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Hello and welcome to the Dividend Cafe. I am your host, David Bahnsen, where today we're going to do a little history lesson that provides some fun information for the future. All investing is essentially a byproduct of learning from the past to apply in the present, to have a better future. I would argue most study of history in any discipline for any purpose and aim is basically the same learning from the past.

I've always loved that quote from John Kennedy about a knowledge of the past, preparing us for the crisis of the present and the challenge of the future. There's tremendous opportunity for investors in the future, but investors who attempt to pursue that future without learning from the past make a grave mistake. And there is no more stark example of this, no clear, shall we say, lesson in history than in the failed merger of AOL and Time Warner. That took place 25 years ago. The reason I'm devoting this week's Dividend Cafe to this particular event is a byproduct of the moment in history hitting a 25 year anniversary of the most spectacular business, failure in history.

The most dollars ever set on fire in history, and that is all the more true in inflation adjusted dollars, but it's actually true in then nominal dollars as well. And there are so many incredible clear. Bright lines of lessons and principles at play here that I couldn't resist devoting this Dividend Cafe to the failure of the AOL Time Warner merger that took place in the year 2000.

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I happened to have read not one, and not two, but three books on the subject here, just since summer began and I had some inspiration. I've been rather intimately familiar with this story for a long time. I was a 1990s investor in various internet bubble investments. The lessons learned out of that period and into the first decade of this tumultuous new century are a substantial reason why I became a dividend growth investor. I wrote about that in one of the chapters of my past book on dividend growth investing. There is a historical marker not only with the just general tech bubble and dot-com implosion from the late nineties going into the year 2000, but that January of 2000 announcement of not Time Warner buying AOL, but AOL buying Time Warner and what would end up resulting in over $200 billion of money being set on fire of value being destroyed represents a seminal moment in my, life and career to the extent that it coincides with various markers in my own journey.

In history in the portion of history that I'm blessed to have come up in and so I can't think of the last 25 years without thinking of the AOL Time Warner merger. Some of the things that preceded it in the eighties and nineties, some of the historical context, some of the things that took place in the years that immediately followed, and then where we are now playing out.

They're just monumental and I think fascinating. I enjoyed reading these books, but I also became very inspired to share what I think are some of the key takeaways around it. The look, the history of AOL is the easier part. First of all, the fascinating part of AOL's history where grit, determination, raw talent, overcoming adversity, reinvention. Those are always to me as a business owner, as someone just utterly obsessed with entrepreneurialism and the triumph of the human spirit. The best parts of the AOL story are the 1980s that it wasn't even called AOL, it was a company called Control Video then Quantum Computer Services. There is a genesis to the story that I won't get into the weeds on today, but it's fascinating.

But basically through these kind of very interesting developments throughout the eighties. It resulted in an early 1990s company in Virginia called America Online, and it went public with a market cap of about $60 million in 1992. And by December, 1999 at its all time high, just days before they announced the merger the planned stock acquisition of Time Warner, had a market cap of $222 billion from 56 million at IPO to 222 billion. So AOL's story was rather clear and there's not a ton of hair on it. In the 1990s, they were just a leading brand and contributor to the internet moment and the delivery of online services to people's bedrooms or offices or living rooms, what have you.

The Time Warner story, is much more historical and there is a lot more mixing and matching of parts involved. Time Magazine was started by Henry Luce in 1922. Henry Luce was an absolutely iconic figure in American history and not only started Time Magazine, but then Life Magazine, fortune magazine, and in 1954 Sports Illustrated Magazine.

So basically homegrown organic, really society transforming media properties when time and life and fortune and Sports Illustrated all coming out of one man's vision and contribution. Wildly popular I'm not being melodramatic to say transformative in American society. Profitable in a way that media had never seen before in the 1970s Time Life Inc would start. HBO was a complicated endeavor in the 1970s as cable and satellite and other technologies were working their way forward, but it obviously became a major home run in the 1980s once there was a sort of paid premium cable model that had gone mainstream. And HBO was the leader in that. In 1989, that entity of time Life HBO was acquired or merged with Warner Communications Warner, of course, being the name brand conglomerate with Warner Music Group, Warner Brothers movie Studio, DC Comics, mad Magazine.

