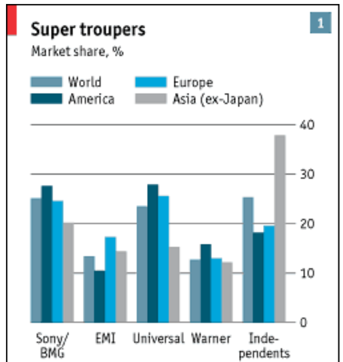
The music industry

Music's brighter future

The internet will eventually be wonderful for music buyers, but it is still a threat to today's dominant record labels

"Dirty pop with wonky beats and sleazy melodies" is how the Sweet Chap, aka Mike Comber, a British musician from Brighton, describes his music. The Sweet Chap has no record deal yet, but he has been taken on by IE Music, a London music-management group that also represents megastar Robbie Williams. To get the Sweet Chap known, last year IE Music did a deal to put his songs on KaZaA, an internet file-sharing program. As a result, 70,000 people sampled the tracks and more than 500 paid for some of his music. IE Music's Ari Millar says that virally spreading music like this is the future.



Source: International Federation of the Phonographic Industry

It may indeed be, and nimble small record labels and artist-management firms will certainly get better results as they find ways to reach more people via the internet. But the question facing the music industry is when that future will arrive. And the issue is most urgent for the four big companies that dominate the production and distribution of music—Universal, Sony/BMG, Warner and EMI (see chart 1). So far they have been slow to embrace the internet, which has seemed to them not an opportunity but their nemesis. Rather than putting their product on file-sharing applications, they are prosecuting free-download users for theft. They have certainly been struggling: sales of recorded music shrank by a fifth between 1999 and 2003.

Today, there is more optimism. In the first half of this year, global physical unit sales of recorded music rose, albeit by a tiny amount. The industry claims that file-sharing has stabilised thanks to its lawsuits. The number of music files freely available online has fallen from about 1.1 billion in April 2003 to 800m this June, according to IFPI, a record-industry body. That said, internet piracy is rampant, and physical CD piracy continues to worsen.

But big music's attitude towards the internet has changed, too. Over the past four years the big companies have come a long way towards accepting that the internet and digital technology will define the industry's future. Thanks to Apple and its enormously popular iPod music players and iTunes download service, most music executives now believe that people will pay for legal online music. (Although they have mushroomed, legal online downloads account for less than 5% of industry revenues.) The big companies are trying to work out how they can harness the internet. Consequently, they are having to rethink their traditional business models.

In the physical world, the big companies have the advantage of scale. In addition to marketing clout, they own a large back catalogue of music that can be repeatedly reissued. They are also bolstered by music-publishing businesses, which collect royalties on already published songs used in recorded music, live performance, films and advertisements.

Historically, the majors have controlled physical distribution of CDs. Yet that barrier to entry will erode as more music is distributed on the internet and mobile phones. Artists can, in theory, use the internet to bypass record firms, though few have yet done this. The principal reason most have not is that they need marketing and promotion, which the majors also dominate, to reach a wide audience.

The majors have a tight hold on radio, for example, by far the most effective medium for promoting new acts. (Perhaps their lock is too strong: Eliot Spitzer, New York's attorney-general, is investigating whether the companies bribe radio stations to play their music.) Could the internet challenge them on this too? So far, bands have not been launched online. But that could change, and there is already evidence that data derived from the preferences shown on illegal file-sharing networks are being used to help launch acts.

Much will depend on whether the majors choose to address a problem that is just as important as piracy: these days they rarely develop new artists into long-lasting acts, relying instead on short-term hits promoted in mainstream media. That has turned off many potential buyers of new music. In future, using the internet, the industry will be able to appeal directly to customers, bypassing radio, television and big retailers, all of which tend to prefer promoting safe, formulaic acts. That could give the majors the confidence to back innovative, edgy music. But much smaller independent labels and artist-management firms can do the same, offering them a way to challenge the big firms head on.

Even in the physical world, the big firms are struggling to maintain their traditional market. Supermarkets have become important outlets, but the likes of Wal-Mart stock only a narrow range of CDs, choosing to shift shelf-space away from music in favour of higher-margin DVDs and videogames. That is a symptom of another headache for all music firms: they face ever more intense competition from other kinds of entertainment, especially among the young. In theory, then, digital technology offers the majors an escape hatch. With infinite space and virtually free distribution online, every track ever recorded can be instantly available to music fans. Of course, smaller firms will be able to do the same thing.

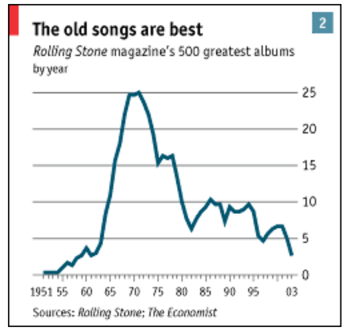
Where did all the music go?

