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The Outlook for AOL

The Accelerating Bleed and What Must Be Done To Stop It

In this analysis, we provide a snapshot of where AOL is today, as well as thoughts about what it must do to survive:

- Despite recent improvements, AOL is in a tough spot, and potential partnerships with Microsoft, Google, *et al*, don't provide an obvious fix.
- Subscriber losses have accelerated of late, especially in the most valuable pricing plans. ARPU and gross profit, which held their ground for years, are also now dropping.
- Subscriber defections hurt not only subscription revenues, but also ad revenue. AOL subscribers generate most of the company's pageviews, so the company cannot simply be cut in half.
- Organic display advertising growth is only 6%-8%, slower than it seems and by far the slowest growth rate of the "big four."
- To save itself, AOL needs to:

    1) Stem subscriber losses by signing broadband distribution deals with most major broadband providers, no matter how poor the terms. This might significantly reduce AOL's current cash flow.

    2) Attract additional web-only users.

- A merger with MSN would probably help, as would a distribution deal with Comcast. Mere partnerships with Google or News Corp. probably wouldn't.
- If the company remains in the Time Warner fold, it must be freed of divisional conflicts (e.g., cable vs. DSL). Time Warner must also be willing to sacrifice much of AOL's current cash flow to bolster the company's long-term future.

OVERVIEW

Despite concerns to the contrary, Time Warner does not appear to be selling AOL at the bottom. Even with recent improvements, AOL is in a tough spot: The decline of the subscription business is accelerating, and the advertising business is losing share. Worse, the advertising business still depends on the subscription business—the majority of AOL web-property pageviews are generated by AOL subscribers—so the company cannot simply be cleaved in two and the subscription business left to die.

Financially, the situation is prettier: AOL throws off more than $1 billion a year and should remain profitable for the rest of the decade. The value of this cash flow to the parent company, however, makes it harder to make strategic decisions that involve near-term pain. If AOL is to survive, the company needs to do something radical. Merging with MSN, Yahoo!, or Google—or signing multiple broadband distribution deals on painfully poor terms—would count as radical. Merely partnering, unfortunately, probably wouldn't.

At a minimum, the company must step up efforts to "save" subscribers who quit the $23.90 plan. Currently, about a quarter switch to the $14.95 plan, which is vastly preferable to their leaving AOL completely. This, however, leaves three-quarters who ditch the service for broadband access. Each AOL subscriber household generates an estimated 6-times as many pageviews as each unaffiliated web user, so the defections hobble both advertising and subscription revenue.

AOL's biggest mistake has been the failure to sign broadband distribution deals. The company must address this immediately, with the same bet-the-company boldness with which it recently threw out its walled garden. Although the terms of such deals will not be as favorable as they might once have been, AOL still brings two major assets to the table: a massive group of potential broadband customers, and superb technology and content. These assets should allow the company to play broadband providers off one another and strike reasonable deals, especially if it offers to serve as full-fledged technology and content partner (a la Yahoo!/SBC). Over time, these deals could be renewed on more favorable terms.

Remaining within Time Warner will probably continue to hinder AOL's ability to do what it must (promote DSL providers that compete with Time Warner Cable, for example). For this reason alone, the company should probably be spun off or sold. If it isn't, management must allow AOL to cut deals with partners that compete with other Time Warner divisions. Management must also forego the joys of today's free cash flow to make the distribution investments necessary for AOL's long-term survival.

THE SUBSCRIPTION BUSINESS

AOL still generates most of its revenue and profit from monthly subscriptions. Even with recent declines, this is a $7 billion business with 26 million subscribers in the U.S. and Europe. AOL is still by far the dominant dial-up access provider in the U.S., and even its value pricing plans--$14.95 and below—are the most successful in the industry. But there ends the good news.