At one point, they also owned MTV Nickelodeon, the movie channel. They had spun those off to Viacom. You basically got time life, HBO, with all the Warner Brothers assets. And then in 1996, Warner acquired Turner. So Turner Broadcasting, which owned CNN, TNN, TBS, Ted Turner. He had also bought a lot of the movie catalog of MGM.

So this was a major library of media content. And essentially when all said and done, you now are going into the year 2000 with on one hand, American online, and on the other hand, this conglomerate of Time/Life, HBO, Warner Turner. So naturally American Online bought Warner Time Warner. It, that alone is a sentence that should give you pause.

Now I talk a lot about critique of M&A and I am a huge proponent of M&A. I believe mergers and acquisitions play a vital role in commercial society. I believe that our corporate finance vehicles are all, assets that can be used for great, good to unlock value to create synergies that M&A when done well, can be very powerful.

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M&A when done poorly can be awful. And this is an extreme example of M&A done awful. But I think it's important to point out that just out the gate, there's always going to be the risk of poor execution, of poor implementation. But in theory, there at least ought to be a vision towards strategy leadership post transaction culture how the two companies are gonna blend together, work together, where there's gonna be cost cutting, where there's gonna be revenue opportunities, and where there are strengths from two companies that are gonna come together to make one plus one equal something more than two. It's cliche, but it's actually a very simple way to put it and you have to have that just to even make the conversation worthwhile.

But then on top of that, the price paid matters. The deal structure matters, which executives stay and which executives go matters. How they all play together in the sandbox matters. The spreadsheet, the financial structure is deeply relevant. It is a necessary but not sufficient condition to success.

There is always a human element. Businesses are human endeavors that are producing goods and services for humans. And so to try to dehumanize the process by making it entirely a game of financial arbitrage or a game of value creation through multiple, expansion or some sort of number exploitation.

It, the numbers have to make sense, but the numbers reflect a human reality. And this to me is where M&A go wrong and one of two ways, an inadequate attention to the human element of a business or an inadequate attention to the numbers that undergird and underlie that re that business. This is a case where it was both.

It was absolutely all of the above the deal never had a chance to make sense. I've written a couple dividend cafes over the last four or five weeks where I alluded to the human nature problem in investing that human beings are highly susceptible to bubbles. It's a fear of missing out to hype to greed, to euphoria, to becoming, to talking themselves into believing the valuation doesn't matter that there is some sort of keeping up with the Joneses thing going on.

That trump's common sense. The idea that is a human dynamic that applies to individual investors, but somehow corporate executives are immune from is an absurd idea. And this is one of the great realizations in my own business career when it fully sunk in for me that corporate executives are human beings, that there are different complexities, and oftentimes very different numbers and stakes involved.

But the reality of human nature is itself the exact same. My friends, the AOL Time Warner merger is a case of human nature gone wrong in spades. The very dynamic that was necessary to make the merger happen was essentially soothing the ego of the CEO of Time Warner. Time Warner was a real company a gentleman by the name of Steve Ross, who had passed away before the deal happened, had brought Warner Brothers public back in 1966.

The market value was 12 and a half million dollars. When they merged with time Life Inc. In 1989, the value was over $5 billion. They had compounded at 30% plus for 20 plus years. Real profit growth, real revenue growth, real synergies, real both financial and operational success, with some failures along the way.

They were paying two at the time that Henry Lewis died, time Inc. Was paying two and a half million dollars a year in dividends for every a hundred million dollars of equity. He owned this founder, Henry Lewis owned 15% of the company. He had never sold a share. At the minority owners who are other time life shareholders were banking these substantial dividends.

