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The Web War Is Over—And Microsoft Lost

Why MSN Should Merge With AOL (and Why Google and Yahoo! Have Little to Fear)

Pundits are buzzing about a coming war between Google and Microsoft. The software giant, the story goes, has the web leader in its sights, and it won't stop firing until it blows Google away. This, after all, is what Microsoft does: let others innovate and then steal the booty. The carcasses of Apple, Lotus, WordPerfect, Netscape, Real Networks, and others tell the tale.

The "coming war" story is a popular story because it promises an epic battle: two undefeated heavyweights bashing each others' brains out, with egos, fortunes, and world domination on the line. Alas, it's also fiction. For the most part, Microsoft and Google compete in different markets—enterprise software and consumer Internet—and will (or, at least, should) continue to do so, no matter how much noise everyone makes.

"But Microsoft's growth engine is the web," the battle-promoters say, "and the weapon that will crush Google is MSN." Baloney. Microsoft and MSN are not new kids on the web block. Microsoft and MSN have been trying (and failing) to catch the web leaders for a decade, and, even now, despite MSN's newfound profitability and Microsoft's awesome financial and technological might, they are falling farther behind. In Microsoft's defense, this failure is not surprising. It is rare for the dominant player in one technology revolution to also dominate the subsequent one, and, all things considered, Microsoft has done a commendable job.

Commendable does not mean dominant, though, and in this case it may not even mean viable, at least over the long term. Despite Microsoft's resources and legendary intensity, the long-term web war is Google's and Yahoo!'s to lose (which isn't to say that if they blow it, Microsoft won't rush in and gobble up the wreckage). An analysis of MSN's current competitive position shows that, like AOL, it is weak and getting weaker, while Google and Yahoo! continue to strengthen. Although advertisers and consumers would benefit from the existence of a third major search/portal competitor—giving MSN a *raison d'etre*—Microsoft's recent innovations and announcements on the search front won't alter the competitive landscape any more than similar moves have over the last ten years.

If Microsoft wants to give MSN the best chance of success, it should continue to talk with Time Warner about an AOL-MSN merger. For Time Warner's sake, too, these talks should not concern a mere "partnership" or "investment." Rather, they should be about merging the divisions and spinning the combined entity off as a separate company. A combined AOL-MSN would still lag Google and Yahoo! in most important areas (growth, advertising revenue, and cash flow), but it would be far stronger than either AOL or MSN alone. If the entity were successful, moreover, its former parents would capture the upside with equity participation, thus allowing senior managers to focus on the core businesses and thus providing shareholders with an asset that might be worth more than a long-term loser's cash flow.

If AOL and MSN do not merge—or if Microsoft and Time Warner don't pursue alternative solutions like marrying one or the other with, say, Yahoo!, instead—AOL and MSN will likely just continue to compete with each other for third place in the web wars. Third place is not the end of the world: most markets support three major generalists, and this one should, too. But as former third-place wannabes like Lycos and Excite can attest, fighting for third place is a scary way to live. AOL and MSN need look no farther than the current state of these two 1990's relics to see what will happen if they lose.

The (Sad) State of MSN

Microsoft boosters make a familiar argument about why the company will eventually take over the web: Microsoft has come from behind in other businesses—operating systems, office productivity suites, and browsers—so it will come from behind in this one, too. This analysis overlooks two factors:

First, every major business that Microsoft has come from behind to dominate is a *software* business,[1] and online media is not a software business. Despite Google's insistence to the contrary, it's not even a technology business, although technology is certainly a key to success. (The browser business, meanwhile, is not *any* kind of business: thanks to Microsoft's obliteration of Netscape, browsers are free.) Second, Microsoft has been trying to come from behind in the online business for a decade, and is about as far behind now as it was when it started (when AOL had about 1 million subscribers, Yahoo! was called "Akebono" and run from a dorm room, and Google didn't exist).

