The Music Industry in the 21st Century

Facing the digital challenge

Jürgen Preiser and Armin Vogel

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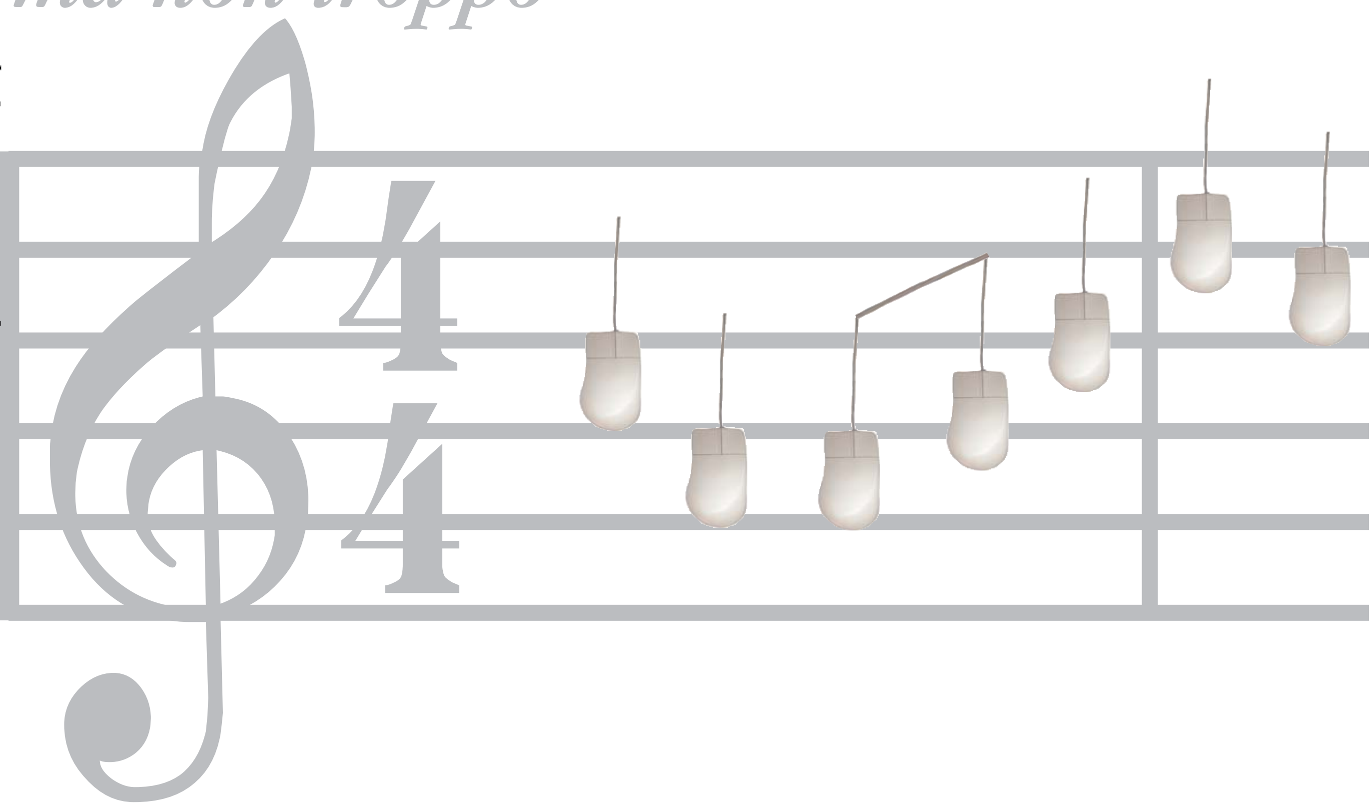

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Introduction

The record industry, after more than a decade of comfortable growth from the early 1980s to the late 1990s, must now adapt to sales increases that are more or less in line with global economic growth. Since its conception the music industry's main growth driver has been technological changes of the content carrier, which delivered music to the consumer. The evolution from vinyl LP to eight-track, then to the music cassette (MC) and finally to the compact disc (CD) brought along with it a huge boost in revenues for the industry.

