Slash and burn: redefining the value equation for music

by James Roberts and Julian Dickens

As recorded music sales continue to collapse and Warner, Edgar Bronfman, BMG and Sony continue the cost-saving mating rituals that could ultimately see five majors become three, two other approaches to restoring revenue growth have emerged from the big labels. The first is another foray into paid-for online delivery services, this time inspired by the apparent success of Apple's iTunes. The second – with Universal leading the way – is to drastically cut CD prices. But on closer inspection neither model seems to address the real need of the industry: to develop a new set of product propositions, both online and real world, that will replace the one-size-fits-all CD approach and finally offer something more suited to the varied needs and pockets of music buyers of all kinds.

The woes of the record industry are depressingly familiar: double-digit revenue decline from one year to the next driven by online piracy and retailer pressure on margins, frantic cost-cutting from – let's face it – an industry with some fat to cut, and a rash of merger discussions to provide the prospect of greater leverage and consolidation savings. But cost-cutting will clearly only go so far. A bright and durable future for the majors that emerge depends on a return to revenue growth with defensible margins, both online and in the real world of retail sales.

Two different strategies dominate the industry's initiatives in these areas: in online, a rush to emulate Apple's iTunes initiative and, in the real world, Universal's 30% cut in retail CD prices. On closer inspection, neither looks much like the kind of radical repositioning of music product that may yet save the day for the majors.

The iTunes music shop (see Exhibit 1) was launched at the end of April 2003 as an extension to the existing iTunes software file player.

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Exhibit 1

Apple's iTunes Music Store: proof that legal music downloading can succeed?

Source: iTunes, 2004

Now available on Windows-based PCs as well as on Macintosh, but to date only in the US, it is essentially an online music store. It sells files rather than physical sound carriers such as CDs or LPs. Tracks are sourced from all five of the major record companies, can be sampled free and bought for 99c. They are downloaded to computers for use or for transfer to MP3 portable devices, such as Apple's iPod.

Unlike the majority of the other services, there is no monthly subscription, and the service has relatively generous usage conditions. Apple has clearly learnt from the mistakes of others – you need all the majors to supply content, subscriptions put people off, it has to be a very simple proposition in terms of execution, and usage limitations need to be minimal. It has also dropped the 'utility' model, trialled by competitors, where downloaded tracks become unusable unless a fee is paid every month.

Apple has learnt from others' mistakes – no subscription, all content and few limitations on usage

However, iTunes balances this relative freedom of use with the imposition of effective, persistent copyright control, the greatest requirement of the majors in protecting the value of their content. The last thing they want is for a service to do well if it's just allowing more recordings to leak into the file-sharing environment. The iTunes service allows consumers to copy to physical sound carriers (e.g. CD or iPod) as many times they want, but each track comes with a digital key so that in their original, best sound-quality Advanced Audio Coding (AAC) form they can only be played on three authorised computers, effectively limiting their appeal for online file-sharers. It is possible to convert the AAC file format to MP3, and then upload it to a file sharer, but the resulting audio quality is poor.

The results are positive, if not earth-shattering given the ultimate size of the Apple user base to which the technology was confined until October 2003, when the service also became available to the PC. Company estimates suggest 2m tracks were downloaded in the first two weeks, subsequently falling to a more modest (but still impressive) 500,000 tracks per week. Eight months after launch Apple claimed that more than 25m songs had been downloaded. Industry estimates suggest this level of activity comes from 150,000 to 200,000 active users (see Exhibit 2).

Exhibit 2

How Apple's iTunes service compares with some key competitors

Source: Companies; Mercer analysis, 2004

Service	Launch	Users	File format	Subscription price/month	Download price	Streaming	Burn to CD	Download to portables
iTunes (Apple)	April 2003	150,000 - 200,000[1]	AAC and MP3	None	99c per single track, album for $9.99	No	Yes	Yes
MusicNet (Real Networks, Time Warner, BMG, EMI)	2001	70,000 - 120,000[2]	Real Audio, Windows Media 9	$3.95-$17.95	Varies	Yes	Yes[3]	Not at the moment
Napster (formerly Pressplay)[4]	2001	70,000 - 120,000[2]	WMA	$9.95-$17.95	5 for $5.95, 10 for $9.95	Yes	Yes	Yes[5]
Rhapsody (Real Networks via Listen.com)	March 2003	Does not release subscriber numbers	Windows Media 8	$9.95	79c	Yes[6]	Yes	No