According to an internal study done by one of the majors, between two-thirds and three-quarters of the drop in sales in America had nothing to do with internet piracy. No-one knows how much weight to assign to each of the other explanations: rising physical CD piracy, shrinking retail space, competition from other media, and the quality of the music itself. But creativity doubtless plays an important part.

Judging the overall quality of the music being sold by the four major record labels is, of course, subjective. But there are some objective measures. A successful touring career of live performances is one indication that a singer or band has lasting talent. Another is how many albums an artist puts out. Many recent singers have toured less and have often faded quickly from sight.

Music bosses agree that the majors have a creative problem. Alain Levy, chairman and chief executive of EMI Music, told *Billboard* magazine this year that too many recent acts have been one-hit wonders and that the industry is not developing durable artists. The days of watching a band develop slowly over time with live performances are over, says Tom Calderone, executive vice-president of music and talent for MTV, Viacom's music channel. Even Wall Street analysts are questioning quality. If CD sales have shrunk, one reason could be that people are less excited by the industry's product. A poll by *Rolling Stone* magazine found that fans, at least, believe that relatively few "great" albums have been produced recently (see chart 2).

Big firms have always relied on small, independent music firms for much of their research and development. Experimental indies signed Bob Marley, U2, Pink Floyd, Janet Jackson, Elvis Presley and many other hit acts. Major record labels such as CBS Records, to be sure, have signed huge bands. But Osman Eralp, an economist who advises IMPALA, a trade association for independent music companies in Europe, estimates that over 65% of the majors' sales of catalogue albums—music that is at least 18 months old—comes from artists originally signed by independents.



In the past, an important part of the majors' R&D strategy was to buy up the independent firms themselves. But after years of falling sales and cost-cutting, the majors have little appetite for acquisitions, and now rely more on their own efforts.

What Mr Levy calls music's "disease"—short-term acts—is not solely a matter of poor taste on the part of the big firms. Being on the stockmarket or part of another listed company makes it hard to wait patiently for the next Michael Jackson to be discovered or for a slow-burning act to reach its third or fourth breakthrough album. The majors also complain that the radio business is unwilling to play unusual new music for fear of annoying listeners and advertisers. And while TV loves shows like "Pop Idol" for drawing millions of viewers, such programmes also devalue music by showing that it can be manufactured. Technology has made it easy for music firms to pick people who look good and adjust the sound they make into something acceptable, though also ephemeral.

The majors could argue that they can happily carry on creating overnight hits; so long as they sell well today, why should it matter if they do not last? But most such music is aimed at teenagers, the very age group most likely to download without paying. And back-catalogue albums make a great deal of money. The boss of one major label estimates that, while catalogue accounts for half of revenues, it brings in three-quarters of his profits. If the industry stops building catalogue by relying too much on one-hit wonders, it is storing up a big problem for the future.

A new duet

There are signs that the majors are addressing the issue. Universal Music and Warner Music are starting up units to help independent labels with new artists, both promising initiatives that show that they are willing to experiment. Thanks to the majors' efforts in the last few years, their music has already improved, says Andy Taylor, executive chairman of Sanctuary Group, an independent, pointing to acts such as the Black Eyed Peas (Universal), Modest Mouse (Sony), Murphy Lee (Universal) and Joss Stone (EMI).

And yet even if they can shore up their position in recorded music, the big firms may find themselves sitting on the sidelines. For only their bit of the music business has been shrinking: live touring and sponsorship are big earners and are in fine shape. In the past 12 months, according to a manager who oversees the career of one of the world's foremost divas, his star earned roughly $20m from sponsorship, $15m from touring, $15m from films, $3m from merchandise and $9m from CD sales. Her contract means that her record label will share only in the $9m.

In 2002 Robbie Williams signed a new kind of deal with EMI in which he gave it a share of money from touring, sponsorship and DVD sales as well as from CDs, in return for big cash payments. Other record firms are trying to make similar deals with artists. That will be difficult, says John Rose, former head of strategy at EMI and currently a partner at the Boston Consulting Group in New York, because many artists, and their managers, see record companies less as creative and business partners than as firms out to profit from them.

Artists' managers will resist attempts to move in on other revenue streams. Peter Mensch, the New York-based manager of the Red Hot Chili Peppers, Shania Twain and Metallica, says "we will do everything and anything in our power to stop the majors from grabbing any share of non-recorded income from our bands." Mr Mensch says that one way to fight back would be to start his own record company.

