joining the likes of Enron, WorldCom, Tyco and Adelphia. The SEC investigation was initiated in response to articles in *The Washington Post* that suggested AOL might have inflated its revenue over a two-year period ending in March.

The week before, new CEO Richard Parsons accepted the resignation of former MTV and AOL *wunderkind* *wunderkind* Robert Pittman, the company's chief operating officer. Parsons reorganized the executive suite, elevating two respected Time Warner executives, Don Logan, CEO of the *Time* magazine publishing unit, and Jeffrey Bewkes, CEO of Home Box Office. At one point, Pittman had been considered heir to the CEO throne, and there is some speculation he could land at another mega-media giant, such as Disney.

Since AOL and Time Warner completed its merger in January 2001, the value of its stock has declined by more than 75%. When news of the SEC investigation broke last week, the price dropped to \$9.51, a one-day decline of 15%, but has since climbed back above \$11. At the height of the Internet boom, America Online used its soaring stock to acquire Time Warner, an old-media company with four times its revenue. Recently, however, some investors and analysts, among others, have targeted Steve Case, the company's chairman and architect of the \$165 billion merger, for removal.

So what's ahead for AOL Time Warner?

"Demerging would be a solution," says [Gerald Faulhaber](#), Wharton professor of business and public policy, and an early critic of the AOL Time Warner merger. "They have to look at [themselves] and ask, 'Are we still a compelling business model for ad agencies to reach people?'"

The merger, Faulhaber adds, has been a "big distraction, not for Time Warner, but for AOL because they lost their focus." The only potentially positive aspect in the deal was that AOL would get "access to broadband conduit ... and that was unsuccessful." Furthermore, the merger's dysfunction has been intensified by bitter infighting and a culture clash between AOL and Time Warner divisions and people.

"AOL Time Warner is clearly not going to survive," says Wharton marketing professor [Jehoshua Eliashberg](#). "It is really about different cultures clashing. Pittman had to resign. It was like trying to mix oil and water. The way AOL and Time Warner [each] think about business is different."

While AOL Time Warner once talked of magical synergies between the "new media" and "old media" and between "content" and "delivery," now many in the business press are openly speculating on when the company will split up. That may indeed be the fate of Vivendi Universal after its meltdown under controversial CEO Jean-Marie Messier, who was forced out several weeks ago. (*See related story in this*



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issue, titled “Challenges Ahead for Vivendi’s New CEO.”)

## Old Media Prevails: Synergy Fizzles

Whatever the future holds for companies like AOL Time Warner – which may decide to sell or spin off AOL in the future – and Vivendi – which is looking post-Messier to sell large units to raise cash to pay down debt – the mega-media companies are under extreme duress.

As recently as July 28, Thomas Middelhoff, CEO of global media conglomerate Bertelsmann of Germany, was fired after an apparent fight with the company’s controlling shareholders over company strategy. Bertelsmann owns interests in publishing, television and music. Its holdings in the U.S. include Random House, Bertelsmann Music Group, Napster and several magazines.

The recent changes make one thing clear: Old media rules, for now. “Synergy” might have been the buzzword for press releases two years ago, but today it’s a business concept that should be used sparingly. “I’ve been a skeptic from the beginning about the AOL and Time Warner merger,” says marketing professor [Peter Fader](#). “In the long run it’s brilliant,” but the cross-fertilization they were betting on won’t occur until the next generation, in other words, “when today’s kids who are six and seven become adults and broadband is ubiquitous.

“Ultimately the marriage of content and delivery is a good one,” he suggests. AOL and Time Warner had a workable idea, just very bad timing. “They should break up as quickly as possible. Maybe they should consider merging again in about 15 years, if AOL is still around.” Although AOL is huge, “nobody looks at the company and says, ‘Wow, that’s tech done right.’ They say, ‘That’s tech for idiots,’ and our kids will want a lot more.” Two years ago, he added, “people viewed AOL as the go-go growth business, even though it had already saturated most of its market potential. It was clear that AOL’s growth would be leveling off.”

According to Faulhaber, AOL lost its focus because it mistakenly was trying to “force feed” AOL and Time Warner content. “AOL is not about pushing content down the pipe; it’s about peer-to-peer. It’s community. The Internet is about peer-to-peer, not TV. The Internet is an inferior distribution channel for content, much inferior to cable and satellite.” As for broadband, Faulhaber adds, “People talk about broadband and a ‘killer app.’ That’s absolutely wrong. The notion it will be the equivalent to movies is wrong. It’s not one-to-many. It’s one-to-one.”