Because Microsoft has a monopoly in operating systems and browsers; because it has $35 billion in cash; and because the ferocious Mr. Ballmer has reportedly vowed to "kill Google," Microsoft has to be taken seriously. But taking it seriously and treating it as an even bet to win are quite different—as a glance at MSN's relative performance makes clear.

After ten years of fighting online, Microsoft now owns the browser market and most of the media-player market. It has significant chunks of the global email and messaging markets, and operates one of the most widely visited portals in the world (420 million monthly visitors). After years of losses, it is also finally profitable, generating some $500 million in operating income this year. Of course, since Microsoft's stock has been treading water for the better part of a decade (it traded at today's level in 1998), it needs these profits, so the online division's years of damn-the-torpedoes investment are probably done.

Importantly, Microsoft's dominance of browsers and its massive user-base have *not* translated into dominance of online content, advertising, transaction, or subscription revenues. A web browser is equivalent to a television set or a radio receiver, not a network or circulation list,

[1] A possible exception is the next generation of gaming consoles. Gaming is an unusual market, in which new products appear with regularity every five years. Microsoft trailed badly in the first cycle. Thanks in part to its tenacity and in part to Sony's incompetence, however, it seems poised to lead the next wave.

and even preset defaults in Internet Explorer to www.msn.com have not allowed Microsoft to displace the web's equivalent of the latter.

As a result, Microsoft's online revenue streams are nothing to write home about (please see below): The company is the not-so-proud owner of a dying dial-up subscription business, whose revenue is 1/10th as big as the industry leader's (AOL) and is declining at the shocking rate of nearly 50% per year. It also runs a small "premium services" subscription business—about $200 million per year, or about a quarter of Yahoo!'s—which, thankfully, is still growing. And, most importantly, it operates the web's third largest advertising business (after Google and Yahoo!), which should produce a respectable $1.6 billion in revenue this year.

Alas, the relatively bright light in the revenue story—the advertising revenue stream—will grow at a paltry rate of about 15%-20% in 2005. This compares to 50% for Yahoo! and 90% for Google. Importantly, it also compares to an estimated industry growth rate of about 25%. Even in its most promising business, in other words, MSN has only 10% market share and is losing ground.

Lastly, there is profit. As mentioned, after a decade of losses, MSN is finally generating operating income. However, the division's expected 2005 operating profit of about $500 million places it squarely in fourth place among the Big Four, with only half the profits of the next closest competitor, Yahoo!. To put this in perspective, Google's 2005 operating profits ($2.4 billion) will likely exceed MSN's 2005 *revenue*. MSN's revenue growth, meanwhile, is dead in the water, while Google's operating income is still growing about 100% per year.

In short, MSN is a real business, but relative to the industry leaders, it's also a disappointing one.   If the online industry evolves the way others have—which, so far, it has—the outlook for MSN is likely to become even bleaker.

MSN: Profitable But A Distant Third
($000s)

