FAILED MERGERS: VIGILANCE IS KEY

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Abstract

This paper seeks to present a case study based on the famous America Online and Time Warner merger, which still subsists as the biggest merger to have taken place in the history of American business at a whopping amount of $350 billion. However, what is cardinal to this paper is the fact the merger that was to be the signature moment of the new economy, proved to be a major disappointment. This paper aims to discuss the calamity of errors and economic conditions, which lead the most anticipated the deal of the century to the altar of downfall.

Key words: Biggest failed merger, America Online, Time Warner, market capitalization

1. Background

BRIEF HISTORY OF THE COMPANIES

AOL is the final offshoot of a company founded in 1983, known as Control Video Corp (CVC). It was founded by a prodigy named Bill Von Meister who was known for his eccentric ideas and love for creation. CVC essentially focused on devising online video games for the *Atari* Gaming Console owned by Time Warner; In 1985 Control Video Corp was reborn as Quantum Computer Services Inc., with a paradigm shift in strategy from online video gaming to computer software, mainly involving *Commodore 64* Computers and its online service called the Q-link. As a company, Quantum wasn't doing so well, despite its innovative strategies it lacked the consumer-base to make it a powerful enterprise. The situation continued to worsen and things came to a standstill when a business deal with Apple, for the design of its on-line service Apple-Link, went down. That's when Quantum came up with its own on-line service called America Online (AOL).

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In 1991, with Steve Case as its CEO, Quantum rechristened itself as America Online.

AOL was slowly gaining momentum, when AOL went public in 1992; the company raised an approximate of $66 million. AOL continued to grow expeditiously, strengthening its hold in the market by securing around ten million subscribers by 1997. Thereon, AOL kept evolving by virtue of serial acquisitions, including CompuServe in 1998, once it's most aggressive competitor in the Internet Services Business, followed by Netscape later in 1999. AOL's market capitalization shot up to an astonishing $63 billion in 1998 but it failed to establish a credible record of profitability. AOL had redefined itself and introduced the world to the wonders of the Internet realm. AOL predates Internet as we know it[2]. Despite the criticism showered on AOL, it is indisputable that it was the visionary to the modern age media we use nowadays.

Having established a position for itself in the Internet Business AOL was now looking to diversify its sources of revenue. AOL already controlled the content that was being transmitted through the Internet, now it desired to collaborate with a media house aiming to establish control over the distribution channels, thereby diversifying its sources of revenue.

Time Warner is the outcome of a merger between Time Inc. and Warner Communications making it the quintessential media conglomerate with access to Time's Publishing House and Warner's Movie Business. The paramount merger which marks the success of Time Warner took place in the year 1990, the most contributing factor to its success being the Home Box Office (HBO), which was acquired by Time Inc. in the 1970's. The collaboration with Turner Broadcasting System in 1996, unfolded new aspects for Times Warner by providing it access to its cable networks like CNN and TBS, thereby furthering its viewership by considerable numbers.

Despite owning hard assets like Time Magazine, HBO, CNN, TBS Time Warner lacked strategy in the digital world. With the growing popularity of the dot-coms Time Warner was desperate to venture in the same direction, owing to the fear of being eclipsed by the Internet. Hence, *Pathfinder* a website to navigate all of Time Warner's brands so to say, was launched in 1994. When Pathfinder failed to provide the required results it was naturally abandoned. This Experiment with Pathfinder cost the Company around $100 million. With the failure of

[2]Richard Parsons in an interview with Charlie Rose dated 09/20/2005 talks about the farsighted vision of AOL.

pathfinder Jerry Levin, the CEO was distraught and restless to enter the Internet Business. By December 1999, Times Warner's Stock was spurning the $60's, while Internet firms were soaring high.

AOL with its desire to convert its stock price into tangible assets was looking to collaborate with an established media house. On the other hand Time Warner with hard assets in its ambit was desperate to enter the Internet Business. Time Warner at the time of the merger was the America's leading cable television operator reaching more than 12 million homes and had a reliable track of profitability, something that AOL lacked. The thought of increasing efficiency by transmitting data through cable lines, which was a faster and a more felicitous alternative to telephone lines, seemed very appealing to the ambitious Steve Case. Time Warner on the other hand was a little ambivalent given the reputation of AOL as hard-edged dealmakers and also because of its unreliability in terms of profits.

GENESIS OF THE MERGER

The talks of the merger commenced with the onset of a business conference in Shanghai in 1999. Later in October that year, Case proposed to collaborate the two companies with Levin as the CEO of the new holding. In the year 2000, on January 10th an official announcement confirming the merger was made. The Federal Trade Commission FTC gave its clearance on 14thof December, after evaluating all possible scenarios where the merger could adversely affect competition in the market and came to a conclusion that the clearance would be given only if the two companies signed an agreement providing open access to the cable lines to a rival competitor. Therefore a deal was struck with *Earth Link* opening its cable lines prior to the clearance.

