AOL'S REVENUE VOODOO
SALES DEALS FROM THE '90S MAY BE MORE FAKE THAN REAL

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Dick Parsons AOL Time Warner CEO

September 3, 2002 -- IF I pay you to cut my hair, and you pay me to shine your shoes, have we both broken the law - or even made a buck?

That's the intriguing question posed by the developing situation at AOL Time Warner, where questions are now being raised as to whether many of the company's bull market media deals in the 1990s generated revenue growth that was more fake than real.

Last week the Wall Street Journal zeroed in on one example of same in the company's back-scratching deal to invest up to $50 million in Oxygen Media, in return for that company's agreement to plow as much as $100 million back into advertising on AOL.

BUT that is only one of literally hundreds - and even thousands - of such deals that flourished in the boom 1990s. Many companies with high-flying stocks consisted of almost nothing but these reciprocal type arrangements. An entire new sector of business - the so-called "Internet incubator" field - was based largely on them.

Major, multibillion-dollar companies like Hewlett-Packard and Cisco Systems as well succumbed to their lure.

Last winter, when the accounting horrors in the telecom space were beginning to make daily headlines, a senior vice president of technology at Qwest Communications told me he was regularly instructed to order large quantities of equipment that Qwest didn't need, such as Sun workstations, Oracle software licenses, and EMC storage gear.

Said the source, "A few weeks after we'd placed the orders, I'd invariably read in the newspapers that we'd signed some deal in which one of those very companies had agreed to purchase similar amounts of Qwest products and services from us."

The question presented by all this is whether the deals represented a deception for investors, who might look at a company's rapidly increasing revenues and think the company's products are in demand when, in reality, the growth is being ginned up by hidden side-deals the public knows little about.

Certainly they caused the stocks of many companies involved in the ploy to soar to absurd heights. Some were obscure little operations like Shopping.com Inc., a Web site retailer for office equipment, whose stock price quadrupled on revenues fueled by Web site orders placed secretly by its own underwriter.

Others were vastly larger outfits like Lucent Technologies, which pumped up its revenues by destroying its balance sheet.

THE favored gimmick: so-called vendor-financing deals. In such deals, Lucent would lend millions to impoverished customers like Winstar Communications, letting Winstar purchase telecommunications equipment from Lucent. This caused Lucent's revenues to soar while Winstar's debt became an asset on Lucent's balance sheet.

When Winstar collapsed, the assets became worthless even as Lucent's revenues tanked as well.

The person who masterminded these deals - Carly Fiorina - escaped from Lucent in the nick of time, hopping over to Hewlett-Packard, where she put together similar vendor financings that ultimately came apart.

A variation on the vendor financing theme involved something known as barter transactions.

In a barter deal, two companies with little or no revenue can be made to look as if they're drowning in money by simply exchanging services for free with each other.

Current accounting rules require that the cost of the bartered service be booked as an expense by the company providing it.

But the value of the service gets treated as income to the company receiving it. As a result, neither company shows any increase in net income, though both companies show growth in their top-line revenues. And in the dot-com era of the 1990s, top-line growth was all that investors looked at.

A New York-based operator of Web sites for women, iVillage.com Inc., eventually reached more than $40 per share on this gimmick. Today the stock sells for barely 80 cents.

Yahoo! Inc., the only surviving member of the dot-com era's four original search engine companies, had its own way of conjuring revenues out of thin air. Much of the credit for that goes to Softbank of Japan, which controlled a third of Yahoo!'s stock.

Softbank held stakes in companies all across the Internet, including control of publisher Ziff-Davis Inc. In 1998 the Japanese company, a kind of Internet incubator in its own right, took Ziff-Davis public in a Morgan, Stanley & Co.-underwritten IPO.

Then Softbank took $400 million of the proceeds and plowed the money into a big stake in E*Trade Group Inc., the Internet brokerage firm. E*Trade, in turn, took the money and spent it on an "extensive advertising, sponsorship, and promotional program" with Yahoo!, where Softbank was already the dominant shareholder.

In this way, the proceeds of an IPO for Ziff-Davis, which has since been taken private by a group from Chicago and is now teetering at the edge of bankruptcy, created the illusion of growth at Yahoo! by financing ads via E*Trade. And of course, it all came from the sale of stock on Wall Street, not the sale of online ads.

The entire telecom bubble was fueled by similar-type back-scratching. Enron Corp., Global Crossing Ltd., Qwest Communications and WorldCom Corp. are but a few of the companies that

used a barter-like hustle known as "Indefeasible Rights of Use" to create money out of nothing.

Basically, so-called IRU deals amounted to swapping around excess fiber capacity within the overbuilt telecom sector, with the companies involved in the shuffle all booking big revenue increases in the process.

In 2001, Qwest Communications alone booked nearly $1 billion in phantom revenues in this way.

From a high of $65, Qwest has now fallen to barely $3; the others, of course, are even worse.

In this world of phantom revenue creation, AOL was one of the most aggressive.

By the summer of 1998, an estimated one-third of AOL's marketing revenues were coming from IPO-financed advertising on AOL by money-losing dot-coms in which AOL was already an investor.

Take AOL's Preview Travel deal, for example. During the 1990s AOL began investing millions in a money-losing TV programming company that had morphed into a Web travel outfit named Preview Travel.

In 1998 West Coast underwriter Hambrecht & Quist, which was headed at the time by AOL honcho Steve Case's brother, Dan, took Preview Travel public in an IPO at $11 per share.

Preview Travel thus wound up with the cash it needed to make good on an agreement to pay AOL $32 million over the next five years in return for being promoted to AOL users as a "primary travel service."

THIS then is how business was done in the 1990s - not just at AOL but indeed everywhere.

The faster a company was growing, the higher its stock would rise. And to create the appearance of growth, which would fatten up their own option deals in the process, executives in one fast-tracking company after the next were willing to engineer deals that never had a chance of profitability but were designed only to boost the top line on the income statement.

Was it illegal? Officials at the Financial Accounting Standards Board can point to no rule that makes it so.

But are we all paying the price in the form of a collapsed stock market? Obviously.

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