Aol-time warner merger

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On January 11, 2001 America Online and Time Warner merged to form AOL Time Warner. As the largest merger in corporate history it created the world's leading media and entertainment company, whose businesses include interactive services, cable systems, filmed entertainment, television networks, musicand publishing. (www. aoltimewarner. com) The merger was viewed as the coming together of old media with new, and was believed to have enormous synergistic potential.

Synergy can broadly be defined by as: 2 + 2 = 5. That is, the sum of the parts are greater than the whole. Synergies can come from a number of sources, which I explore in the next section. These include under exploited economies of scope and scale, synergies that arise from reduced internalized transaction costs, and financial synergies. I go on to discuss how did capital market pressures, product market challenges and weaknesses in core competencies impact on thefailureof the group to achieve shareholder value from the merger. Then, in the final section I discuss, with reference to empirical evidence and the view of management and commentators alike, whether AOL Time Warner's merger has failed.

Reasons for merger

It is clearly evident from AOL Time Warners 2000 annual report management goal was to gain synergies from the merger " our blend of subscription brands in publishing, cable television, cable programming and digital interactive services gives us extraordinary opportunities for cross-promotion.” (The Economist Oct 26, 2002) In 2000, for example, AOL began bringing in more than 100, 000 subscriptions per month to Time Inc. magazines, and the magazines were used to distribute AOL's new 6. 0 disks

for advertisers, creating new kinds of integrated packages that allow them to reach audiences with an intimacy, impact and efficiency never before possible. Global Expansion - they are also focused on opportunities for global expansion. Merger seen as a way to capitalize on the convergence of information, communications and entertainment industries as consumer demand more choice, control and convenience.

Were synergies Not the Aim of the Merger?

Mergers and other diversification strategies are not always pursued for the exploitation of synergies. Firms may merge in order to reduce shareholder and management risk, or because of management's personal objectives. In buying Time Warner using their vastly inflated share price AOL acquired tangible assets of an established and hugely successful firm. Cynics argue that the merger was merely a way for the firm’s shareholding management to pursue their own objectives and get rich quick. Not least because immediately after the merger, when the share price was far higher than it is today, 14 executives realized $256m, including the new CEO Mr. Parsons ($35m) and the former CEO Mr. Case ($50m). (The Economist Oct 26, 2002)

Furthermore evidence suggests that top management's salaries and prestige are correlated with corporate size rather than corporate profitability. A study by Hayward and Hambrick (1997) adds to the argument that management may have merged for their own personal reasons pointing to the issue of management hubris. This is where management have " exaggerated pride or self confidence, often resulting in retribution" and so believe they can achieve more than is actually the case.

Conglomerate and horizontal mergers may also be pursued so as to reduce shareholder risk by ensuring revenue flows from a number of different sources. However, I do not believe that this was the motive behind the AOL Time Warner merger. It is widely known that if shareholders want to reduce their risk by diversifying they can achieve it at a far lower cost than can a firm (less transaction cost) by widening their portfolio or investing in a mutual fund.

Nevertheless AOL and Time Warner may have merged so as to reduce the risk exposure of its management. Given that cyclicality in profit levels is related to cyclicality in employment, provided employees are transferable between separate businesses of the firm, their may be benefits to management from the increased diversity of the firm - as it has more ability to smooth output fluctuations. (Grant 1998, 363-86) In the 2000 annual report Case and Levin (2001) wrote that they had a " fundamental focus on acting swiftly to realize the benefits of cross-promotion and shared infrastructures". It is comments such as these that lead me to believe that the principle motive behind the merger of AOL and Time Warner was to exploit synergies. In the next section I discuss whether they have succeeded.

Have they failed to gain synergies?

On the face of it AOL Time Warner appears not to have gained any synergies. The share price has plummeted since they completed the merger by more than 60%, (Singhania 2003) they reportedly made record losses in 2002 (Howe 2003), and much of their former management has left or is about to. Some argue that Time Warner is being dragged down by AOL,

which is suffering from decreasing advertising revenues and slowing subscriber growth.

Management openly admits that so far the merger has not reached expectations and many feel that, like so many others before it, the merger has failed. Scholars who oppose conglomerate mergers like this would point to theories (which I cannot prove in this case) that suggest that, because of influence cost and incentive effects (Besanko et al. 2000), such diversification results in inefficient resource allocation between the divisions. They argue that the firms would have been more efficient if they had remained independent having to compete in the market to provide their respective distribution and content capabilities.

