



Music industry still on song

But key changes are playing out

June 27, 2008

Digital music market increasingly calling the tune. The music download business is booming in Germany (unit sales rose 39% in 2007), whereas sales of physical recordings are falling (down 4% in 2007). The industry's decision to scrap copy protection will give the digital market a further boost. The traditional recording industry is attempting to share in this growth by entering into alliances (with, for example, mobile communications companies, makers of mobile phones and mail-order firms).

Music industry at the crossroads. Digital content and the increased importance of the internet have led to the record companies losing control of the distribution of music. Efforts have been made in vain to stem the tide of illegal copying of music using legal and technical means. Instead, industry outsiders (e.g. Apple with its online store for music downloads) seized their chance to enter the market and contribute to the value-added process.

Concerts becoming ever more popular. Music reproductions are universally available, simple and cheap to obtain and are thus increasingly becoming commoditised. While the recorded media market therefore implodes, concerts are drawing ever larger audiences as music is gaining importance for consumers when it is performed live in concert. This trend facilitates higher prices and enables the event market to further extend its turnover advantage over the recorded media market in Germany. Inevitably record companies and concert promoters are battling for market share. A new business model is becoming established: the 360-degree deal, i.e. the marketing of all an artist's activities.

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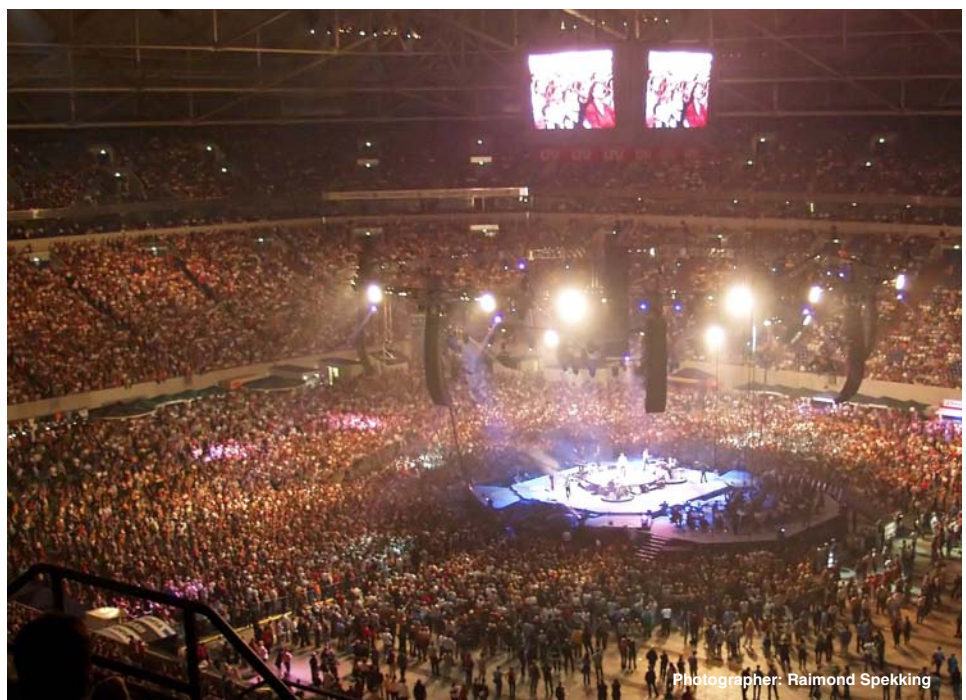
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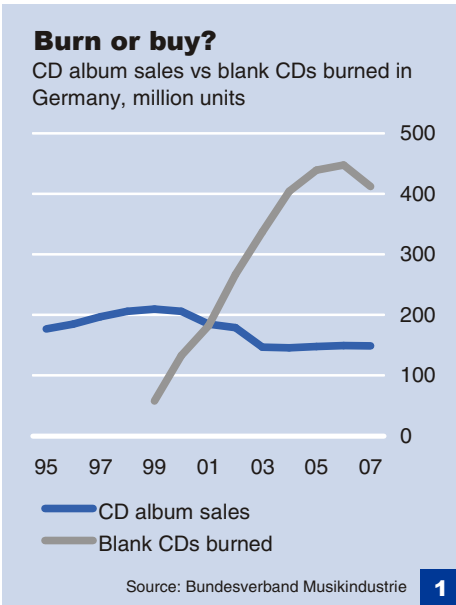
Photographer: Raimond Spekking