These technology changes stimulated consumer interest and led to huge sales gains, as music listeners replaced huge parts of their existing collections by re-purchasing music recordings on the new carrier. Admittedly, each technology change brought with it significant quality improvements over those of the replaced carriers. The introduction of DVD Audio (DVD-A) or Super Audio CD (SACD) appears to be just another step in this evolution. But we believe that neither of the two new carriers offers the consumer enough added value, compared with the CD, to lead to a new wave of replacement purchases and significantly boost sales for the record industry.

In the long term, we are convinced that Flash memory card players will be the new physical carrier for music and that credit card size recordings have the potential to create a revenue boom similar to that caused by CDs. However, there is still a long time to go before prices of these new carriers come down to acceptable levels leading to mass-market consumer purchases.

The advent of the Internet, however, is another story.

Digital technologies create a host of new business opportunities.

The parallel evolution of three distinct technologies is driving the increase in the number of business models available today. These are:

- access technology—eg, Internet, broadband, mobile telecommunications
- software development—eg, compression, encryption, player formats
- hardware—eg, flash memory, PDA.

All three developments will have a profound effect on the music industry because it completely changes the industry's entire value chain. They both allow and influence business models such as virtual record labels, online radio, digital downloads, streaming and music destination sites. Not all the business models being developed today will prove successful—ie, be profitable. And others will most likely be adopted by the masses much later than today's forecasters may want us to believe. Still it seems there is no doubt that the future consumer will have much more choice of how he wants to consume music than his counterpart has today.

Whereas in the past the industry could more or less passively ride out changes to the music carrier, with the coming of Internet Age, industry companies must actively drive changes if they are to prosper.

The Internet offers music creators and performers the opportunity to take a more prominent role in the industry's value chain than they could in the past. Prince, Chuck D and David Bowie have all shown that the Internet gives them, for the first time, the chance to control the marketing and distribution of their music.

Although several functions of the music industry's traditional value chain, such as A&R, marketing and promotion lend themselves easily to migrate online, others—eg, manufacturing and physical distribution—will begin to be replaced by a virtual market of digital downloads, file sharing and subscription services. The Internet will probably change the manner in which record labels execute their core functions of A&R and marketing/promotion, but the labels should still retain control over these functions.

More and more music-content channels—eg, music TV, digital radio, mobile phones, etc—are continually emerging through which fans can consume music. The Internet is another, albeit more important, one of these channels.

More channels mean not only increased music consumption but also additional opportunities for the industry to convert listeners into commercial consumers—ie, music buyers. The record industry has known for a long time that there are twice as many listeners as purchasers of music.

In the world of physical carriers the record companies have in the past tried with some success to stimulate commercial consumption of music—ie, purchases—by opening up new distribution channels. The industry used more non-traditional outlets such as petrol stations, fast food chains, newsagents, etc, to stimulate the consumer with the opportunity to buy music recordings any time and any place. The Internet offers not only more possibilities for music to reach the consumer but also allows the music industry to learn more about the consumer and to establish direct links with him.

The Internet has the potential to increase significantly the demand for paid music consumption. It will deliver on this potential provided that reasonable rules of operation are established on the Internet under a legal framework that is fair to both the industry and the consumer. If this is not done, then music piracy will continue to flourish both on- and off-line.

The Internet provides the record industry with more than just an additional distribution mode for incremental sales but, more importantly, a marketing and communication platform to increase overall interest in music. Through proper online marketing techniques the industry can mold communities of like-minded consumers, which are the basis for purchases.

Music is one of the top interests for consumers on the Internet and today the different music offerings reach around 50 per cent of all Internet users.

Whilst consumer interest is there to listen to music via the Internet, the question still remains of how to turn this interest into purchases of music and thereby create a viable and profitable business model.

Predictions of the future of music retail vary wildly, ranging from the doom of record labels to projecting a huge boom in music industry sales. There are claims that digital distribution (eg, downloads via the PC and future devices, streaming technologies and file sharing) will completely replace the physical distribution of pre-recorded plastic discs. If this were to happen then both online and offline music stores that built their business on physical distribution would be cut out of the record industry's value chain.