This was a mature company, a grownup company that again, had made mistakes. But had a very desirable position in media and content and in the bones behind it with significant investment in cable infrastructure. Jerry Levin, the CEO, who has also now since passed away more recently though knew that he had a better company.

AOL was worth a lot more in stock market capitalization, but had inferior earnings, inferior revenues, inferior executive team. What they did was offer him the position of CEO. They said, you are now gonna be the CEO of this combined company. Now, AOL's board was still gonna be in the driver's seat. The AOL CEO Steve Case was gonna be the chairman.

But this conscious appeal to the ego took a no and turned it into a yes. For no other reason than gratifying this sort of C-suite corner office aspiration that was entirely juvenile and sacrificed an extraordinary amount of shareholder value of the company. He had a fiduciary duty to Warner to basically meet what it was his own.

I think narcissistic aspiration. It was a toothless CEO role, but it scratched the only itch that mattered. It got him to do the deal. I think this, the pathologies involved in these types of M&A transactions really undermine the idea that greed is the defining driver in corporate America.

A childish insecurity, self-aggrandizement often is, and that is what was happening here. AOL stock had continued to climb. It went up another 50% from the time that they orig that AOL pursued Time Warner. And Time Warner said no to the time they ended up doing the deal that made the deal less valuable to Time Warner.

AOL was now paying for it with a more expensive currency. In other words, the, to the dollar value they were getting to now came with much less shares because the price per share was so much higher. They had that late 1999 blow off top. Warner hadn't really gone up at all. AOL at the time was now double the value of Berkshire Hathaway.

It was triple the value of Disney. It was worth more than McDonald's. Philip Morris. And Pepsi combined. This was an insane moment of valuation and internet bubble and AOL used it to buy Time Warner. They paid $60 million of fees to their banker, Solomon Smith Barney. $60 million of fees Time.

Warner's Banker Morgan Stanley, ironically, Morgan Stanley and Smith Barney would end up merging together. When? When I worked there in, in 2009 in the aftermath of financial crisis, $120 million investment banking fees on one deal was outrageous at the time, but no one even batted an eye because they thought, Hey, this is a couple hundred billion dollars deal.

Who care? What's 120 million here or there? Little do they know how much 120 million would be. As a percentage of what the actual value of this combined company would end up proving to be in the end. So it was essentially a deal that happened with fake money AOLs currency. They presented a proforma value of $290 billion combining the two companies together.

AOL had $760 million of earnings in the last fiscal year before the deal. If you use the calendar year, it was about a billion. And Time Warner had about 1.3 billion, so you're somewhere at about $2 billion of combined earnings for $200 billion plus transaction a hundred times earnings. And there was significant non-recurring earnings in the 2 billion.

If you x out non-recurring items, which is the way generally we would value these things, it was really done at about 300 times. Forward earnings AOL used EBITDA in the way they measured their own earnings. Earnings before interest, taxes, depreciation, amortization. Time Warner used ebitda, meaning didn't include, didn't subtract depreciation.

From their own earnings, they used a more accurate measure because depreciation was a very real deal for them based on the fact that they depreciated so much of the cable assets. They had so much capital investment that had to be depreciated, that they, it really mattered. But when they valued this forward, they used the combined ebitda.

They were using an apples and oranges measure because Time Warner's valuation was really off of an E earnings metric that didn't subtract depreciation on a go forward basis. They combined it. It was totally disclosed. It was totally legal, but it was, it speaks to the dis ingenuity of what was going on at the time.

Companies rationalizing within the legitimacy of modern accounting. Noise that made no sense, that defied logic. But essentially now said, look, if we can grow profits 15% a year. For 15 years, we're gonna get to a $50 billion pre-tax level, 34 billion after tax. That was their pro forma projection when they rationalized the deal.

At the time, general Electric, one of the largest companies in the world, had more than double. The market cap of AOL was worth about $560 billion. They had 12 and a half billion dollars of after tax profits. All right, so they were using the rost of projections for a very long period of time when an awful lot of things can go wrong.