Introduction: Music consumption is changing

The international music industry has been in upheaval for years. A number of changes have already taken place: from the advent of digital music and its universal availability in online file-sharing networks to the introduction of Digital Rights Management (DRM) copy protection systems – and their subsequent scrapping – and ultimately to legal download offerings becoming established on the internet. Implementation of all these measures has, however, been unable to arrest the decline in sales of music – that is of both physical recordings and digital downloads combined.

This does not mean that music has become unimportant as a consumer good. There is no substitute for music consumption; it is nevertheless increasingly being enjoyed in a different form: audio files have become more popular than CDs, falling unit sales of recorded music tracks stand in stark contrast to rising expenditure on live concerts. So the music business is spawning new revenue streams and market players are responding – the upheaval is heading for its next phase.

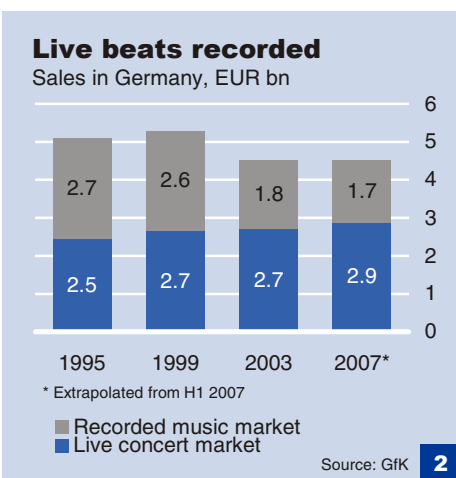
In this report we focus on the recorded music and live performance markets as key elements of the music business. We describe both the changes that have occurred to date as well as current developments. We conclude by drawing a comparison with the media industry, which is battling with similar problems, and give our assessment of the outlook for the music industry.¹



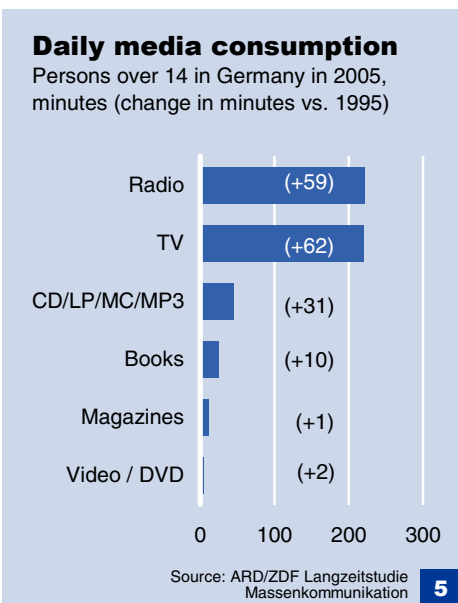
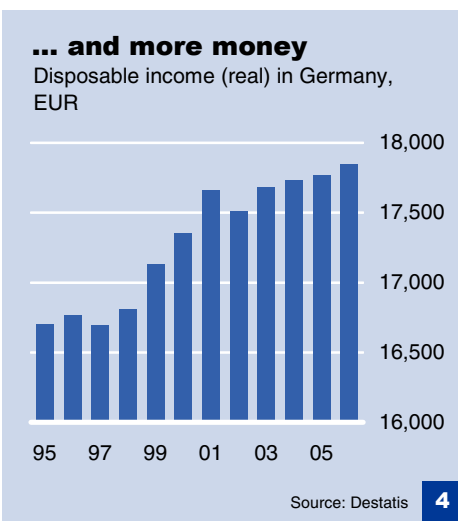
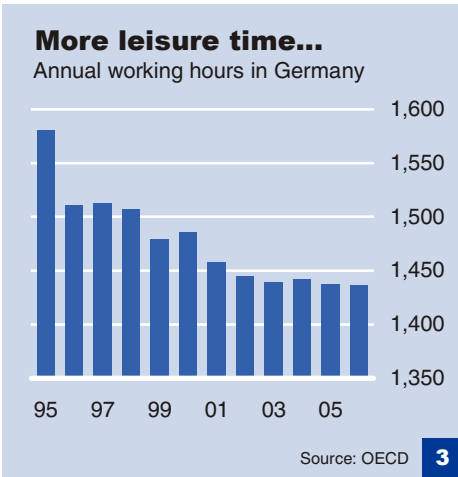
Digital technology and interconnection are driving change