If, as some predict, all music ever recorded is available free on the Internet with person-to-person (P2P) models like Napster, then there would be dire consequences for the industry.

On the other hand, predictions of a doubling in size over the next 10 years as music listeners completely switch to online music subscription services and abandon their CD archives, would be like music to the industry's ears. Such a consumer migration would give the music industry a push in sales similar to what happened with the advent of CD technology.

The reason for these differing predictions is the massive uncertainty about the viability and adoption rate of online business models.

In recent years a number of new channels for music consumption have been introduced and there have been quite a few attempts to improve the business processes of the traditional record industry to make them more effective as well. These changes and improvements were initiated by a number of young and creative entrepreneurs and new players in the market rather than by the business development staffs of the large companies.

Despite the majors' prestige and big money on the line they did not act or react to market developments. It was the new entrants to the market that had the initiative to try out new business models and to experiment with new approaches using the latest technology. It was newcomers who were driving innovation in their attempts to carve out a niche in the new value chain that they saw on the digital horizon. The major record companies are embracing the Internet slowly and cautiously, and some say reluctantly.

Over recent years the traditional industry companies went through different phases in their approach to the Internet. At the same time that the traditionals were foundering some of the new entrepreneurs reached critical mass and became the industry's new patrons, offering fans a multitude of music-content portals, e-tailers and online radio sites. It is the few successful newcomers that are in a prime position to benefit when the Internet starts to be a real moneymaking business. Most of them only just survived the euphoric hype phase and are now running out of cash as their business models prove too weak to guarantee their backers a reasonable return on investment. The losers paid dearly, as noted by the large number of bankruptcy cases, for their mistakes and experiments. But every small entrepreneur who experimented with a new digital process or innovation in an attempt to shape the record business of the 21st century helped to drive the music industry a bit closer to the business models that will finally succeed.

The early prediction that the rise of the Internet would lead to the demise of traditional record companies is proving to be wrong. The failure of most entrants who tried to carve a business out of the change in the value chain shows this. So does the little success that artists have had trying to take over record companies' traditional roles such as marketing and distribution. Artists and start-ups alike soon realised that having one single product offering, be it the artist's own works or a single site with little-known artists, did not provide them a vehicle strong enough to draw millions of consumers.

The consumer, whether he is on or offline demands a strong blend of content and brands—ie, artists. That is what he is looking for when he enters a music shop or accesses the Internet, and only the big record companies can provide this by licensing their assets.

Only after the tremendous success of industry rebels like Napster pure-plays were successful in gaining the pole position for online music sales. This did stir the industry into action. The companies' initial move was litigation. They had to stop the bleeding and fast if they were to survive. Once their position had stabilised they began their own offensive using digital distribution.

For the big record companies it had become evident that they had to find and try new business models pro-actively before these new entrants—often able to command vast amounts of cash through their IPOs—became legal and solidified their positions even further. The major record labels have only just now begun to sell directly to consumers in order to win back revenue they had lost by ignoring the Internet and leaving it to upstart competitors.

The Internet poses two crucial questions for the music industry: one centered on sales, the other on distribution. The first is whether online music retail and music on new carriers will generate incremental revenues or merely replace offline sales. The second is whether the industry can come up with a digital distribution business model to recoup revenues lost to illegal digital distribution of music online.

For the IFPI the 1.3 per cent decline of global recorded music sales in 2000 was the first evidence of the impact that digital distribution and electronic piracy (eg, Napster, CD-burners, and MP3) have had on industry revenues. This has deepened with a five per cent decline in sales value in 2001.

The dramatic collapse of physically and digitally distributed CD single sales in a world where music has become more and more pervasive is extremely alarming to the industry.

On the positive side, results of industry surveys of music fans vary a bit but generally indicate that Internet users who listen to music online do not necessarily buy less music. The majority of Internet consumers interviewed, approximately 60 per cent, believe that their purchasing behavior did not change, 30 per cent report or expect increased purchases, and only 10 per cent report or expect a decrease.

There are some uncomfortable questions to be asked—particularly to the major record companies—why they did not act pro-actively.