And saying that if we get there at a 20 times multiple, then we'll be at a $680 billion valuation. All of the rosiest of projections put together to get to a place that based on AOLs then market cap. Was a five and a half percent return per year, which is what government bonds were paying at the time.

If everything had gone beyond perfectly, they were projecting something that was completely unattractive on a risk reward basis. They ended up in 2002 writing down a hundred billion dollars, the largest write down in corporate history what's called a goodwill impairment. The amount of the value of the assets, what was paid for in excess is referred to as the goodwill.

And sometimes goodwill can be legitimate, that you believe there's gonna be this value creation. There's this sort of goodwill, there's this synergy, there's these strategic benefits that we're willing to pay more for, but they're not locked into the tangible value of factories, equipment, plants, hard assets.

So that excess was referred to as goodwill. In this case, the excess was AOL stock. That then comes down to planet Earth and they that intangible value essentially has to get written down. And at the time, the accounting jargon, it seems irrelevant. There was no cash lost at that time. When they wrote it down, but this is why I bring it up to say why things like goodwill, things like ebitda, the way that accounting works, matters so much to dividend growth investors like us, because these things are not illegal or smoke and mirrors, but they require additional due diligence.

In this case, there was not something that happened in 2002. If it was value destructive, they just got the books up to speed with the real value destruction that took place in 2000 when the deal was done. The write down was basically just catching up to reality that a massively overpriced stock had been used to buy an asset that then provided no value, no synergies, and never came close to delivering on promises.

Now, they talked about 15% earnings growth per year. For 15 years, they talked about $50 billion of pre-tax profits. They also said there will be no dividends. This is, to me the point as I get ready to wrap up, I wanna say about going back in time 25 years ago as they're putting this deal together already with a massively overpriced stock, already having to couch the whole thing in ego and basically pacifying the egotistical aspirations of people to make a deal happen already without any logical strategy or synergy whatsoever.

They then say, 'cause by the way, there's no debt involved. This wasn't a levered buyout. That's the good thing you would say. Sometimes a big merger can't pay out big dividends because they have to go to the bank that lent them the money to make the deal happen. That's a problem for dividend investors with over levered M&A.

But this wasn't a levered M&A. It was a stock swap. The problem was. They simply didn't believe their own promises. They said they were gonna be creating tens of billions of dollars of free cash flow, and they paid no dividends. Therein lies the rub. They didn't believe their own projections. When you get companies like Walmart that have grown the dividend every year for 50 years, and the owner, founder, family never sell shares, I bring up Henry Lu who started Time Magazine, who ha was getting two and a half million dollars a year of dividends on his a hundred million dollars of stock in the 1960s.

Never ever sold a share. Owned 15% of the company. There. There was a free cash flow that justified a dividend and a dividend that provided a boost of optimism to the sustainability of the free cash flow, a truly virtuous cycle. This entire AOL Time Warner story is not merely a story of a company that didn't pay a dividend.

Therefore, you shouldn't believe it, though, based on the rationale they provided. Nobody should have ever believed it, but even absent the dividend. You already had a path to shareholder value creation that made no sense. You had a ticking time bomb with the entire deal rooted to a stock that was irrationally valued, and you had all kinds of talk about ignore what you're supposed to care about here because this is about the future.

This futuristic pie in the sky, nonsense. The AOL Time Warner deal blew up more money than any deal in history, but the lessons from the deal are here to stay. The lessons were there before the deal, and they will be there into the future. There will be more stories like it, hopefully to not that degree of financial violence, but ultimately I would encourage all of us 25 years later to learn from the largest business loss in American history.

And to focus on the true principles that drive value, that avoid big mistakes, and ultimately produce consistent deliverable returns year in, year out the way it's supposed to. The old fashioned way. Thanks very much for listening, watching and reading the Dividend Cafe.