REVENUE ($ millions)	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Subscriptions	**$ 1,919**	**$ 1,902**	**$ 1,840**	**$ 1,816**	**$ 1,774**	**$ 1,734**	**$ 1,665**
Y/Y Change	*1%*	*0%*	*-3%*	*-5%*	*-8%*	*-9%*	*-10%*
Seq. Change	*1%*	*-1%*	*-3%*	*-1%*	*-2%*	*-2%*	*-4%*
Advertising	**$ 214**	**$ 221**	**$ 257**	**$ 313**	**$ 311**	**$ 320**	**$ 328**
Y/Y Change	*-4%*	*23%*	*44%*	*53%*	*45%*	*45%*	*28%*
Seq. Change	*5%*	*3%*	*16%*	*22%*	*-1%*	*3%*	*3%*
Other	**$ 58**	**$ 54**	**$ 44**	**$ 54**	**$ 48**	**$ 43**	**$ 48**
Total	**$ 2,191**	**$ 2,177**	**$ 2,142**	**$ 2,184**	**$ 2,133**	**$ 2,097**	**$ 2,041**
Y/Y Change	*0%*	*2%*	*1%*	*1%*	*-3%*	*-4%*	*-5%*
Seq. Change	*2%*	*-1%*	*-2%*	*2%*	*-2%*	*-2%*	*-3%*

Source: Company filings.

Subscriber losses accelerating…

AOL's subscriber losses have accelerated in recent quarters, hitting 12% year-over-year in Q2 and Q3. The bulk of the decline, an average of 652,000 subscribers a quarter over the last year, has come from the domestic business. AOL Europe has lost an average of 43,000 subscribers a quarter over the same period.

SUBSCRIBERS (000s)	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Total AOL Brand	**31,632**	**30,801**	**29,714**	**28,546**	**28,015**	**26,999**	**26,223**
Net Change	(369)	(831)	(1,087)	(1,168)	(531)	(1,016)	(776)
Y/Y Change	*-8%*	*-7%*	*-8%*	*-11%*	*-11%*	*-12%*	*-12%*
AOL Brand U.S.	**24,022**	**23,354**	**22,708**	**22,244**	**21,695**	**20,778**	**20,100**
Net Change	(237)	(668)	(646)	(464)	(549)	(917)	(678)
Y/Y Change	*-8%*	*-8%*	*-8%*	*-8%*	*-10%*	*-11%*	*-11%*
AOL Brand Europe	**6,389**	**6,301**	**6,293**	**6,302**	**6,320**	**6,221**	**6,123**
Net Change	38	(88)	(8)	9	18	(99)	(98)
Y/Y Change	*2%*	*1%*	*1%*	*-1%*	*-1%*	*-1%*	*-3%*

Source: Company filings.

The percentage of subscribers in a free-trial or retention period (i.e., non-paying subscribers) has declined in the last two quarters, which has made subscriber attrition look worse than it is. Even when one accounts for these non-paying subscribers, however, the loss rate is still accelerating.

PAYING SUBSCRIBERS (000s)	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
AOL Brand U.S.	**24,022**	**23,354**	**22,708**	**22,244**	**21,695**	**20,778**	**20,100**
Net Change	(237)	(668)	(646)	(464)	(549)	(917)	(678)
Y/Y Change	*-8%*	*-8%*	*-8%*	*-8%*	*-10%*	*-11%*	*-11%*
% Free-trial or Retention	*17%*	*15%*	*14%*	*13%*	*14%*	*11%*	*11%*
Regular Paying Subs	19,938	19,851	19,529	19,352	18,658	18,492	17,889
Net Change	(197)	(87)	(322)	(177)	(695)	(165)	(603)
Y/Y Change				*-4%*	*-6%*	*-7%*	*-8%*

Source: Company filings.

Loss of the most-profitable subscribers is really accelerating…

Unfortunately, as might be expected, the biggest attrition is from subscribers paying $15-or-more a month, most of whom are (or, rather, were) on the $23.90/month plan. The rate of decline in this group has accelerated in the past four quarters, from 12% in Q4 last year to 19% in the most recent quarter.