- Why did the industry wait for so long before offering consumers a legal music service comparable to Napster or MP3.com?
- Did it really need to take a Napster with its huge success and 50m annual users to shake up the industry?
- What internal workings prevented the industry from offering legal Internet music services of comparable value to customers—eg, Pressplay and MusicNet—sooner? (Both of which finally demonstrate that the record industry is getting ready to join the online party.)
- Was the litigation of pure-plays a waste of time in a vain effort to preserve traditional structures or a brilliant tactical maneuver to gain time?
- Would a more pro-active approach exploiting the opportunities the Internet provides have reduced the piracy problem earlier and thereby made it easier to convince consumers that they have to pay for music on the Internet ?

3 The new music consumer

General consumer trends

A number of consumer trends have become apparent over the last couple of years that will shake up the record industry and determine the role the Internet in the life of the modern consumer.

Individualism
Born out of the increasing number of single-parent households and the demise of the community/family, the consumer now strives to be different. The individual seeks to achieve a unique identity, one that separates him from the anonymous masses. The lack of global trends in both fashion and music is a clear indication of the drive toward individualism. The proliferation of niches in all markets is another.

The resulting increased number of market segments has prompted the need to communicate effectively to small groups, thus the emergence of fractal marketing. The Internet is a medium particularly suited towards this development.

Globalisation
This phenomenon was spawned by the increasing availability of instant worldwide communication and the rise of the new media (telephone, mobile telephones, TV, video conferencing, Internet). Consumer proximity within the younger generation in particular has radically increased, facilitated by cheaper forms of transport.

Recent consumer research showed that young consumers have greater proximity to young consumers of other nationalities than to older consumers of the same nationality, particularly in Europe. Again, the Internet enhances this trend.

Critical consumer
Higher levels of education and greater availability of information have made the consumer increasingly critical when making a product choice. This trend has developed as the number of alternatives, within the same product category as well as replacement products from other categories, offers the consumer an almost infinite range to choose from.

The availability of information over the Internet has made the consumer ever more critical, and thus more powerful, particularly with respect to product pricing.

Convenience
New distribution channels, such as petrol stations, offering a wider range of products and new media, such as direct response TV, the Internet, home shopping TV and mail order, allow the consumer to buy at his convenience. He can do this from the comfort of his home, office, or hotel room 24 hours a day, seven days a week, without losing time travelling.

This developing convenience behaviour applies particularly to the purchase of goods for which shopping is not a pleasure.

Enhanced shopping experience
Whilst the consumer values convenience when shopping for low-involvement

products, he still expects to be entertained while leaving the comfort of home for shopping. Many retailers have already responded to this trend by offering consumers far more than more shelf space.

Shopping malls and record shops in the USA provide live gigs and even chances to meet film, TV or other entertainment stars while shopping.

Youth orientation

Open media access and both parents being employed , turns children into adults much earlier today than in previous generations. This trend is demonstrated by statistics on sexual awareness, crime and consumption of drugs. At the same time older consumers try to appear young and active—eg, increased sales of cosmetics and use of plastic surgery. This movement is furthered by the idealisation of youth through the media.

Social differences

The gap in western societies between rich and poor is widening and an increasing part of economic wealth is owned by a decreasing number of people. Although information as the currency for economic wealth is available to everyone the access barrier is getting steeper.

Unfortunately, the Internet will increase this trend globally, as access to it requires a computer, a reliable telecommunication network, and the knowledge to use them effectively.

The music consumer

Reach and buying intensity

The global market size of the record industry is determined by two factors:

1 the reach of music among the population—ie, the percentage of the total population buying records;

2 average music spend per buyer composed of

- the number of records bought by each buying consumer;
- the average amount spent by each consumer per record bought.

The reach of music among the population is relatively stable within a country but differs between countries. This difference correlates vaguely with the country's level of economical development (see also table of music spending vs GNI, page 36). The reach is also influenced by other determinants such as lifestyle, consumer attitudes and, obviously, the penetration of playback devices in the domestic market.

There are also indications that circumventing certain barriers could increase the reach. Some of these barriers could be avoided through effective use of Internet (see section on *Sleepers*, below).