	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	CY 2003	CY 2004	CY 2005
Revenue	$ 591,000	$ 588,000	$ 540,000	$ 588,000	$ 564,000	$ 582,000	$ 2,104,000	$ 2,307,000	$ 2,365,200
Y/Y Change	*16%*	*5%*	*10%*	*8%*	*-5%*	*-1%*		*10%*	*3%*
Operating Income	$ 101,000	$ 29,000	$ 77,000	$ 130,000	$ 100,000	$ 104,000	$ (260,000)	$ 337,000	$ 473,040
Y/Y Change	*NA*	*NA*	*35%*	*NA*	*-1%*	*259%*		*NA*	*40%*
% of Revenue	*17%*	*5%*	*14%*	*22%*	*18%*	*18%*		*15%*	*20%*
Ad Revenue	$ 330,000	$ 330,000	$ 300,000	$ 339,000	$ 344,000	$ 403,000	$ 1,009,000	$ 1,299,000	$ 1,558,800
Y/Y Change	*43%*	*35%*	*23%*	*17%*	*4%*	*22%*		*29%*	*20%*
Subscription Revenue	$ 261,000	$ 258,000	$ 240,000	$ 249,000	$ 220,000	$ 179,000	$ 1,095,000	$ 1,008,000	$ 806,400
	-6%	*-18%*	*-3%*	*-3%*	*-16%*	*-31%*		*-8%*	*-20%*
Access Subscribers	4,600	4,300	3,800	3,500	3,000	2,700			
Y/Y Change		*-34%*	*-32%*	*-33%*	*-35%*	*-37%*			
Premium Subscribers	3,600	4,500	5,300	5,800	6,100	6,400		-	
Y/Y Change			*121%*	*100%*	*69%*	*42%*			
Total Subs	8,200	8,800	9,100	9,300	9,100	9,100			
Y/Y Change		*10%*	*14%*	*15%*	*11%*	*3%*			
Internet Access Revs.	$ 240,000	$ 221,000	$ 202,000	$ 203,000	$ 172,000	$ 112,000	$ 1,048,000	$ 866,000	
Y/Y Change	*-13%*	*-28%*	*-12%*	*-14%*	*-28%*	*-49%*		*-17%*	
Premium Subs/Transacs.	$ 21,000	$ 37,000	$ 38,000	$ 46,000	$ 48,000	$ 48,000	$ 47,000	$ 142,000	
		311%	124%	130%	129%	30%		*202%*	
MSN Monthly Users		350,000	350,000	380,000	400,000	420,000			
Y/Y Change						*20%*			
Active Hotmail Accounts		187,000	187,000	191,000	200,000	205,000			
Y/Y Change						*10%*			
Active Messenger Accounts		135,000	146,000	156,000	165,000	175,000			
Y/Y Change						*30%*			
Monthly Ad+Premium Rev Per User		$ 0.35	$ 0.32	$ 0.34	$ 0.33	$ 0.36			
Y/Y Change						*2%*			

Source: Company filings, Cherry Hill Research estimates.

The Rule of Three

In a book called *The Rule of Three*, professors Jagdish Sheth and Rajendra Sisodia show that most industries eventually evolve toward a similar competitive landscape. Specifically, every mature industry tends to support three major volume-driven "generalists" (not four or five—*three*) and a handful of niche specialists. Companies that fit neither description tend to fail.

According to Sheth and Sisodia, the three generalists together usually control about 70% to 90% of a market, with 40%, 20%, and 10% being a common share distribution among the three. Successful specialists, meanwhile, concentrate on defensible niches and usually have no more than 5% market share each. In between the three big generalists and successful specialists is a "ditch" encompassing companies with neither enough share to make the top three nor enough focus to defend a specialized niche. To survive, companies need to crawl out of the ditch into one group or the other.

In the global web industry, which is not yet mature but is headed that way, there are currently four major generalists: Google, Yahoo!, Microsoft, and AOL. Assuming the industry conforms to the Rule of Three, the market will not continue to support all four forever. Given the current market shares, moreover, it seems safe to assume that the companies at most risk of succumbing to the perils of the "ditch" are Microsoft and AOL.

Because of the huge-but-shrinking dial-up businesses at MSN and AOL, revenue is not a particularly meaningful measure of market share. More relevant, in our opinion, are operating profit and advertising revenue. No matter what measure one looks at, however, Microsoft's current share is only about 10%—and falling. Microsoft, in other words, is in the ditch.

Current Competitive Position

REVENUE	CY 2005E	Share
AOL	$ 8,409,860	38%
Google	$ 6,000,000	27%
Yahoo!	$ 5,300,000	24%
MSN	$ 2,365,200	11%
Total	$ 22,075,060	100%

OPERATING PROFIT	CY 2005E	Share
Google	$ 2,400,000	46%
AOL	$ 1,261,479	24%
Yahoo!	$ 1,060,000	20%
MSN	$ 473,040	9%
Total	$ 5,194,519	100%

ADVERTISING REVENUE	CY 2005E	Share
Google	$ 6,000,000	43%
Yahoo!	$ 5,300,000	38%
MSN	$ 1,558,800	11%
AOL	$ 1,256,250	9%
Total	$ 14,115,050	100%

Source: Company filings, Cherry Hill Research estimates.