Independent labels are also gunning for the big firms. For one thing, they are fighting to stop further consolidation among the majors because that would make it even harder for the independents themselves to compete for shelf space and airplay. IMPALA will soon take the European Commission to court for allowing Sony and BMG to merge earlier this year. But the small firms are also optimistic that they can grow at the expense of their big rivals. The majors are cutting back in smaller markets and dropping artists who lack the potential to sell in lots of countries. That leaves a space for the indies. For example, Warner Music Group is thought to be readying itself for an initial public offering in 2005 and, as part of cutting costs in Belgium, it dropped artists this year. Among them was Novastar, whose manager says the group's latest album has so far sold 56,000 copies in Belgium and Holland.

The more the majors scale back, the more the market opens up. People who have left the big firms are starting up new ventures. Emmanuel de Buretel, previously a senior manager at EMI, is about to launch an independent record label called "Because", with help from Lazard, an investment bank. Tim Renner, formerly chairman of Universal Music in Germany, will soon set up a music internet service, a radio station in Germany and possibly a new record label.

In the material world

Meanwhile, the majors are trying to plot their move to digital. Making the transition will be tricky. Bricks-and-mortar music retailers need to be kept happy despite the fact that they know that online music services threaten to make them obsolete. It is still unclear what a successful business model for selling music online will look like. People are buying many more single tracks than albums so far. If that persists, it should encourage albums of more consistent quality, since record companies stand to make more money when people spend $12 on a single artist than if they allocate $2 to each of six bands. Or it could mean that the concept of the album will fade.

Online pricing is unstable too. It is likely that download prices will vary in future far more than they do now. Apple forced the industry to accept a fixed fee per download of 99 cents, but the majors will push for variable, and probably higher, prices. Online prices will have an impact on prices in the physical world, which are already gradually falling in most markets. But the result of all these variables might be structurally lower profits.

Edgar Bronfman junior, chairman and chief executive officer of Warner Music Group, expects that paid-for digital-music services via the internet and mobile phones will start to have a measurable impact on music firms' bottom lines as soon as 2006. The new distribution system will connect music firms directly with customers for the first time. It will also shift the balance of power between the industry and giant retailers. Wal-Mart, for instance, currently sells one-fifth of retail CDs in America, but recorded music is only a tiny proportion of its total sales.

The best distribution of all will come when, as many expect, the iPod or some other music device becomes one with the mobile phone. Music fans can already hold their phones up to the sound from a radio, identify a song and later buy the CD. At $3.5 billion in annual sales, the mobile ringtone market has grown to one-tenth the size of the recorded music business.

But can paid-for services compete with free ones? The paying services need to put more catalogue online if they want to match the file-sharing networks with their massive music libraries. And it is still unclear how much "digital-rights management"—technology that restricts how a music download can be used—people will tolerate. Another key issue is interoperability: whether the various new devices for playing digital music will work with other online stores. Apple's iPods, for instance, work with iTunes, but not with Sony Connect or Microsoft's MSN Music Store. Too many restrictions on the paid-for services may entrench file-sharing.

Out of the more than 100 online music sites that exist now, a handful of big players may come to dominate, but there will be specialist providers too, says Ted Cohen, head of digital development and distribution at EMI. iTunes is like the corner store where you buy milk and ice cream, he says, but a customer does not spend much time there. Real Networks' Rhapsody, on the other hand, charges a monthly subscription in return for unlimited streaming music and gives descriptions that lead people to new artists. Recommendation services like these, as well as people sharing playlists, will eventually make the internet a powerful way to market music as well as to distribute it.

Jiving with the enemy

In September, according to comScore Media Metrix, 10m American internet users visited four paid online-music services. The same month another 20m visited file-sharing networks. The majors watch what is being downloaded on these networks, although they do not like to talk about it for fear of undermining their legal campaign.

Online music might truly take off if the majors were to make a truce with the file-sharing networks. The gulf between the two worlds has narrowed now that the industry sells its product online and allows customers to share music using digital-rights management. As for the file-sharing networks, "the other side is more willing to talk and less adversarial," says an executive at one of the majors in Los Angeles.

Music industry executives say that Shawn Fanning, founder of Napster, the first file-sharing network, is working out how to attach prices to tracks downloaded from such services, with a new venture called "Snocap". Mr Fanning tried to make the original Napster legal back in 2001, but the music industry decided instead to sue it out of existence. Sam Yagan, boss of eDonkey, currently the most popular file-sharing network, says he had meetings with three of the four major labels last summer about how his network could start selling their music alongside free content. As IE Music's experiment shows, that is not an impossible dream. Music executives may not have the confidence yet to make a deal with their arch-enemies. But eventually they have to get bolder. It seems clear that the only way for the majors to stay on top of the music industry into the next decade is to take more risks—both technological and creative—than they have done for a long time.