1 Industry estimates
2 Do not release user numbers, some estimates suggest 240,000 together, others are lower
3 Offered with the second release of programme
4 Pressplay, originally launched by Universal and Sony to compete with MusicNet, was acquired recently by Roxio and re-launched under its Napster brand
5 Only to WMA compliant devices
6 Users spend up to 72% of their time listening to streaming, only 13% pay to burn tracks down to CD

"Steve Jobs has liberated us": Sony America CEO Howard Stringer on iTunes

iTunes' figures have been large enough for the major record companies to enthuse, and for other music outlets, such as MTV, to want to compete. Late last year Coca-Cola became the first consumer brand to signal interest, announcing plans to launch its own UK download service. Wal-Mart is trialling a Windows-only service that undercuts iTunes at 88c per song. "I think its going to be amazing," said Roger Ames, Warner Music's chief executive, of the iTunes proposition. Howard Stringer, the CEO of Sony America, described the service as a 'sea-change' in how music is sold, suggesting to a group of executives that, "Steve Jobs has liberated us". Although the gross revenue from iTunes sales is relatively healthy, how much net revenue the digital service is getting after the labels take their cut, and therefore its viability as a standalone service, remains unclear. Its real purpose may be to drive sales of iPods, which accounted for about 7% of Apple's fourth quarter revenue in 2003.

iTunes' product proposition has been carefully tailored to maximise its chances of success in ways that are easily replicated by competitors.

But other conditions have probably contributed as much to its initial success: the Apple user-base has a long tradition of being technophile, media-centric and loyal to Apple; many of the best video and music production and editing software suites are Apple-based. It is also likely that any iTunes user will invest significantly in buying an iPod, the cult white portable music file player which has sold around 1.4m units despite its relatively high price point. Until now this fan base has not had a dedicated legal online music service; the early figures may, at least in part, reflect significant pent-up demand. Apple also has a strong existing brand amongst its faithful. While other online services like Pressplay (now re-launched as Napster after its acquisition by Roxio) and MusicNet had to create brands from scratch, anything with the Apple logo attached is likely to be in a better position to attract attention and prompt trial.

Should the majors bother to replicate iTunes' business model?

So can the iTunes non-subscription model be replicated by the majors? Probably, at least in theory. Other than pre-existing brand equity, there is nothing that the majors could not build into an 'owned' service. But the history of their cooperative working is hardly a model of speed and nimble adaptation to market conditions, and separate operations could both confuse the user and result in no site offering a full range of content and services.

A more relevant question is, should they bother? One of the key learnings from their previous online attempts (including Pressplay, MusicNet) should be when to stay away from those parts of the value chain that others are better at exploiting. If pre-existing brand equity is important, online retailing could be best left to those who have it, such as the Amazons of this world. If the majors still feel it vital to own a direct route to the consumer, they need a clear idea of what they want to achieve, since the business models open to them are many and

varied (see Exhibit 3). Above all, however, unlike iTunes, the majors need to remember that they still have a huge packaged media business, and that any online initiative has to work to in concert with, and not against, initiatives to reinvigorate sales. Looked at in this way, if Universal's price cut proves typical of the kind of initiative the industry will be taking as a whole, making sense of online is going to be an uphill struggle.

Any online efforts must work together with initiatives to reinvigorate real-world packaged media sales

Universal's decision to cut its wholesale and recommended retail price by up to 31%, hoping that retailers will pass on the cuts to consumers, is an attempt to drive enough new volume to offset the cut in margins. They also hope to draw consumers away from the file-sharers, and begin to realign the CD with the cost of other, cheaper packaged media such as DVD. Although the price drop may not necessarily translate into an equivalent level of savings for the consumer – Universal is also cutting its volume discounts to retailers and cooperative promotional budgets – most commentators see it as a move in the right direction.

However, initial estimates suggest that sales need to rise by around one-third to offset the effect of the price cut. To restore revenues to

Exhibit 3

Three potential options and their implications for the music majors in responding to the challenge of online music services

Source: Mercer analysis, 2004

The majors could find themselves in the wrong place in the value chain

Online music service options for the majors

	Do it (all) yourself	**Back office and white label, but keep some control**	**Rely on the retailers for online music distribution**
What's involved	■ Build back end and consumer-facing property ■ License content from other majors ■ Significant marketing to build the brand	■ Build back office proposition, e.g. storage, rights management, delivery ■ License content ■ Have sufficient interest in the entity to maintain control over pricing and promotion	■ Just license content ■ Retailers build back office and consumer-facing elements
Advantages	■ Total control over environment	■ Allows experimentation at a lower risk	■ Low cost/risk
Disadvantages	■ No brand equity, little consumer-facing experience ■ Cost of building back office and consumer-facing front end is prohibitive ■ Little prospect that returns will cover costs ■ The majors may find they are in the wrong place on the value chain	■ Not necessarily in the retailers' best interests because of lack of control over pricing and share of revenue – The service will probably need to be subsidised by the majors	■ No control over pricing, promotions, not an experimental environment ■ Retailers may squeeze margins ■ The majors will not learn a great deal