In its second quarter 2002 financials released last week, the company reported that all Time Warner divisions posted second quarter results that met or exceeded expectations. Overall, second-quarter revenue rose 10%, to \$10.6 billion, from the period a year earlier, and its cash flow, or earnings before interest, taxes, amortization and depreciation, rose 2%, to \$2.5 billion. Its film and television studios and networks performed particularly well with the film-entertainment division reporting a 31% increase in cash flow on a 26% increase in revenue. Brisk sales of home videos such as “Harry Potter and the Sorcerer’s Stone” and box-office hits like “The Lord of the Rings” helped.

Parsons told the business media last week that he stands by the company’s projections for a single-digit percentage increase in third-quarter revenue, and flat or modestly declining cash flow. For the full year, Parson says AOL Time Warner expects revenue to increase nearly 8%, at the high end of its previous projections.

Overall, however, results were dragged down by the performance of America Online, whose revitalization Parsons called his “top priority.” AOL’s revenue fell 3%, and its cash flow fell 27% from the previous year. The Internet company reported a [31% decline](#) in its business to \$501 million. Advertising revenue fell more than 40%, with few signs of a recovery anytime soon.

Additionally, the online service only added 492,000 subscribers, less than half as many new subscribers as in the quarter the previous year. Its share of the online market in the United States has slipped to 37% from 41% two years ago. And the company is lagging way behind in broadband with less than 5% of the market. Today, in the U.S. about 13 million of the 60 million households with Internet access have high-speed, broadband connections. The adoption of broadband by consumers, and AOL's slow growth in it, are providing openings for its rivals, including Microsoft, [Yahoo](#) and telephone and cable companies.

Some analysts say the SEC investigation and America Online's weakness overshadow Parsons' reassuring comments. "The investigation into AOL's accounting and the dramatic decrease in the growth of new subscribers at AOL" are two big causes for concern, Jordan Rohan, an analyst at Soundview Technologies, told *The Washington Post*.

### **Mega-mergers: Some Unlikely Partners?**

Given these developments, what could happen with the AOL part of AOL Time Warner? "It could be spun off in an LBO," says marketing professor [David Schmittlein](#). "Certainly it would be hard to imagine that someone else would buy it. It's a tough market to sell into. If Time Warner is selling AOL it would be as a fixer upper."

While it's hard to imagine the world's largest online service – with 34 million dial-up customers – as a fixer upper, perhaps that's the most likely solution, one that would make sense long-range. In the meantime, who knows what mega-media companies will emerge in the next generation, possibly from the unlikeliest sources.

For example, General Motors and Microsoft.

"If someone proposed a merger between Microsoft and GM, people would say that's absurd," says Fader. "But in 15 to 20 years, a lot of computing that people do will be done in their cars, which will be actively computerized. So it will be a natural match, but it seems so far from anything on the radar screen right now. People should view AOL and Time Warner in the same way."

Today's mega-media companies – AOL Time Warner, Viacom, Vivendi, Disney, Bertelsmann, Sony – may not be tomorrow's. While they all became behemoths because of past mergers among big media companies, it's very likely some of them will change into different entities, perhaps with some unusual partners.

"The mega-media companies that exist today," says Schmittlein, "only exist because of previous mega-mergers. There have been tons of media mergers and buyouts cutting across all kinds of businesses, from content providers to delivery, and they have not been successful. There has been a substantial inclination to merge among content providers, like movie studios and music. It is only when content providers and media vehicles merge that there has been a real problem. The efficiencies or revenue opportunities have underwhelmed."

Faulhaber says he has always been a "skeptic of mergers of media and media, and certainly of distribution channels and content. I think the Time Warner merger with Turner is a good case in point. Time Warner got some great cable properties with great possible synergies between content and cable, but these guys just have never demonstrated they know what to do with it. Time Warner has messed it up. I don't think Time Warner gained anything."

It would be "premature," however, Schmittlein says, "to suggest that there aren't more mega-mergers out there. The markets for content providers and consumer-based producers, like SONY, are not as global as they will be 10 years from now. Continued globalization does represent market opportunities that are best

likely exploited through mergers. The world's media market is not yet global."

## Sleeping Beauty and Ozzy Osbourne

In looking at the world's largest media companies, Eliashberg and Fader are intrigued by SONY and Viacom. Viewed less favorably, along with Vivendi, is Disney, while General Electric and its NBC-MSNBC-CNBC divisions suggest interesting possibilities.