U.S. SUBSCRIBERS BY PLAN	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
$15/Month and Over	**19,600**	**18,800**	**18,100**	**17,500**	**16,800**	**15,600**	**14,700**
Change	(300)	(800)	(700)	(600)	(700)	(1,200)	(900)
Y/Y Change				*-12%*	*-14%*	*-17%*	*-19%*
ARPU	$ 20.66	$ 21.10	$ 21.02	NA	$ 20.52	$ 20.84	$ 21.15
Premium Svcs Revs. (mm)	$ 22	$ 26	$ 26	NA	$ 20	$ 22	$ 23

Source: Company filings.

Only one in four canceling subscribers signs up for a cheaper plan…

The company has improved its ability to “save” departing subscribers by converting them to cheaper plans, but the save-rate is nothing to whoop and holler about.

In Q3, for example, the company added 200,000 $15-and-below subscribers while losing 900,000 $15-and-above subscribers (mostly the $23.90/month plan), or about one in four. This “save-rate” has remained between 20% and 25% for the last three quarters. The profit-per-subscriber is lower on cheaper plans (probably $9 a month lower), however, and the company still loses three subscribers for every one it retains.

U.S. SUBSCRIBERS BY PLAN	**Mar-04**	**Jun-04**	**Sep-04**	**Dec-04**	**Mar-05**	**Jun-05**	**Sep-05**
$15/Month and Over	**19,600**	**18,800**	**18,100**	**17,500**	**16,800**	**15,600**	**14,700**
Change	(300)	(800)	(700)	(600)	(700)	(1,200)	(900)
Y/Y Change				*-12%*	*-14%*	*-17%*	*-19%*
ARPU	$ 20.66	$ 21.10	$ 21.02	NA	$ 20.52	$ 20.84	$ 21.15
Under $15/month	**4,400**	**4,600**	**4,600**	**4,700**	**4,900**	**5,200**	**5,400**
Change	-	200	-	100	200	300	200
Y/Y Change				*7%*	*11%*	*13%*	*17%*
% "Saved"		*25%*	*0%*	*17%*	*29%*	*25%*	*22%*
ARPU	$ 12.77	$ 13.07	$ 13.27	NA	$ 13.11	$ 13.31	$ 13.21

Source: Company filings.

This said, retaining subscribers on *any* plan saves profit that would otherwise disappear. And, critically, it also saves eyeballs that can be monetized with advertising.

Until recently, subscriber ARPU has held its ground, but not anymore…

Exacerbating the impact of the subscriber losses is a recent downturn in average monthly revenue per subscriber. Until this year, domestic ARPU had increased year-over-year, but in the last three quarters, as a result of migration from the $23.90 plan to $14.95 plan, it has begun to decline.

U.S. ARPU	**Mar-04**	**Jun-04**	**Sep-04**	**Dec-04**	**Mar-05**	**Jun-05**	**Sep-05**
Avg. Sub Rev per U.S. Sub	**$ 19.24**	**$ 19.58**	**$ 19.47**	**$ 19.45**	**$ 18.91**	**$ 19.05**	**$ 19.09**
Y/Y Change	*4%*	*5%*	*1%*	*0%*	*-2%*	*-3%*	*-2%*

Source: Company filings.

Network cost reductions have preserved gross profit, but not anymore…

Thanks to a rapid reduction in network costs, the gross profit of the subscription business also held its ground until recently—an amazing performance in light of the subscriber declines. Last quarter, however, the rate of network cost reduction slowed, and the preliminary subscription gross profit (revenue minus network costs) also began to decline.

NETWORK COST REDUCTION	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Network Costs	**$ 527**	**$ 500**	**$ 401**	**$ 349**	**$ 359**	**$ 338**	**$ 308**
Y/Y Change	*NA*	*NA*	*-31%*	*NA*	*-32%*	*-32%*	*-23%*
% of Cost of Revenue	*50%*	*47%*	*38%*	*34%*	*37%*	*35%*	*33%*
% of Subscription Revenue	*27%*	*26%*	*22%*	*19%*	*20%*	*19%*	*18%*

Source: Company filings.