The Future If Microsoft Goes It Alone

Yes, the MSN optimists say, but what about Microsoft's new search strategy? What about its recent technology advance that enables advertisers to target ads based on demographic criteria? What about new search algorithms? What about its browser monopoly, cash pile, and Windows tie-ins? What about MSN's hundreds of millions of global users? Won't these give it a leg up, allow it to do something Google and Yahoo! can't? Won't these allow it to knock off AOL and climb out of the ditch? Won't it eventually just win the whole game?

Not likely (except for eventually overtaking AOL, which seems a reasonable bet). With regard to the new targeting technology, don't forget that Google's advertisers don't pay for ads that don't work and can already measure ROI, so this innovation does not seem a quantum leap in benefits to advertisers. Yahoo! and AOL have long had the same data about users, and they haven't leveraged it into a major competitive advantage. As for improved algorithms, web search may not have high user switching costs, but habits do matter, and Google's engineers aren't stupid. If Microsoft manages to create a better user experience, Google will probably duplicate the innovation before a meaningful percentage of users defect.

As for the browser and Windows monopolies, the cash war-chest, and the hundreds of millions of users, these assets are arguably what have allowed Microsoft to amass the limited revenue share it has today—and they won't necessarily allow to capture much more tomorrow. The browser and Windows monopolies, for example, aren't going to become *more dominant*: it's hard to improve on 90%-plus market share. In fact, as more software becomes available for free, they will likely become less dominant.

Similarly, for a variety of possible reasons, Microsoft's hundreds of millions of users do not allow it to generate anywhere near as much revenue per user as, for example, Yahoo!. In the June quarter of this year, Yahoo! generated $1.11 of advertising, premium subscription and listing revenue per month for each of its 379 million unique users ($0.78 excluding Traffic Acquisition Costs), up from $0.97 last year. Microsoft, meanwhile, generated only $0.36.

Microsoft optimists will point to the revenue-per-user figures and suggest that the gap is a *positive* leading indicator for MSN rather than a negative one: Yahoo! is already wringing every available cent from users; Microsoft is still leaving one-half to two thirds of the money on the table. With better monetization, the optimists will say, MSN should be able to double or triple its advertising and premium services revenue on the same number of users.

This is a possible interpretation, but it seems the wrong one. Again, Microsoft has been at the monetization game for a long time now (as long as Yahoo! and longer than Google). It has even been at the search monetization game for a long time (from the beginning). In the last year, moreover, MSN's ad and premium services revenue per unique user has grown all of 2% ($0.01), while Yahoo!'s has increased 14%. This suggests that it is Microsoft, not Yahoo!, that has already maxed out the value of its user base.

Furthermore, according to Microsoft, the recent growth in MSN's advertising revenue has not come from better monetization of the juiciest online fruit: valuable search and sponsorship inventory. Rather, it has come primarily from "display advertising driven by MSN Hotmail and MSN Messenger and a true-up for performance-based advertising revenue." In other words, MSN owes even its modest recent ad revenue growth to the tapping of low-value banner slots and an accounting catch-up. This does not support the theory that the company is in the early stages of monetizing a vast store of untapped potential.

The more likely explanations for the disparity in revenue per user are that 1) a significant percentage of Microsoft's unique users are only users because their browsers default to MSN, (which they visit temporarily before heading to Google and Yahoo!), and 2) most MSN users are outside the U.S., where advertising spending per person is lower than it is domestically.

The latter explanation would bode well for the future: as global online advertising becomes more weighted toward international, Microsoft's share might grow. The former, however, would suggest that Microsoft's share will continue to dwindle, as global users discover that a reset of the browser default is only a click or two away.