Strategically speaking, it was an arranged marriage whereby each fulfilled the demands set out by the other. Time Warner with its well established distribution channels and America Online with its fast paced Internet services, collaborated to change the face of new age media, making it more accessible and expeditious.

What seemed like a merger of equals was actually an acquisition of Time Warner by AOL for $164 billion. Yes, the new Internet startup was buying the Quintessential Media Powerhouse. The merged company was to be called AOL Time Warner. The merger was structured as a stock-for-stock exchange. For every share of Time Warner, shareholders would get 1 share of AOL Time Warner and for every share of AOL; they would receive 1.5 shares of the new Company. Owing to the high market capitalization of AOL, their shareholders would own 55% of the new company while Time Warner's shareholding was restricted to 45%.

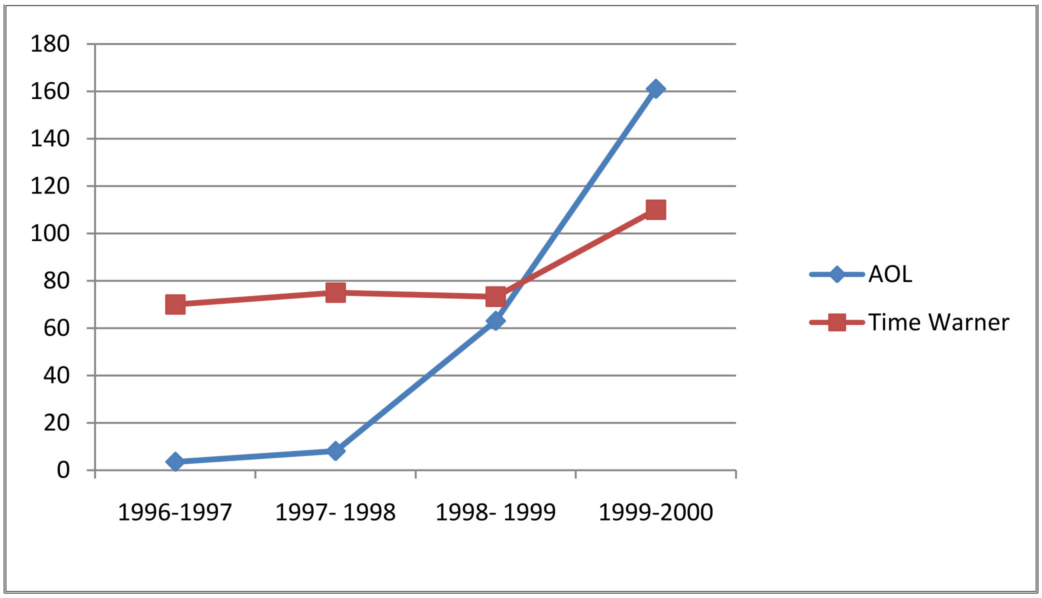

Figure 1 : Chart showing change in market capitalization of the two companies (in billions)

2. Method

The content of the paper has been prepared after extensive research of the financial positions of the companies before, during and after the said merger. It is a study focusing on the reasons, which lead to the extensive investigation by the Securities Exchange Commission and the Justice Department, resulting in the epic disaster. Research methodology to compile this paper involved analyzing interviews of the personnel at the respective companies focusing on issues like cultural differences and the trail of bad managerial decisions, which lead to the failed merger.

The two companies failed to develop the desired synergy due to a wide range of differences, which lead to the ultimate pitfall. The downfall could have been avoided while the merger talks were in the nascent stages, by involving key personnel better appraised with the statistics and working of their respective company, in the decision making process. The pace at which AOL was acquiring market capitalization was enthralling. Time Warner with comparatively low market capitalization was obviously the more powerful company with higher profits and a larger workforce. The two companies, although merged to form a single entity but failed drastically to establish a sense of responsibility amongst the employees, owing to the negligible integration efforts on the part of the managerial teams.

EXPECTATIONS FROM THE MERGER

The announcement of the merger left the world anticipating for a new evolution of media. The deal validated the role of Internet, as a leader in the new world economy redefining the way media was perceived. Michael Eisner, the former CEO of Disney went so far as saying that Steve Case was his idol as he had achieved something, which was unattainable.[3]

Growth potential was expected to enhance through new service opportunities, which would open up as a result of the merger, offering consumers expanded broadband and online services. Also, there was a lot of scope to initiate cost saving opportunities through combined marketing efforts. But the main USP remained the brand name of the company itself, making a dynamic international presence in redefining modern age media. Business strategy involved cross promotion of Time Warner and AOL media products, selling the existing product through Internet to make it more accessible, thereby increasing its subscriber base.

