The AOL Time Warner Merger[1]

On January 10, 2000, AOL and Time Warner announced their intention to merge to create the world's first Internet-age media and communications company. The proposed deal represented the biggest corporate merger of all time, with the merged entity valued at approximately $350 billion. The deal was also unique in that it combined one of the leading names from the booming "new economy" with one of the largest "old economy" media companies. While the deal was billed by AOL and Time Warner as a "merger of equals," AOL was generally recognized as the "acquirer" and Time Warner as the "target." The objective of this case is to understand the structure and financial implications of the merger. Further details concerning the proposed merger are provided in the online exhibits included with the case, which can be found at www.lundholmandsloan.com .

Finally, you can load the case data for AOL into *eVal* (the AOL data are already adjusted for the November 1999 stock split) and examine the valuation. (*Note:* case data can be imported by going to the Case Data sheet in *eVal* and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.) Please use the number of shares on pages 13 and 16 of the proxy statement (2,255 for AOL and 1,301.5 for TW).

QUESTIONS

1. Describe the major synergies and other sources of value creation associated with the merger.
2. The terms of the merger represent a significant premium to Time Warner shareholders. Quantify this premium.
3. Do you think that the additional value created by the deal is sufficient to justify the premium being offered to Time Warner shareholders?
4. Estimate AOL's premerger intrinsic value by importing AOL's historical financial statements into *eVal*, setting the forecast horizon to 10 years and the valuation date to January 10, 2000, and leaving all other assumptions at their default values. What is the intrinsic stock price for AOL? Do you think that this is a reasonable premerger valuation?
5. Assume that the default assumptions in question 4 are appropriate for a pre-merger AOL and that the addition of Time Warner to AOL increases the value of AOL by exactly the $142 billion purchase price given in the online Exhibit 2
(i.e., the acquisition is a zero NPV investment). Compute AOL's post-merger intrinsic stock price. You do not need to use *eVal* for this question.
6. Reconcile the pre- and post-merger intrinsic valuations in questions 4 and 5. Why did a zero NPV investment change the value of AOL's intrinsic stock price?
7. Estimate whether the merger will be accretive (i.e., increase AOL's near-term EPS relative to what EPS would have been if the merger hadn't taken place) or dilutive (i.e., decrease AOL's near-term EPS relative to what EPS would have been if the merger hadn't taken place).

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[1] This case was prepared by Richard Sloan as the basis for class discussion.