One Possible Salvation: Merge With AOL

So where does MSN go from here? To win by pursuing its current course, in our opinion, the company needs help from others. Specifically, it needs both Yahoo! and Google to implode. This is not inconceivable. If the search market stumbles, even temporarily, the stocks, profit, and morale of Yahoo! and Google will plummet, and, if nothing else, this will make it easier for Microsoft to buy them. Similarly, if Google decides that its future growth depends on it displacing Microsoft in the enterprise software market, it will probably follow in the glorious footsteps of Netscape. We believe that the search market will hit a speed-bump eventually—probably in the next quarter or two—but a wholesale collapse seems unlikely. And, in any case, Microsoft's staking MSN's future on the hope that the two industry leaders will blow up seems, well, feeble.

So what else could Microsoft do? It could pursue possible strategic combinations, probably involving a spin-off. The most obvious of these would be the one rumored a few weeks ago: a merger with AOL.

Yes, it seems bizarre: Two enemy superpowers of the 1990s teaming up to save themselves. Yes, it would be hard for the egos to swallow, especially the egos at Microsoft (the egos at the formerly dominant AOL having long since escaped to greener pastures). Yes, there would be control issues, management issues, valuation issues, partnership issues. Yes, execution would be challenging (to say the least). Yes, a merger would not guarantee success: even a combined MSN-AOL would face an uphill climb.

This said, a combined, stand-alone MSN-AOL would have a far easier time competing with Yahoo! and Google than either division alone—especially if Microsoft and Time Warner made long-term commitments to share technology, distribution, and content with the new company. Together, the combined entity would generate about $11 billion in revenue and $1.7 billion in operating income (assuming no synergy—of which there would be plenty), placing it second behind Google on the profit scale. Similarly, it would generate $2.8 billion of online advertising revenue, still behind Google and Yahoo!, but with a meatier 20% market share. Revenue would not be growing—indeed, overall revenue would likely shrink for years as the dial-up business died—but the outlook for future cash flow growth would again be much improved over that of either division alone (please see *pro forma* income statement on p. 11).

Post AOL-MSN Merger

REVENUE		CY 2005E	Share
AOLMSN	$	10,775,060	49%
Google	$	6,000,000	27%
Yahoo!	$	5,300,000	24%
Total	$	22,075,060	100%

OPERATING PROFIT		CY 2005E	Share
Google	$	2,400,000	46%
AOLMSN	$	1,734,519	33%
Yahoo!	$	1,060,000	20%
Total	$	5,194,519	100%

ADVERTISING REVENUE		CY 2005E	Share
Google	$	6,000,000	43%
Yahoo!	$	5,300,000	38%
AOLMSN	$	2,815,050	20%
Total	$	14,115,050	100%

Source: Company filings, Cherry Hill Research estimates.

Most important, having already climbed out of the "ditch," a combined MSN-AOL could focus its attention purely on clawing global market share away from Google and Yahoo!. In this endeavor, it would be better off in many ways, including:

- **Focus.** AOL-MSN would be an online media company, not the online division of a global media conglomerate or the online division of a global software company. Advertisers, users, customers, managers, and employees would begin to view it this way, as well as know what its priorities were and where it was headed.

- **Talent.** The best talent gravitates to leading companies, not leading divisions (Who wants to work for an entity that has to fight for internal resources when other divisions are closer to the company's core competency?) A stand-alone AOL-MSN, would be able to attract—and compensate—managers who would never work for a massive bureaucracy that conducted most of its operations in a different industry.