By virtue of the merger AOL hoped to convert substantial portion of its stock value into real assets. Time Warner expected the merger with AOL to work as a safety net in its plunge into the dot-com world.

IMPLICATIONS OF THE MERGER

The outcome of the Merger is not unknown to us. It is safe to say that the brightest minds in the technological and media industry ventured into a deal eventuating into the colossal downfall of

[3] Michael Eisner in an interview with Charlie Rose dated 03/19/2001 post the announcement of AOL's merger with Times Warner claimed that he regarded Steve Case as his hero, his Idol as he had achieved the unachievable.

the respective companies. The decision to merge was solely taken by CEO's of the respective companies Mr. Steven Case of AOL and Mr. Gerald Levin of Times Warner, without comparing the strengths and weaknesses of the respective companies, not to forget the complete ignorance of the drastic variation in the work environment, ethics and methods.

Around January 2000, AOL's Stock was highly inflated, at its highest peak and the officials at AOL knew it was bound to drop sooner or later[4]. Having said that, AOL despite this knowledge had extremely high expectations for growth, showcasing the over-confidence the company had acquired as a consequence of the sudden dominance in the market.

On perusing through the history, stressing on the fact that the management at AOL expected the stock price to fall, it can be conveniently inferred that the merger was entered into, solely for the purpose of keeping the company afloat. Time Warner, an established steady powerhouse would not only provide security in terms of physical assets but also help in expanding its global presence, covering in its ambit a wider customer base. Contrary to these unrealistic expectations AOL actually lost around $4 million subscribers to other broadband services from 2001 to 2003.

During the year following announcement and prior to the time when the companies actually combined, AOL was allegedly involved in fraudulent accounting activities to keep its stock price up. AOL was a part of series of so called barter advertisement deals whereby it recorded the warranties given by the partner companies as investments. These fraudulent activities came to light after the merger, by virtue of an article published by Washington Post, which in turn invited investigations from the Securities Exchange Commission and the Justice Department. To attract investors and Time Warner, AOL executives allegedly worked up illegal marketing arrangements with companies such as WorldCom, Hewlett-Packard, Sun Microsystems and Veritas Software. AOL by virtue of these "round-trip" transactions was paying these companies to buy online advertising space and falsely recording the proceeds as revenue.

Due to the growing skepticism investors were reluctant to invest in AOL Time Warner thereby causing the stock price to plummet majorly, dropping from $71 in 2001 to $9 in 2003. A 75% deflation in stock was reported after the merger due to the alarming deflation in AOL's stock

[4]Barry Schuler, who was then president of AOL's interactive-services group talks about the expected deflation in AOL's stock price, says, "We did talk about a coming 'nuclear winter.'"

price inducing the company to write off around $100 Billion as annual loss in the year 2002. This extraordinary loss of valuation combined with the series of calamities which took place almost consecutively, marked the downfall of the new holding.

The Internet bubble burst and the Company failed to capitalize on its first mover advantage as a result the proposed synergies failed to materialize. Due to the above reasons its vision of creating the world's first global, fully integrated media and Communications Company for the Internet century could not be achieved.

YEAR	MARKET CAPITALIZATION
JANUARY 2000	$250 BILLION
JANUARY 2001	$190 BILLION
JANUARY2002	$150 BILLION

Figure 2: showing AOL Time Warner's Change in market capitalization post the merger.

3. Results

WHAT WENT WRONG

There are numerous reasons, which contributed to the downfall of AOL Time Warner. On one side the failure can be explained by an array of logical reasons while on the other it can merely be blamed on poor timing and bad luck. Also, the deal was entered into with such haste that thorough due diligence between the companies could not be conducted. The CEO's of the respective companies entered into the deal singlehandedly without involving its Key Managerial Professionals in the negotiations.

Deflation in stock price - By 2002 AOL Time Warner's stock price had fallen by considerable numbers owing to the highly deflated AOL stock prices. The investigations by Securities Exchange Commission (SEC) and the Justice Department added to the loss of goodwill. Fraudulent accounting entries and manipulative advertising drastically affected AOL Time Warner's credibility in the market, which acted as a contributing factor in the deflation of the stock price.

Non-involvement of employees in decision making process - One of the biggest reasons for the colossal downfall of the company was that it failed to involve the management in the decision making process. The key managerial professionals possess an in-depth knowledge of the day to day working and the financial position of the company, therefore are in a better position to scrutinize the prospective opportunities for growth.

Lack of Motivation - Since the employees were not involved in the decision-making process the feeling of belongingness no more prevailed. The staff lost its drive to work towards achieving the common goal. This preceded by the fact that Jerry Levin CEO of Time Warner and the new company retired in May 2002. A few months down the line the boardroom politics drove out Bob Pittman in August 2002, followed by Steve Case in 2003. The fact that the very people responsible for the merger were no more a part of the struggle to pull the company out of the state of subversion acted as the most de-motivating factor for the employees.

