Case Report #3

Valuating the AOL Time Warner Merger

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Summary

The stock-stock exchange enabled shareholders of AOL to get valuable assets from TW with their overvalued stocks and exposes shareholders of TW to the risk of the stock price drop. The fixed-ratio stock payment with collars might be a better-compromised method. The merger was not a good idea because of the macroeconomic factor, overvaluation and unreasonable management structure. The value received by AOL's and TW's shareholders was different by different payment methods. The agency problem and unsuccessful due diligence damaged this so-called "deal of the century".

1. Payment Methods and Deal Structure

The issued and outstanding shares of AOL and TW were converted to shares of AOL-TW in a 1:1 and 1:1.5 ratio respectively in the case, which exposes TW (owning 45% of the newly merged company) to the risks of drastic changes in stock prices.

However, standing from AOL's angle, the overvaluation of AOL's stocks can be regarded as the appreciation of "currency" held by its shareholders, enabling AOL to exchange TW's stocks with a stronger "purchasing power". The stock-stock transaction with a fixed ratio and no collars might be suitable for AOL at that time to share the downside risks of share price with TW and to acquire TW's such physical assets as brand-name magazines, music labels and cable networks at a low price.

TW's shareholders were obsessed with the so-called new economy[1] and internet innovation, without realizing the compatibility and huge uncertainty of transforming the traditional business with IT technology. They were so optimistic about the jump of stock prices because of the expected synergies that they still carried on the stock swap contract without "collars" (acting as a protection shield) to fully enjoy the projected

[1] MCGRATH, RITA GUNTHER. "15 Years Later, Lessons from the Failed AOL-Time Warner Merger." Fortune, 10 Jan. 2015.

high returns due to the consolidation.

Regarding the huge internet bubble and increasing probability of the price fluctuation, from TW's perspective, receiving cash or fixed-value stock swap might be a better way to hedge the uncertainty of the deal. However, AOL's shareholders will be unlikely to agree on such methods of payment for losing the chance to take advantages of their overvalued AOL stocks. Therefore, a fixed-ratio stock payment with collars will serve as a compromised scheme for both AOL and TW. Other deal mechanisms like the break-up fee and walk-away right could also be used to protect shareholders' interests once they believe the deal will be unprofitable.

2. The Exaggerated Merger

Even though AOL and TW both declared this merger will create an innovative business model making contents to be widely and easily delivered to customers through internet distributions, the post-merger synergies were not obvious as expected. From my perspective, this merger was not a good idea and it would be difficult for the combined company to achieve its goals for 2001.

2.1. Macroeconomic Environment

The existence of the internet bubble brought enormous uncertainty to the macroeconomic environment. Moreover, the new business model had not seen precedents that were successful. Investors doubted the synergies by voting with their feet. The stock price of AOL and TW both experienced a drop from $72 to $47 and $90 to $71 respectively during the deal announced-closed period.

2.2. Overvaluation

The market was overly optimistic about AOL and finds it difficult to reasonably price TW which conducting businesses in six different industries for the reason that each industry has its own growth rate, profit drivers and analytic logic. The inaccurate valuation threatens two companies when facing systematic risks. Besides, the tremendous goodwill bubble created by the excessive premium in the merger process may significantly reduce AOL-TW's profits and bring loses to shareholders once there will be a large amount of goodwill impairment.

2.3. Management Structure

The management structure[2] was not very reasonable. After the merger, most of the management positions were occupied by AOL's stuff and many TW's employees were fired, but the AOL-TW's CEO was Gerald Levin from TW. For one thing, AOL may fail to understand how TW runs and its numerous business in a short time. For another, Gerald Levin may have conflicts with other management executives and his subordinates due to their different backgrounds on the internet and traditional industry, so the decision-making and decision-execution process might not be smooth.

My first advice is to properly balance the proportion of executives from two companies to ensure that two parties could understand each other's business in a short time. Second, merging two firms from new and traditional industries are not enough to form barriers against other imitators. More importantly, the merged entity should integrate their profit centres and cut the overlapping cost centre like compliance, administration and human resource divisions as soon as possible to achieve the synergies by using the first-mover advantage.

3. Value Received and Due Diligence

In the fixed-ratio stock exchange, AOL's shareholders did get TW's valuable assets with overvalued stocks. They tried to diversify the risk of stock price decline,

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2 Dignan, Larry. "AOL Time Warner Unveils Massive Org Chart." CNET, 03 Jan. 2002. Web.

which did work after the merger. Even if owners of AOL suffered from the price fall in the short run, they got returns from media, entertainment, news and information delivery, and broadband infrastructure in the long run. Nevertheless, TW's shareholders suffered huge losses for lacking protective covenants.

The valued received may be different if AOL considered the cash payment. Under this circumstance, the acquirer is usually more certain and confident about the deal and have no intention to share the rise in stock price with the seller. In other words, shareholders of TW may get short-term profits by receiving cash from AOL, but they cannot have the capital gains once the promised synergies produced after the combination.

One of the reasons for this unsuccessful deal is the failure to conduct thorough due diligence[3] influenced by agency problems. Although shareholders of AOL realized their stocks were not that valuable and the market was irrational, they were reluctant to prick the stock price bubbles at the cost of their salaries. Although the financial advisors may realize the price is not fair, they wouldn't stop the deal at the cost of their huge amount of advisory fees.

Due diligence includes business, financial and legal investigations. First, it helps bidders and targets evaluate the possibility of business integration and estimate the synergies. Second, it's useful for finding a company's financial vulnerabilities, such as huge debts, imperfection accounting system and excessively radical depreciation. Third, it promotes the merger as smooth as possible in compliance with regulations. Due diligence benefits shareholders of both sides, especially the sellers, in a longer time horizon despite lower deal premium for the buyers.

[3] Unsuccessful due diligence example: The different width of rail tracks was not noticed (Case#2_CSX - Conrail).