PRELIM. GROSS PROFIT	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Subscription Revenue	**$ 1,919**	**$ 1,902**	**$ 1,840**	**$ 1,816**	**$ 1,774**	**$ 1,734**	**$ 1,665**
Network Costs	$ 527	$ 500	$ 401	$ 349	$ 359	$ 338	$ 308
Gross Profit (Less Network)	$ 1,392	$ 1,402	$ 1,439	$ 1,467	$ 1,415	$ 1,396	$ 1,357
Y/Y Change					*2%*	*0%*	*-6%*
% of Subscription Revs.	*73%*	*74%*	*78%*	*81%*	*80%*	*81%*	*82%*

Source: Company filings.

Because network cost reduction will not continue at the same rate going forward, the subscription profit will likely soon start dropping in line with or slightly faster than subscribers. In fact, in the latest 10Q, the company predicted that increasing network costs in Europe (as subscribers transition to broadband) will more than offset a small decline in domestic network costs, so this expense may actually increase next year.

Over the long term, network costs should decline roughly in line with the subscriber base. The relationship is stair-step rather dollar-for-dollar because some costs are fixed, but there is a direct correlation.

Unfortunately, the subscription business still contributes most of AOL's profit:

Our analysis suggests that the subscription business contributes about 70% of AOL's gross profit and between 50% to 70% of operating profit (see below). What's more, as discussed in the next section, the subscription business drives the advertising business, because most pageviews on the AOL portal are generated by AOL subscribers[1]. So it is a mistake to think that the company could just separate the two businesses and let the subscription business die.

[1] There are two ways to look at "traffic": unique users and pageviews. According to press reports based on third-party traffic measurements, more than half of the unique users of AOL's web properties (including web-based IM) are not AOL subscribers. This, however, suggests that the portal is more independent of AOL's subscription business than it really is. According to management, at least 75% of the pageviews on the AOL portal—including the vast majority of the highly profitable search pageviews—are generated by AOL subscribers. So if these subscribers suddenly disappeared, AOL's ability to generate advertising revenue would suffer immensely.

We derive our gross profit and operating profit estimates two ways:

First, we assume a cost-of-revenue percentage for *advertising and other* revenues and then subtract this from the company's total cost of revenues. *Advertising and other* revenues consist of high-margin display and search revenue, advertising.com, and transport revenues from Time Warner Cable. Based on comparable companies (Google and Yahoo!, ex-traffic acquisition costs), we assume that these revenues generate gross profit in the neighborhood of 80%. This suggests that advertising and other revenues generate approximately 30% of AOL's gross profit, with the balance of 70% generated by the subscription business. If we assume that SG&A expenses are shared pro-rata, we can further estimate that the subscription business generates approximately 70% of the company's operating profit. This, however, seems high.

EST. GROSS PROFIT	**Mar-04**	**Jun-04**	**Sep-04**	**Dec-04**	**Mar-05**	**Jun-05**	**Sep-05**
Subscription Revenue	**$ 1,919**	**$ 1,902**	**$ 1,840**	**$ 1,816**	**$ 1,774**	**$ 1,734**	**$ 1,665**
Network Costs	$ 527	$ 500	$ 401	$ 349	$ 359	$ 338	$ 308
Gross Profit (Less Network)	$ 1,392	$ 1,402	$ 1,439	$ 1,467	$ 1,415	$ 1,396	$ 1,357
Est. Other Sub COGS	$ 482	$ 501	$ 585	$ 599	$ 547	$ 550	$ 554
Est. Gross Profit (Subs)	$ 910	$ 901	$ 854	$ 868	$ 868	$ 846	$ 803
% of Sub Revenue	*47%*	*47%*	*46%*	*48%*	*49%*	*49%*	*48%*
% of Total Gross Profit	*81%*	*80%*	*78%*	*75%*	*75%*	*74%*	*73%*
Ads and Other Revenue	**$ 272**	**$ 275**	**$ 301**	**$ 367**	**$ 359**	**$ 363**	**$ 376**
Est.Cost of Revenue %	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*
Est. Cost of Revenue	$ 54	$ 55	$ 60	$ 73	$ 72	$ 73	$ 75
Est. Gross Profit (Ads)	$ 218	$ 220	$ 241	$ 294	$ 287	$ 290	$ 301
Est. % of Total Gross Prft	*19%*	*20%*	*22%*	*25%*	*25%*	*26%*	*27%*

Source: Company filings and Cherry Hill Research estimates.