Cultural Differences - The two organizations differed drastically. AOL employees were young, ruthless hardcore dealmakers, aiming for instant success while employees at Time Warner were more focused towards the long-term gain. The cultural differences made it difficult to merge the old media with the new media. AOL was more inclined towards achieving market capitalization and pleasing shareholders; the old established media house Time Warner on the other hand gravitated towards generating revenue and organic growth. Since, there existed no harmony between the workforces; Time Warner was obviously reluctant to allow its premium content to be screened via Internet channels.

Structural Incongruities - The diverse structures of the two companies posed operational challenges, which could be overcome only by co-operation and collaboration. AOL was a centralized impenetrable bubble while Time Warner on the other hand followed a decentralized approach ensuring accountability from its employees. Lack of integration efforts on behalf of the top management officials acted as a barrier to achieve harmony in implementing the proposed strategy for expansion. Top senior executives from the respective companies remained at war with each other; promoting an attitude of “us v. them”.

Biased Executive Placing - Although Time Warner was far more profitable in terms of revenue and had nearly 70,000 employees, AOL held a dominant position in terms of market capitalization. Employees at Time Warner felt a degree of frustration at the failure of the market to value the company in a way that approximated their superior worth.[5] Executive placing of personnel involved a flood of boardroom politics, which caused resentment amongst the employees of Time Warner, especially because over two-thirds of the major executive posts rested with the AOL Officials.[6]

Non – existence of joint vision - Due to the cultural differences the professionals were unable to agree on a set plan of action. Differences between various divisions started cropping up due to lack of co-operation and co-ordination. As a result, combined effort and joint vision to ensure that the company treads towards success remained absent.

RECOMMENDATIONS

Integration Plan **-** In order to wring value from the merger the prime aim of AOL Time Warner should have been to contrive a plan focusing on integration. The only way to integrate two enterprises with diverse cultures is by devising an unbiased integration plan that helps in achieving an amiable work environment. Culture is the invisible glue that binds people within an organization. AOL Time Warner as an enterprise should have worked towards achieving co-

[5]Alec Klein, (2003) *Stealing Time: Steve Case, Jerry Levin, and the Collapse of AOL Time Warner*, where in Jerry Levin in a memo addressed to his staff stated that “we all feel a degree of frustration at the failure of the market to value our company in a way that approximates its superior worth”.

[6]Alec Klein, an investigative reporter at *Washington Post* in an interview with C-span dated 04/24/07 talks about his interactions with the employees at Time Warner who claimed that AOL managed to pull of a major heist against Time Warner.

ordination, collaboration and co-operation between the departments. Integration plans help to replace employee skepticism with optimism and align their expectations to make way for an enterprise which functions as a unitary organization.

Amputation of AOL in the nascent stages - Post the merger announcement, the new organization almost immediately ventured on the path leading to downfall. Internal managerial politics combined with AOL's fraudulent marketing tactics caused immense loss of goodwill to the Company. The Company was losing its credibility amongst the investors, as a result the shareholder valuation gradually started eroding. The stock price plummeted from $71 in 2001 to $9 in 2003, followed by investigations by SEC and the Justice Department adding to the resentment. Taking an ouster from the merger in the nascent stage would have proved to be the best panacea saving years of frustration and the absurd amounts of money lost due to the trail of bad managerial decisions.

Joint Ventures - Studies reveal that corporate mergers have an even greater percentage of failure than the liaisons of Hollywood stars. Practically speaking, joint ventures provide a more suitable approach for companies to grow as the companies are allowed to preserve their culture. The companies can thereon secure their independence, focusing their energies towards achieving the goals set out by the strategical plan and decoupling from the arrangement once the same have been achieved. Since the energies are focused in the right direction the desired synergy and traction is achieved almost indubitably.

Clear Vision - Even before a cleverly set out vision, the companies forming part of the prospective merger must contrive a clear strategy to attain the vision. In the present case the CEO's of the respective companies lacked both, the vision and the strategy to achieve the vision. There was a lot of confusion amongst the two workforces due to lack of co-ordination and harmony between the employees. Time Warner was reluctant to share its premium content via internet channels, in such a case the combined vision of making AOL Time Warner the world's first global, fully integrated Media and Communications Company for the Internet century seemed utterly preposterous.

CONCLUSION

The fact that mergers so often fail is not, in itself a reason for companies to avoid them altogether. In the corporate world where the big is always deemed to be better, perhaps the implications of the ultimate pitfall of AOL Time Warner would stand as a lesson; cautioning other business leaders treading down the value destructive path trod by Steve Case and Jerry Levin years ago.

4. References

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