Universal's 2002 level would require closer to double that increase, a tall order by any standards. Secondly, cutting the price of all product for all demographics can be a clumsy way to respond to a pricing problem predominantly focused on younger users. Music buyers come from many customer segments, including older, more affluent, less techno-savvy (and maybe even more law-abiding) groups. Whether a 30% cut is enough to persuade the price-sensitive downloaders to pay up ($12 per CD is still more than he or she is paying right now, after all) has to be questionable, and it may not make relatively price-insensitive buying segments more profitable. There is a serious risk that a blunt price cut will misfire on both cylinders.

Online pirates aren't just price-sensitive – they also want to use music in new ways

Strategic implications

It's the product, stupid

The majors blame online piracy for falling CD sales. Therefore they believe they need to fix downloading to restore equilibrium to the CD business. 'Fixing it' for the majors seems to mean a mix of stopping it (sue your customers), making it less worthwhile (don't save $18, save $12 instead) and setting up their own online stores (despite no persuasive evidence of pirates flooding to iTunes) which replicate many of the existing faults in their real world retail propositions, such as static, albeit cheaper, pricing.

But online pirates aren't downloading just to save money; they also want to use music in a different way, including selecting only the tracks they want, storing and sharing them, and carrying huge playlists around on a variety of portable media. From this perspective, CDs are a poor product for the file-sharers. But if the majors can get the music off the CD and into a new product proposition, maybe the future will look a little brighter.

CDs seem expensive relative to other demands such as mobiles, games and tall skinny lattes

To consumers who have been exposed to iPods or other MP3 players, CDs appear static, inflexible, pre-selected and awkward to carry around. They are also expensive relative to other demands on their pockets such as mobile phones, computer games and tall skinny lattes. To many media consumers, they look increasingly poor value compared with other media products. Digital has brought the consumer more for less in nearly every medium – 200 TV channels where we used to get 20, DVDs with the movie plus out-takes plus interviews plus games – but the CD has stayed the same: 40-60 minutes of recorded music in an irritatingly fragile case, and minus the artwork and (legible) sleeve notes that its vinyl predecessor had to offer. Critically, the price itself has also come to look overly rigid; on the whole, it makes little difference if you buy an album in its first week or after five (or 15)

years, or whether it sold one copy or a million – one price fits all, pretty well for all time.

Yet despite all this some customer segments still buy them in their millions, so let's assume we shouldn't rush to throw them out altogether. There may not be much to gain by dropping the price to everyone – including the relatively happy buyers who don't want to download, pre-select, or share. Instead the music industry needs to develop a range of music products, at a range of prices, to suit the differing customer needs of all its key customer segments – without going broke in the process.

The record industry needs to listen to customers and develop a range of products at a range of prices

Developing a new proposition will be complex but not as painful as the majors might think

The challenge for the majors is to reinvent the business from the bottom up, rather than slash it from the top down. This will require something the industry has not been known for: listening to all its customers very hard in a granular and sophisticated way. Different customer segments will value different aspects of music in different ways and – as with DVDs – at different times (for example they may be willing to pay more for a new release, but expect to pay less as the product ages).

The industry will no doubt have to face up to unpleasant surprises but may also find pleasant ones; some customers might happily pay for some of the giveaways the majors have resorted to in their desperation to support the collapsing CD model, such as cover-mounted CDs on magazines; or they may value a limited-edition ring-tone clipped from a new release as much or even more than the CD it came from. Customer-focused market research must be linked to robust pricing analysis to accurately devise and position new products, and adapt and re-position existing ones in order to maximise revenues and margin from all customer segments.

Although such analysis is new and may seem complex to the record industry, other retailers have been benefiting from price experimentation for years. The same tools developed by Mercer for use by supermarkets – offering more than 100,000 product variants to their customers across thousands of stores, with infinite combinations of special offer, shelf space and marketing resource – are adaptable to the record industry which already depends on those retailers for a huge slice of its revenues.

Compared with collapse, complexity could be just the thing ■

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