In the second analysis, we make an assumption about the operating profitability of the advertising and other revenue lines. Again based on comparable companies, we assume that advertising and other generate about a 40% operating margin. In this scenario, advertising and other would have generated about 50% of the company's operating profit in the most recent quarter, leaving 50% for the subscription business.

EST. OPERATING PROFIT	**Mar-04**	**Jun-04**	**Sep-04**	**Dec-04**	**Mar-05**	**Jun-05**	**Sep-05**
Other Revenue	40%	40%	40%	40%	40%	40%	40%
Operating Profit (Other Revenue	$ 109	$ 110	$ 120	$ 147	$ 144	$ 145	$ 150
% of Total Operating Profit	*39%*	*40%*	*46%*	*122%*	*44%*	*39%*	*50%*

Source: Company filings and Cherry Hill Research estimates.

Thus, we conclude that AOL's subscription business *directly* generates 50%-70% of the company's operating profit. Indirectly, however, because it drives advertising revenue, it is responsible for a good deal more.

Outlook:

Some good news: the actual number of subscribers lost in 2005 is likely to be smaller than the number lost in 2004. It seems prudent to assume that the number will again increase next year, but AOL may already have passed the peak in terms of absolute annual subscriber losses.

On the negative side, the rate of subscriber loss on a percentage basis is likely to continue to increase. Subscribers to the $23.90 plan will probably continue to cancel at an accelerating rate, with some being retained on the $14.95 or other cheaper plans. We have assumed that the loss rate in the $23.90 plan will gradually accelerate to 30% in 2007, from 20% in the last quarter, and that the “save rate” percentage will remain at 25%. We have further assumed that subscriber attrition in Europe will accelerate to 5% annually for the forecast period.

In this scenario, the subscriber base would drop by about half by 2010 (to 13 million from today’s 26 million), and subscription revenue would drop by about 60%, as a result of a declining ARPU from conversions from high-priced to low-priced plans. A 60% drop in revenue would probably lead to a profit drop of approximately 60%-70%, not including the impact of lost subscribers on advertising revenue.

THE ADVERTISING BUSINESS

AOL's advertising run-rate is $1.4 billion, placing the company in fourth place in the web wars, just behind Microsoft. Ad revenue grew 28% in Q3, faster than Microsoft (20%), but slower than Google and Yahoo!. AOL's ad revenue also benefited from the advertising.com acquisition: On an organic basis, advertising revenue grew only 18%--the slowest rate of growth among the big four.

REVENUE ($ millions)	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Subscriptions	**$ 1,919**	**$ 1,902**	**$ 1,840**	**$ 1,816**	**$ 1,774**	**$ 1,734**	**$ 1,665**
Y/Y Change	*1%*	*0%*	*-3%*	*-5%*	*-8%*	*-9%*	*-10%*
Seq. Change	*1%*	*-1%*	*-3%*	*-1%*	*-2%*	*-2%*	*-4%*
Advertising	**$ 214**	**$ 221**	**$ 257**	**$ 313**	**$ 311**	**$ 320**	**$ 328**
Y/Y Change	*-4%*	*23%*	*44%*	*53%*	*45%*	*45%*	*28%*
Seq. Change	*5%*	*3%*	*16%*	*22%*	*-1%*	*3%*	*3%*
Other	**$ 58**	**$ 54**	**$ 44**	**$ 54**	**$ 48**	**$ 43**	**$ 48**
Total	**$ 2,191**	**$ 2,177**	**$ 2,142**	**$ 2,184**	**$ 2,133**	**$ 2,097**	**$ 2,041**
Y/Y Change	*0%*	*2%*	*1%*	*1%*	*-3%*	*-4%*	*-5%*
Seq. Change	*2%*	*-1%*	*-2%*	*2%*	*-2%*	*-2%*	*-3%*

Source: Company filings.