Even in the most developed countries, the reach of music does not exceed 60 per cent of the total population.

reach	**country**
45-55%	UK, Germany, France, Sweden, Netherlands, Japan, USA
30-40%	Italy, Spain, Taiwan, Poland
15-25%	Mexico, Brazil

Of those consumers buying records, nearly all buy albums. However, in the markets which have strong single/maxi-single segments—eg, Japan, Germany, UK, 40-50 per cent of all record buyers purchase singles. A well developed single/maxi-single segment can significantly extend the total reach of music in general and particularly among consumers under 30 years old.

It is important to realise that the record industry still has tremendous long-term growth potential in less developed countries, which it can realise if it effectively exploits the rise in economic prosperity in those countries. To do this it must promote consumption of record products ahead of other luxury goods and even other entertainment products. The record industry's competitors are also trying to exploit the increase in wealth in these countries at the same time.

1 The average music spend per buyer is calculated by multiplying the number of records bought by the average amount spent per unit. The result, multiplied by the population of a country and the reach of music in that country, forms the market size of the domestic market. The average music spend per unit is influenced by

- the mix of formats (MC vs. CD, strength of single/maxi-single segment);
- the mix of price categories (budget, mid-, full-price) and
- the overall price level in a country.

2 The number of records bought by those consumers reached by music does not correlate as clearly with the stage of economic development as the reach of music. The number of records sold depends on domestic price levels. This does not necessarily refer to differences in price for single products—ie, internal competitive prices within the music industry, but could refer to differences in market structure.

For example, the availability of cheaper budget or mid-price products, or the existence of a strong single/maxi-single market segment, would have a great effect on the number of records bought.

The average number of purchases varies from four in countries where practically no singles/maxi-singles segment is available (Italy or Spain) to 8-10 in countries with a strong singles/maxi-singles segment (Japan, UK and Germany). The latter three countries account for approximately 60 per cent of the global singles/maxi-singles market segment and domestic sales in this segment account for 20–40 per cent of total unit sales in those country.

The average music spend per buyer can differ significantly by country. For example, music buyers in Poland spend less than $20 a year, which is due to the high share of MCs and cheap pirated product in that market. In Japan, on the other hand, music buyers spend more than six times that amount due to the very high retail prices.

World population and music market shares compared

	% of total population	*% of total music market*
Argentina	0.7%	0.5%
Australia	0.4%	1.5%
Austria	0.2%	0.8%
Belgium	0.2%	0.7%
Brazil	3.4%	2.0%
Bulgaria	0.2%	0.0%
Canada	0.7%	2.2%
Chile	0.3%	0.2%
China/Hong Kong	30.3%	0.5%
Colombia	0.7%	0.3%
Croatia	0.1%	0.0%
Cyprus	0.0%	0.0%
Czech Republic	0.2%	0.1%
Denmark	0.1%	0.6%
Ecuador	0.2%	0.0%
Egypt	1.3%	0.1%
Estonia	0.0%	0.0%
Finland	0.1%	0.3%
France	1.2%	4.6%
Germany	1.8%	6.6%
Greece	0.2%	0.2%
Hungary	0.2%	0.2%
Iceland	0.0%	0.0%
India	18.8%	0.6%
Indonesia	4.3%	0.3%
Ireland	0.1%	0.4%
Israel	0.1%	0.1%
Italy	1.3%	1.4%
Japan	2.7%	17.7%
Korea	1.0%	0.8%
Latvia	0.1%	0.0%
Lebanon	0.1%	0.0%
Lithuania	0.1%	0.0%
Malaysia	0.4%	0.1%
Mexico	1.9%	1.8%
Netherlands	0.3%	1.2%
New Zealand	0.1%	0.2%
Norway	0.1%	0.6%
Pakistan	2.4%	0.0%
Paraguay	0.1%	0.0%
Peru	0.5%	0.0%
Philippines	1.4%	0.1%
Poland	0.8%	0.4%
Portugal	0.2%	0.4%
Russia	3.2%	0.5%
Saudia Arabia	3.7%	0.2%
Singapore	0.1%	0.1%
Slovakia	0.1%	0.0%
Slovenia	0.0%	0.0%
South Africa	0.8%	0.4%
Spain	0.9%	1.5%
Sweden	0.2%	0.9%
Switzerland	0.2%	0.7%
Taiwan	0.5%	0.7%
Thailand	1.2%	0.3%
Turkey	1.3%	0.3%
UK	1.2%	7.7%
Ukraine	1.1%	0.0%
Uruguay	0.1%	0.0%
USA	5.7%	38.2%
Venezuela	0.4%	0.1%
Zimbabwe	0.2%	0.0%