- **Lack of duplication / synergy.** The divisions' two sales forces, engineering teams, and administration teams could be combined into one, as could the data centers, call centers, online content deals, portal infrastructure, and networks. MSN's small dial-up subscriber base could be loaded onto AOL's network, relieving Microsoft of the cost and burden of managing its own. The combined company would need only one VOIP system, instead of the two currently under development. It could make all of its messaging systems interoperable—MSN, AIM, and ICQ—while continuing to shut out those offered by Google and Yahoo. It could develop its own search technology (as Microsoft is anyway) and dump Google and Yahoo's, thus saving costs, hurting its competitors, and offering advertisers a truly viable and unique third option in search. It could steer subscribers who dump expensive AOL and MSN pricing plans to cheaper AOL plans, instead of losing them completely.

- **Favored rights to Microsoft and Time Warner technology, distribution, and content.** An AOL-MSN combo could secure a right of first refusal on content and technology partnerships made with Microsoft or Time Warner. This would resemble the favored position that each division now occupies on either side of the technology-media aisle, except with access to *both* sides—a clear improvement.

- **Freedom to compete with the core business.** Microsoft and Time Warner have to tread a fine line between encouraging the growth of their online divisions while also trying not to cannibalize their core businesses. In many areas--online telephony vs. cable telephony, cable modems vs. DSL , digital music and movie downloads vs. CD and DVD sales, online print content vs. offline magazines, software services vs. package software sales—the best strategy for online companies is to remain agnostic. For the soon-to-be-cannibalized traditional businesses, meanwhile, it is better to own a piece of the entity that is cannibalizing you than to watch some baby-faced entrepreneur abscond with your profit. Strategically, therefore, a separation would benefit both the online company and its former parents.

Conclusion

There will be no great war between Microsoft and Google/Yahoo, because despite Microsoft's vast resources, Google/Yahoo! have already left MSN far behind. There will be skirmishes, of course, but these will be irrelevant. Microsoft is as far behind in the web business as it was when it launched its online effort ten years ago, and short of disastrous mistakes by Google and Yahoo!, nothing Microsoft does on its own is likely to change that. Microsoft's best chance to make MSN the industry leader is to spin it off, most likely in a merger with AOL. This won't guarantee success—the combined entity would still be in third place—but it would create a company far stronger than either AOL or MSN on its own.

AOL: Praying for the Hail-Mary Portal Play
($ millions)