Advertising.com goosed this year's revenue growth, but no more…

In the last four quarters, Advertising.com has added $30-$60 million in acquired revenue per quarter to AOL's advertising revenues, which has boosted the growth rate. This will end this quarter. As the following chart illustrates, AOL's organic advertising growth—including search—has only averaged about 17%-18% over the last three quarters.

ADVERTISING REVENUE	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Advertising Revenue	**$ 214**	**$ 221**	**$ 257**	**$ 313**	**$ 311**	**$ 320**	**$ 328**
Y/Y Change	*-4%*	*23%*	*44%*	*53%*	*45%*	*45%*	*28%*
Advertising.com			**$ 54**	**$ 60**	**$ 60**	**$ 60**	**$ 66**
Y/Y Change							*22%*
Organic Ad Revs (Less Ad.com)		**$ 221**	**$ 222**	**$ 253**	**$ 251**	**$ 260**	**$ 262**
Y/Y Change		*23%*	*25%*	*24%*	*17%*	*18%*	*18%*

Source: Company filings and Cherry Hill Research estimates.

Search has also bolstered growth, and this, too, will fade…

Search is the fastest growing portion of AOL's advertising revenue—40%-42% over the last few quarters—and now accounts for one-third of the advertising revenue stream. Although search will likely continue to grow faster than the rest of advertising revenue, AOL's partnership with Google for AOL Europe will soon anniversary, which may slow growth. We believe this deal was consummated in October, 2004. Year-over-year comparisons in Q4, therefore, should benefit from the AOL Europe roll-out, but by Q1, the effect will likely be gone. In Q1, therefore, we expect AOL's search revenue growth to slow significantly.

PAID SEARCH REVENUE	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Paid Search Revenue (Est.)	**$ 67**	**$ 72**	**$ 73**	**$ 90**	**$ 94**	**$ 102**	**$ 104**
Y/Y Change	*68%*	*76%*	*70%*	*18%*	*40%*	*42%*	*42%*
% of Ad Revenue	*31%*	*33%*	*28%*	*29%*	*30%*	*32%*	*32%*

Source: Company filings and Cherry Hill Research estimates.

Ex search and Advertising.com, advertising growth is a paltry 6%-8%...

AOL's organic display advertising, which still represents about half of overall ad revenues, is only growing about 6% a year (8% per management), slower than billboard, cable, and other ancient forms of advertising. Given the subscriber attrition, this is actually a reasonable, if disheartening, performance. At least it's growing faster than radio.

ADVERTISING REVENUE	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05
Advertising Revenue	**$ 214**	**$ 221**	**$ 257**	**$ 313**	**$ 311**	**$ 320**	**$ 328**
Y/Y Change	*-4%*	*23%*	*44%*	*53%*	*45%*	*45%*	*28%*
LESS: Advertising.com			**$ 54**	**$ 60**	**$ 60**	**$ 60**	**$ 66**
Y/Y Change							*22%*
Organic Ad Revs		**$ 221**	**$ 222**	**$ 253**	**$ 251**	**$ 260**	**$ 262**
Y/Y Change		*23%*	*25%*	*24%*	*17%*	*18%*	*18%*
LESS: Paid Search (Est.)	**$ 67**	**$ 72**	**$ 73**	**$ 90**	**$ 94**	**$ 102**	**$ 104**
Y/Y Change	*68%*	*76%*	*70%*	*18%*	*40%*	*42%*	*42%*
% of Ad Revenue	*31%*	*33%*	*28%*	*29%*	*30%*	*32%*	*32%*
Organic Display Revs		**$ 149**	**$ 149**	**$ 163**	**$ 157**	**$ 158**	**$ 158**
Y/Y Change						*6%*	*6%*

Source: Company filings and Cherry Hill Research estimates.