The recording industry has been confronted with numerous technological changes over the last few decades. Digital technology, which initially triggered strong market growth thanks to the introduction of the CD, has had a lasting impact on record companies' established business models. Digital technology has after all enabled music to be copied more cheaply and most importantly without any loss in quality for the first time. CD burners have allowed consumers to make high-quality copies of their own virtually free of charge. This led to a decline in recording industry sales. There was a similar sequence of events when the compact cassette was launched: initially sales went up, but subsequently the ease of home copying had a negative impact on sales.

The possibility of making digital copies did not, however, remain the only innovation but was supplemented by the advent of the MP3 format. This new standard compounded the impact of digital technology, because it meant that music no longer had to be delivered on a physical medium. Internet users were thus able to obtain music files easily, quickly and virtually free of charge from the music-sharing networks that sprang up from 1998 onwards. These file-sharing networks were freely accessible. Music thus became even easier to acquire and for the recording industry it became more and more difficult to charge prices that covered their costs. The music labels lost more and more control of distribution, the key stage of the value chain. In addition, the uniform digital standard provided the basis for the technological convergence between previously independent



¹ We would like to thank Andrea Schütz of the Musikgymnasium Schloss Belvedere (Weimar) for her valuable assistance in producing this report.



sectors. This helped the music industry outsiders to enter the market and thus intensified competition.²

Live entertainment takes centre stage

The changing face of the music industry is highlighted by the shift in the breakdown of revenues: the live music segment is generating a sharply increasing share of sales at the expense of recorded music. The live concert market in Germany has grown by 18% since 1995, whereas unit sales of recorded music have fallen 38% over the same period. In the past twelve years the live concert business has overtaken the recorded music segment and generated turnover nearly twice as high as the latter in 2007. The number of regularly held music festivals in Germany almost tripled from 136 in 1994 to 360 in 2007.³

The growth of the live concert market in Germany can partly be explained by the trends in working hours and income. Between 1995 and 2006 the average annual working hours of the workforce in Germany declined by some 9% at the same time as real disposable incomes increased 7%. It should be noted that many consumers still satisfy their personal music demands via illegal and consequently largely free internet downloads. The share of the consumer's media and time budgets that has been freed up is evidently being partially absorbed by the live concert market.

The revenues generated by the live concert market confirm that despite the crisis in the recorded music industry music has certainly not lost any of its importance. Rather, it is the daily usage of audio media (CD/LP/cassette/MP3) that tripled between 1995 and 2005 – total duration is now 45 minutes – which means it is much higher than for alternative media formats like books or videos/DVDs. In addition, the share of overall consumption expenditure allocated to entertainment in Germany increased from around 10% in 1993 to about 12% in 2003. This trend will continue in the next decades.⁴ The shifts in the music market are thus the result of rising incomes, increased leisure time, falling prices and technological facilities.

In addition, attending a concert is a particularly good way to satisfy one's social needs. Although the experience of being at a concert has long been an important element of music consumption, the increasingly individualised form in which music is now enjoyed possibly may not fulfil the listener's desire to belong to a group of like-minded people and identify with the artist in the same way that the traditional buying of music in a record shop once did. In this context concerts are becoming more important for consumers.