	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	CY 2003	CY 2004	CY 2005
Revenue	**$ 2,191**	**$ 2,177**	**$ 2,141**	**$ 2,183**	**$ 2,133**	**$ 2,097**	**$ 8,598**	**$ 8,692**	**$ 8,410**
Y/Y Change	*0%*	*2%*	*1%*	*1%*	*-3%*	*-4%*		*1%*	*-3%*
Operating Income	**$ 277**	**$ 276**	**$ 261**	**$ 120**	**$ 324**	**$ 368**	**$ 662**	**$ 934**	**$ 1,261**
Y/Y Change	*44%*	*31%*	*74%*	*9%*	*17%*	*33%*		*41%*	*35%*
% of Revenue	*13%*	*13%*	*12%*	*5%*	*15%*	*18%*		*11%*	*15%*
EBITDA	**$ 489**	**$ 487**	**$ 463**	**$ 333**	**$ 518**	**$ 558**	**$ 1,505**	**$ 1,772**	
Y/Y Change	*22%*	*13%*	*25%*	*11%*	*6%*	*15%*		*18%*	
% of Revenue	*22%*	*22%*	*22%*	*15%*	*24%*	*27%*			
REVENUE									
Subscriptions	**$ 1,919**	**$ 1,902**	**$ 1,840**	**$ 1,816**	**$ 1,774**	**$ 1,734**	**$ 7,593**	**$ 7,477**	**$ 6,954**
Y/Y Change	*1%*	*0%*	*-3%*	*-5%*	*-8%*	*-9%*		*-2%*	*-7%*
Seq. Change	*1%*	*-1%*	*-3%*	*-1%*	*-2%*	*-2%*			
Advertising	**$ 214**	**$ 221**	**$ 257**	**$ 313**	**$ 311**	**$ 320**	**$ 785**	**$ 1,005**	**$ 1,256**
Y/Y Change	*-4%*	*23%*	*44%*	*53%*	*45%*	*45%*		*28%*	*25%*
Seq. Change	*5%*	*3%*	*16%*	*22%*	*-1%*	*3%*			
Other	**$ 58**	**$ 54**	**$ 44**	**$ 54**	**$ 48**	**$ 43**	**$ 220**	**$ 210**	**$ 200**
S Total	**$ 2,191**	**$ 2,177**	**$ 2,142**	**$ 2,184**	**$ 2,133**	**$ 2,097**	**$ 8,596**	**$ 8,694**	**$ 8,410**
Y/Y Change	*0%*	*2%*	*1%*	*1%*	*-3%*	*-4%*		*1%*	*-3%*
Seq. Change	*2%*	*-1%*	*-2%*	*2%*	*-2%*	*-2%*			
DETAIL									
Paid Search Revenue (Est.)	$ 67	$ 72	$ 73	$ 90	$ 94	$ 102	**$ 200**	**$ 302**	
Y/Y Change	*68%*	*76%*	*70%*	*18%*	*40%*	*42%*			
% of Ad Revenue	31%	33%	28%	29%	30%	32%			
Organic Ad Revs (Less Advertising.com)			$ 212	$ 253	$ 251	$ 260			
Y/Y Change			*19%*	*24%*	*17%*	*18%*			
SUBSCRIBERS									
Total AOL Brand	31,632	30,801	29,714	28,546	28,015	26,999			
Net Change	(369)	(831)	(1,087)	(1,168)	(531)	(1,016)			
Y/Y Change	*-8%*	*-7%*	*-8%*	*-11%*	*-11%*	*-12%*			
AOL Brand U.S.	24,022	23,354	22,708	22,244	21,695	20,778			
Net Change	(237)	(668)	(646)	(464)	(549)	(917)			
Y/Y Change	*-8%*	*-8%*	*-8%*	*-8%*	*-10%*	*-11%*			
% Free-trial or Retention	*17%*	*15%*		*13%*	*14%*	*11%*			
$15/Month and Over	19,600	18,800	18,100	17,500	16,800	15,600			
ARPU	$ 20.66	$ 21.10			$ 20.52	$ 20.84			
Premium Services Revenue (	$ 22	$ 26			$ 20	$ 22			
Under $15/month	4,400	4,600	4,600	4,700	4,900	5,200			
ARPU	$ 12.77	$ 13.07			$ 13.11	$ 13.31			
Premium Services Revenue (	$ 5	$ 6			$ 6	$ 8			
AOL Brand Europe	6,389	6,301	6,293	6,302	6,320	6,221			
Net Change	38	(88)	(8)	9	18	(99)			
Y/Y Change	*2%*	*1%*	*1%*	*-1%*	*-1%*	*-1%*			
ARPU	$ 21.72	$ 20.84	$ 21.19		$ 23.11	$ 22.31			
Avg. Rev per U.S. Sub	$ 21.82	$ 22.29	$ 22.75	NA	NA	NA			
Avg. Sub Rev per U.S. Sub	$ 19.24	$ 19.58	$ 19.47	$ 19.45	$ 18.91	$ 19.05			
Y/Y Change	*4%*	*5%*	*1%*	*0%*	*-2%*	*-3%*			

Source: Company filings, Cherry Hill Research estimates.