Outlook:

The future of AOL's advertising business depends on traffic. And AOL's traffic, as previously noted, depends heavily on the success of the subscription business. If the company can generate enough interest in AOL.com and the other web properties to offset the loss of pageviews from departing AOL subscribers, the advertising business will grow. If not, it will follow the subscription business into the tank.

According to management, approximately half the total monthly unique users of AOL's properties are AOL subscribers and about half are web users (AIM, Netscape, Moviefone, Mapquest, etc.). This fact, however, understates the dependence on the subscription business. Each AOL subscriber, per management, encompasses approximately 2.5 unique users[2]. And each subscriber unique user generates approximately 2.5-times as many pageviews as the average non-subscriber unique user[3].

AOL subscribers, therefore, generate the vast majority of pageviews on AOL's web properties (we estimate around 75%). Moreover, because the loss of each subscriber equates to the loss of 2.5 unique users, the company must attract 6 new web users just to stay in place (2.5 users times 2.5 as many pageviews per user).

Anecdotal reports suggest that pageviews at AOL.com have stabilized recently, after a period of decline. This is good news, especially if the 6-to-1 ratio approximates reality. It is not great news, however, as the steady departure of subscribers means that the company must keep swimming against a strong tide.

[2] Usually, subscriptions represent households rather than individuals.
[3] Subscribers tend to be heavier users than web visitors.

PRIORITIES: WHAT AOL MUST DO

If it is to survive, AOL must do two things:

1) Staunch the flow of subscriber departures, and

2) Attract more web-only users to AOL.com and the other web properties.

1. How to staunch subscriber departures? Sign broadband deals. NOW.

If there is one overarching mistake AOL (and Time Warner) management has made over the past five years, it is the failure to sign broadband distribution deals. Whether this is a result of stubbornness, infighting, myopia, short-term thinking, or denial is unclear, but the company must address this immediately. Subscribers who quit AOL are no longer defecting to cheaper dial-up services—NetZero and Earthlink are dead in the water (and AOL's cheap dial-up plan is growing). Subscribers who quit are headed for broadband.

AOL has only one major broadband distribution deal, with Time Warner Cable, which started earlier this year. It also has smaller deals with Covad, *et al*. The company must immediately sign deals with one or both of the major broadband providers—cable or DSL—in every geography. At this late date, the terms of such deals are likely to be painful, but they are also almost irrelevant. AOL simply must retain the eyeballs and pageviews of its subscribers, no matter the cost. Any terms in such deals are better than no terms, and if AOL survives, the deals can be renegotiated later.

AOL, moreover, has two major assets to offer broadband providers: 1) a subscriber base that represents a massive group of potential customers, and 2) strong technology and content. This should allow it to play telecom and cable companies off each other in each market, thus earning better terms. (The best situation, obviously, would be to have marketing deals with every broadband provider, and help the subscriber migrate to the provider of his or her choosing).

Broadband partnerships are in the broadband provider's interest, too…

Every subscriber that calls AOL to cancel could be steered toward a particular broadband provider, thus providing a significant benefit to the provider. And every provider that partners with AOL—and uses its portal, email, and other properties—could save the cost required to develop inferior, duplicative services on its own. AOL could co-brand its content, or design and provide private-label brands for its partners. Its sales force could sell advertising, its technology team run the network, its parental controls and virus protection soothe non-techie users; its call centers handle much of the customer service, etc. There is no reason for Verizon, Comcast, *et al*, to do this themselves. As with the Yahoo!-SBC deal, such partnerships would allow each partner to focus on its core competency.

Even if AOL generates only a dollar or two a month from subscribers that switch to broadband, these are dollars the company would otherwise have lost. And if the subscribers can be persuaded to continue to spend time on the AOL portal, this will create more dollars in advertising and commerce revenue opportunity.

Importantly, the company need not *encourage* this migration; it should obviously keep its 15 million $23.90 subscribers paying $23.90 as long as it can. But if and when these subscribers call up to quit, the company must have an attractive broadband option to offer them—even if the offer is only the ability to keep their AOL address in exchange for a couple of dollars a month in kickbacks from a broadband provider.