excl. Central America & Gulf states
Source: IFPI, US Census, Screen Digest calculation

Market growth through increase of music spending per capita

excl. Central America & Gulf states

	market size 2000	*music spend per capita 2000*	*market size 2005*	*CAGR*
mature markets	32,631.7	43.8	32,631.7	0.0%
Eastern Europe	523.4	2.1	1,118.5	16.4%
Asia	1,328.1	0.6	2,062.64	9.2%
South America	1,821.6	5.3	2,491.32	6.5%
Middle East/Africa	454.1	1.5	551.0	3.9%
all regions	36,758.9	9.3	38,855.11	1.1%

Mature markets: North America, Western Europe, Japan, Australasia
Source: IFPI, US Census, Screen Digest calculation

Consumers in northern European markets spend $75-$100 a year, whilst in the south European markets the music spend ranges from $35-$55 a year, the same level as in the developing markets of Mexico, Brazil or Taiwan.

A comparison of the share of the population with the share of the global record market indicates that some countries account for a higher share of the global record market than their share of the global population would suggest and gives indications of unexploited market potential.

To exploit this potential fully the music industry must take specific measures, some of which are dependent on the circumstances within the individual market. The industry first needs to generate a favourable market infrastructure consisting of

- the right product offering—ie, singles, compilations, different price categories;
- an extensive retail infrastructure including distribution;
- marketing and promotion tools adapted to that market, such as charts, music TV, radio channels promoting new product, etc.

The above three are interdependent and movement of any one will affect the other two. The Internet might prove to be an important help in developing markets, particularly as regards the last two points. Although lower prices might help to increase reach in some markets, it does not necessarily increase the market size. Pricing must therefore be used very carefully in market development, particularly as the consumer's decision-making process in buying a record is not primarily driven by price.

Distribution of consumer types in the global music market

	records bought	*average share of*	
	per year	*total buyers*	*total sales*
	no	*%*	*%*
light buyers	1-3	45	15
medium buyers	4-9	35	30
heavy buyers	10-19	15	30
super heavy buyers	20+	5	25

Source: industry estimates

Under a hypothetical scenario where the developing markets evolve as follows within the next five years:

developing market	*improves to level of (as it is today)*
Russia, Baltic states	Poland
China, India, Pakistan	Indonesia
Brazil, Chile, Argentina	Mexico
Other Latin American markets	Venezuela
most advanced Eastern European markets	Greece
Ukraine	Bulgaria
Saudi Arabia	Egypt
Bulgaria	Russia

The global record market would grow at an annual rate of around one per cent—without taking the population effect (see Chapter 2) into account—and the share of mature markets in the global market (where music spend *per capita* will remain stable at best in the coming years) would fall from 89 per cent to 84 per cent.

Another important feature of the record industry is its dependence on a relatively small number of consumers who spend a lot of money on buying music. Only 4–10 per cent of all record buyers in any one market purchase 20 or more records a year, but this group represents 15–35 per cent of the total market size.

This dependency on super heavy buyers seems to be greater in the more developed markets than in others. On the other hand this shows that there are still a large numbers of consumers who buy little. The industry's market approach must be tailored to address both consumer groups.

The heavy and super heavy buyers are predominantly male and concentrated in the 20–39 age bracket. Fifty per cent of heavy/super heavy buyers are 20-39, and 35 per cent are 20-29.

With such a strong dependency on relatively few consumers the record industry is understandably cautious in its management of any fundamental change coming along with the Internet. This is even more so if the Internet's socio-demographic structure is similar to that of the record industry's core target group.