AOL-MSN: A Stronger Number Three

AOLMSN (000s)	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	CY 2003	CY 2004	CY 2005E
Revenue	**$ 2,782,000**	**$ 2,765,000**	**$ 2,681,000**	**$ 2,771,000**	**$ 2,697,000**	**$ 2,679,000**	**$ 10,702,000**	**$ 10,999,000**	**$ 10,775,060**
Y/Y Change	*3%*	*3%*	*3%*	*3%*	*-3%*	*-3%*		*3%*	*-2%*
Operating Income	**$ 378,000**	**$ 305,000**	**$ 338,000**	**$ 250,000**	**$ 424,000**	**$ 472,000**	**$ 402,000**	**$ 1,271,000**	**$ 1,734,519**
Y/Y Change	*613%*	*140%*	*63%*	*1567%*	*12%*	*55%*		*216%*	*36%*
% of Revenue	*14%*	*11%*	*13%*	*9%*	*16%*	*18%*		*12%*	*16%*
REVENUE									
Subscriptions	**$ 2,180,000**	**$ 2,160,000**	**$ 2,080,000**	**$ 2,065,000**	**$ 1,994,000**	**$ 1,913,000**	**$ 8,688,000**	**$ 8,485,000**	**$ 7,760,010**
Y/Y Change	*0%*	*-2%*	*-3%*	*-4%*	*-9%*	*-11%*		*-2%*	*-9%*
Seq. Change	*1%*	*-1%*	*-4%*	*-1%*	*-3%*	*-4%*			
Advertising	**$ 544,000**	**$ 551,000**	**$ 557,000**	**$ 652,000**	**$ 655,000**	**$ 723,000**	**$ 1,794,000**	**$ 2,304,000**	**$ 2,815,050**
Y/Y Change	*20%*	*30%*	*32%*	*32%*	*20%*	*31%*		*28%*	*22%*
Seq. Change	*10%*	*1%*	*1%*	*17%*	*0%*	*10%*			
Other	**$ 58,000**	**$ 54,000**	**$ 44,000**	**$ 54,000**	**$ 48,000**	**$ 43,000**	**$ 220,000**	**$ 210,000**	**$ 200,000**
Total	**$ 2,782,000**	**$ 2,765,000**	**$ 2,681,000**	**$ 2,771,000**	**$ 2,697,000**	**$ 2,679,000**	**$ 10,702,000**	**$ 10,999,000**	**$ 10,775,060**
Y/Y Change	*3%*	*3%*	*3%*	*3%*	*-3%*	*-3%*			
Seq. Change	*3%*	*-1%*	*-3%*	*3%*	*-3%*	*-1%*			
GOOGLE									
Gross Revenue	**651,623**	**700,212**	**805,887**	**1,031,501**	**1,256,516**	**1,384,495**	**1,465,934**	**3,189,223**	**6,000,000**
Adjusted Operating Profit	231,796	245,719	280,093	362,330	491,678	523,036	571,825	1,119,938	2,400,000
% of Revenue	36%	35%	35%	35%	39%	38%	39%	35%	40%
Y/Y Growth (Revs)								*118%*	*88%*
YAHOO!									
Gross Revenue	**747,909**	**832,299**	**906,715**	**1,077,717**	**1,173,742**	**1,252,997**	**1,625,097**	**3,564,640**	**5,300,000**
Adjusted Operating Profit	122,280	149,494	172,105	234,825	247,363	261,357	295,666	678,704	1,060,000
% of Revenue	16%	18%	19%	22%	21%	21%	18%	19%	20%
Y/Y Growth (Revs)								*119%*	*49%*
Unique Users	**274**	**300**	**325**	**345**	**372**	**379**			
Y/Y Change	*18%*	*27%*	*33%*	*31%*	*36%*	*26%*			
Active Registered Users	**141**	**146**	**157**	**165**	**176**	**181**			
Y/Y Change	*26%*	*26%*	*28%*	*24%*	*25%*	*24%*			
Revenue Per Unique	**$ 0.93**	**$ 0.97**	**$ 0.97**	**$ 1.07**	**$ 1.09**	**$ 1.11**			
Y/Y Change	*121%*	*111%*	*98%*	*23%*	*17%*	*14%*			
Fee Paying Customers	**5,800**	**6,400**	**7,600**	**8,400**	**8,900**	**10,100**			
Y/Y Change	*100%*	*83%*	*81%*	*71%*	*53%*	*58%*			

Source: Company filings, Cherry Hill Research estimates.

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