2. Attract more web-only users.

More acquisitions would help (Weblogs was good; MySpace would have been great). More concerts. More usage of proprietary Time Warner content. More aggressive roll-out of VOIP. More integration with Google keywords linking to AOL content (perhaps as part of the partnership). And, in our opinion, a merger with MSN, which has an enormous number of global IM, email, and web users.

CONCLUSION

The decision to open AOL's walled garden to the web was smart, and Jon Miller and his team should be applauded for it. Despite this and other recent improvements, however, AOL is still between a rock and a hard place. Although it is presumably tempting for Time Warner to just milk the company's impressive cash flow, the current strategy amounts to letting AOL bleed to death.

In our opinion, it is unlikely that a mere partnership with Google or Microsoft will save the company. A broadband distribution deal with Comcast would certainly be helpful. If the company is to survive over the long-term, however, the current cash flow will likely have to be reinvested in broadband deals and acquisitions—something Time Warner management seems unlikely to do.

AOL

($ millions)

	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05	CY 2003	CY 2004	CY 2005E
Revenue	**$ 2,191**	**$ 2,177**	**$ 2,141**	**$ 2,183**	**$ 2,133**	**$ 2,097**	**$ 2,041**	**$ 8,598**	**$ 8,692**	**$ 8,361**
Y/Y Change	*0%*	*2%*	*1%*	*1%*	*-3%*	*-4%*	*-5%*		*1%*	*-4%*
Operating Income	**$ 277**	**$ 276**	**$ 261**	**$ 120**	**$ 324**	**$ 368**	**$ 302**	**$ 662**	**$ 934**	**$ 1,254**
Y/Y Change	*44%*	*31%*	*74%*	*9%*	*17%*	*33%*	*16%*		*41%*	*34%*
% of Revenue	*13%*	*13%*	*12%*	*5%*	*15%*	*18%*	*15%*		*11%*	*15%*
EBITDA	**$ 489**	**$ 487**	**$ 463**	**$ 333**	**$ 518**	**$ 558**	**$ 481**	**$ 1,505**	**$ 1,772**	**$ 2,007**
Y/Y Change	*22%*	*13%*	*25%*	*11%*	*6%*	*15%*	*4%*		*18%*	*13%*
% of Revenue	*22%*	*22%*	*22%*	*15%*	*24%*	*27%*	*24%*		*20%*	*24%*
REVENUE										
Subscriptions	**$ 1,919**	**$ 1,902**	**$ 1,840**	**$ 1,816**	**$ 1,774**	**$ 1,734**	**$ 1,665**	**$ 7,593**	**$ 7,477**	**$ 6,804**
Y/Y Change	*1%*	*0%*	*-3%*	*-5%*	*-8%*	*-9%*	*-10%*		*-2%*	*-9%*
Seq. Change	*1%*	*-1%*	*-3%*	*-1%*	*-2%*	*-2%*	*-4%*			
Advertising	**$ 214**	**$ 221**	**$ 257**	**$ 313**	**$ 311**	**$ 320**	**$ 328**	**$ 785**	**$ 1,005**	**$ 1,357**
Y/Y Change	*-4%*	*23%*	*44%*	*53%*	*45%*	*45%*	*28%*		*28%*	*35%*
Seq. Change	*5%*	*3%*	*16%*	*22%*	*-1%*	*3%*	*3%*			
Other	**$ 58**	**$ 54**	**$ 44**	**$ 54**	**$ 48**	**$ 43**	**$ 48**	**$ 220**	**$ 210**	**$ 200**
Total	**$ 2,191**	**$ 2,177**	**$ 2,142**	**$ 2,184**	**$ 2,133**	**$ 2,097**	**$ 2,041**	**$ 8,596**	**$ 8,694**	**$ 8,361**
Y/Y Change	*0%*	*2%*	*1%*	*1%*	*-3%*	*-4%*	*-5%*		*1%*	*-4%*
Seq. Change	*2%*	*-1%*	*-2%*	*2%*	*-2%*	*-2%*	*-3%*			

Source: Company filings.

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