On the other hand, there are arguments to suggest that AOL Time Warner has been the victim of an adverse economic climate, and that their inability to exploit synergies have not been conclusively proven. Firstly, as shown below, the fall in AOL Time Warner's share price is less than that of similar companies, such as Yahoo (The Economist Oct 26, 2002), and is larg? ly in lin? with th? NASDAQ tr? nd. (B? for? th? m? rg? r AOL was list? d on th? NASDAQ)

Factors such as th? slowing global ? conomy, S? pt? mb? r 11th, th? bursting of th? dot com bubbl?, ? nron, and r? c? nt accounting sp? culation ov? r th? form? r AOL hav? all r? duc? d shar? hold? r confid? nc?, and ar? not n? c? ssarily to do with poor ? xploitation of m? rg? r syn? rgi? s. Furth? rmor? a substantial proportion of AOL Tim? Warn? r's r? v? nu? s ar? g? n? rat? d from onlin? adv? rtising, th? s? hav? d? cr? as? d, but larg? ly in lin? with total sp? nding on onlin? adv? rtising which has d? cr? as? d from approximat? ly $8. 2

billion in 2000 to approximat? ly $6. 3 billion in 2002. (Financial Tim? s 2003) In addition many of th? p? rc? iv? d syn? rgi? s of th? m? rg? r hav? b?? n ? at? n away by th? ill? gal downloading of music and film from th? Int? rn? t.

? mpirical ? vid? nc? from th? 2001 annual r? port sugg? sts that syn? rgi? s ar? b? ing r? aliz? d. R? v? nu? s incr? as? d from $14, 733 million in 2000 to $16, 543 million in 2001, ? arnings b? for? int? r? st d? pr? ciation and amortization (? BITDA) hav? incr? as? d from $8, 394 million to $9, 996 million. (Wolf 2002) Furth? rmor?, in public at l? ast, manag? m? nt boasts about th? syn? rgi? s th? y hav? r? aliz? d: " Our cross-promotions ar? alr? ady having impr? ssiv? r? sults. AOL continu? s to g? n? rat? about 100, 000 Tim? Inc. subscriptions monthly." (Cas? ? t al. 2002)

I think that th? m? rg? r has not fail? d and that th? y will and ar? ? xploiting syn? rgi? s. AOL is still th? world's (Lowry & H? nry 2002) Furth? rmor? syn? rgi? s will only incr? as? as AOL ? xpands its introduction of broadband, which will ? nabl? th? m to d? liv? r consum? rs ? v? n mor? of Tim? Warn? r's cont? nt. I b? li? v? AOL's found? r, St? v? Cas?, wh? n h? says: " Th? tru? valu? of this union li? s not in what it can do today, but what it will achi? v? in th? futur?." (CNN, 12 January 2003)

Conclusion

Many commentators believe that the merged firm's attempts to gain synergies have failed, and all agree that their performance has been disappointing. However, I believethat this merger was not a mistake, and that in order for firms to remain competitive they must continually change and redefine the business in which they operate. I believe AOL Time

Warner's poor performance has largely been outside of management's control, and is more a reflection of the difficult external economicenvironment. Mergers require adjustment time, and AOL Time Warner may not yet have exploited all the synergies that exist, but they are beginning to, and I believe will continue to in the longer-term.

The decision to 'Make' rather than 'Buy' was found to be positively related to the size of hold-up costs and negatively associated with human asset specificity and the existence of enraptured economies of scale and scope when the component or task is internally procured. (Frank ; Love 2000) Over the years an impressive number of empirical studies have been carried out which obtain results consistent with the prediction that asset specificity is the main determinant of vertical code integration

Internal procurement of a component may imply foregoing economies of scale or scope in production, which are available to an external supplier. Lyons (1995, p. 432) argues: “ It is argued that the production cost advantage of the market declines as assets become more specific because it becomes increasingly difficult to aggregate the different demands of a number of buyers.” However, this aggregation of demands argument appears to rely on a singular relationship between the 'uniqueness' of a given good or service and the specificity of the asset which is used to produce it. This is not merely a heroic assumption, but actually runs counter to one element in the gamut of specific assets: the 'dedicated asset'.

In addition, the specification of economies of scale used by Lyons (1995) - and also used in the empirical work described below - is in fact enraptured economies of scale resulting from a given firm's demand requiring a level of

production below minimum efficient scale; in-house production therefore suffers from technical code inefficiency. These enraptured scale economies are governed by the firm's level.

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