"It's perfectly possible for GE to spin off NBC, or to add to NBC," says Fader. "I have faith in them that whichever way they decide to go, it will probably be the right way. So far the way they have handled things has showed good restraint and judgment."

Fader saves his disdain for Vivendi and Disney, calling them "Public Enemy Number One" and "Public Enemy Number Two." Vivendi "has been against consumers more than any other ... for instance in the way they have led the charge against online file sharing. They don't care what the customer wants."

As for Disney, Fader says the company "tries to give a warm and fuzzy feeling to the public, yet they tell their customers to 'go to hell.'" He criticizes Disney's marketing tactics, including its long-standing decision to release classic movies such as *Sleeping Beauty* once every seven or so years. "That model doesn't work any more. People want it now. Disney has to recognize that the business rules have changed; in the long run all successful companies have to recognize and obey them."

Additionally, Fader doesn't believe that ABC, which has fallen on hard times, and Disney are a "good match. It was a great coup when it happened. It was a nice way for Disney to try to change its stripes by aligning with a much more progressive player." He jokes that they should have changed the name of the entire corporation from Disney to ABC "in order to send a strong signal to the marketplace about their willingness to try new things." As for Michael Eisner, Disney's chairman and CEO, Fader describes him as "a good manager for a different industry. In a world where change is constant, he's not the right man for Disney any longer."

When it comes to Viacom, however, Eliashberg and Fader agree that it is a solid, well-run business with proven leadership. CBS is on the upswing, Infinity Broadcasting churns out radio cash flow, Ozzy Osbourne has pumped new life into MTV, and even with their alleged personality conflicts, Sumner Redstone and Mel Karmazin are considered two of the top men in the industry. The company last week reported sharply higher net earnings for the second quarter with a profit of \$546 million, and better results at its cable and broadcast TV networks. CBS announced last week it has sold out of third-quarter advertising time adding that there was strong demand for the fourth-quarter, and said that it's upfront, or pre-season, advertising revenue of about \$1.9 billion for the 2002 to 2003 prime-time schedule broke records.

"Sumner Redstone knows how to run a business," says Eliashberg. "He has experience in all kinds of media businesses, and Viacom is likely to survive." Fader, however, believes that "to succeed in the long-term Viacom must be well-placed in emerging media," suggesting the possibility of a "big investment" by one of the firms with a larger stake in the digital world.

Both Eliashberg and Fader see intriguing possibilities for Sony, which was named in a recent Harris Poll as the number one quality brand. Sony has "much more control over its fate than any other company" in its space," says Fader." Adds Eliashberg: "They have a good management team running the studio. It is yet to be seen if they can get the synergy between all of the digital devices they have developed and the software."

As Japan's largest electronics maker, owner of the highly popular PlayStation 2, Sony also owns a strong cluster of entertainment properties, including a movie studio, theaters, TV shows, video games, and more.

And while Sony hasn't found the magic formula – the "synergy" – its three main divisions are doing well. "Spiderman," which has made \$675 million worldwide, and PlayStation 2, which has sold 30 million units and millions more games, has helped Sony exceed expectations by earning net income of \$492 million for the quarter ended June 30.

Fader is interested in whether Sony can figure out how to meld its popular hardware and software. "The tension they are facing is tremendous between the hardware and software sides. They are building a lot of hardware that customers love, but they are putting restrictions on the software, like MP3 file sharing. If they removed those restrictions, Sony's business would skyrocket. If they make the right decision, amazing things could happen ... It would benefit them, and it would benefit the industry. The question is: Will Sony take the lead, or react?"

Sony chairman Nobuyuki Idei recently told *The New York Times* that "it took nearly 10 years since we acquired the different culture (movie studio) before we started talking positively to each other." That's a lesson the clashing cultures of AOL and Time Warner haven't yet learned – and a reason why Robert Pittman took the fall. For Vivendi, it doesn't appear it will ever have the chance to learn.

So what does the future hold for mega-media companies? Comments Schmittlein: "How are people going to get high-speed Internet access? Who will provide it? Who will provide the opportunities to marry media and content? Is it the cable companies? The telephone company? We don't know yet who that will exactly be. AOL's bet is that there is a lot of inertia among consumers and a disinclination to abandon AOL's service for a new provider."

According to Eliashberg, the mega-media merger trend "was a mirage. Some of this was driven by ego. You are a CEO with a big ego and you say 'synergy, synergy, synergy' to your board of directors and they say 'yes.' That's an ego-driven acquisition, and ego-driven acquisitions are not good business. You can't decide to acquire another business if it's only remotely related to your core competency."

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