Reactions to digitisation

The recording industry's first response to the decreasing marketability of their music was to try and take legal action against the file-sharing networks. These attempts were unsuccessful and tarnished the image of the industry. Consumers did not approve of the companies' decision to seek legal recourse and felt they were being criminalised. The record companies then introduced technical copy protection mechanisms to control the distribution of music. In the

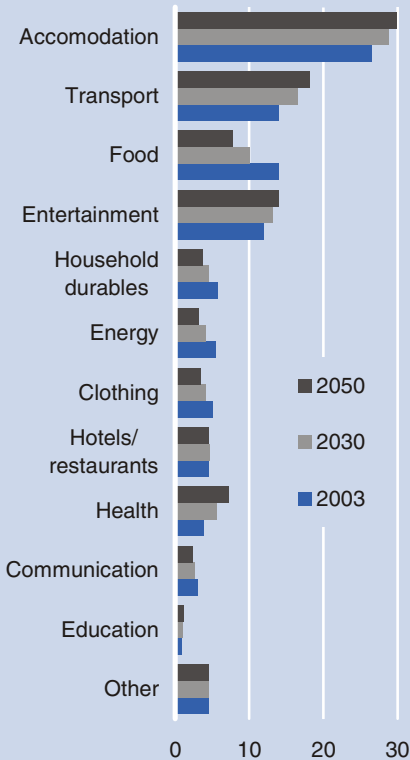
² See Stobbe, Antje and Tobias Just (2006). IT, telecoms & New Media: The dawn of technological convergence. Deutsche Bank Research. E-economics 56. Frankfurt am Main.

³ Willnauer, Franz (2007). Musikfestspiele und Festivals. In Musik-Almanach 2007/08, p. 65. Regensburg.

⁴ Schaffnit-Chatterjee, Claire (2007). How will senior Germans spend their money? Deutsche Bank Research. Current Issues. Frankfurt am Main.

Entertainment gaining ground

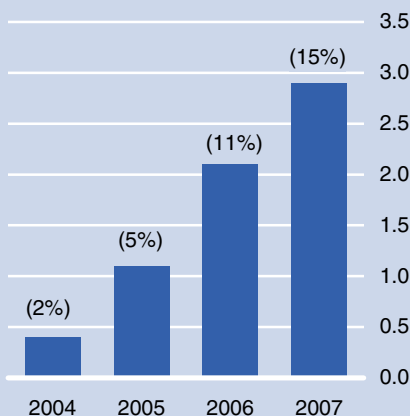
Share of total consumption expenditure by households in Germany, %



Sources: EVS 2003, DB Research **6**

Online is where music is at

Digital music sales worldwide, EUR bn (share of overall music market)



Source: IFPI **7**

download stores set up by the record companies from 2001 onwards the music files on sale could only be copied a limited number of times by the consumer and could not be played back on all media devices. These restrictions were heavily criticised by consumers. Furthermore, the major music labels (Universal, Sony BMG, Warner and EMI) could not agree on a single, comprehensive music catalogue, which meant the choice of music available remained small. That is why these download stores enjoyed limited success and DRM remained just an episode in the annals of the music industry. At the start of 2008 the last major label stopped trying to enforce copy protection. In hindsight it would probably have been better for the recording industry to utilise the benefits of file-sharing networks (low transaction costs, broad offering, ease of access) for their own business models.⁵

Apple showed how this could be done successfully by opening its “iTunes Music Store” download platform in 2003. This was the first time that the music catalogues of all the major labels had been licensed and bundled in a single online offering. Apple uses the music service primarily as an instrument for promoting its own MP3 player. Apple now commands a large share of the market for online music distribution and accounted for some 70% of the world’s largest music market – the US – in 2006, for example.⁶

The digital music market overall is experiencing unfettered growth. In 2007 its share of global revenues was 15% and thus nearly three times as high as just two years earlier in 2005. Although CD sales still generate around 80% of global music revenues, consumers are already satisfying their music demands more frequently via downloads rather than with physical media. The number of illegal downloads in Germany is three times as high as the number of legal ones.⁷ It is already foreseeable that in a few years the lion’s share of sales will come from digital music delivery. When exactly this will happen depends to no small degree on how vigorously digital music distribution is promoted by the established players in the recording industry in the years ahead.

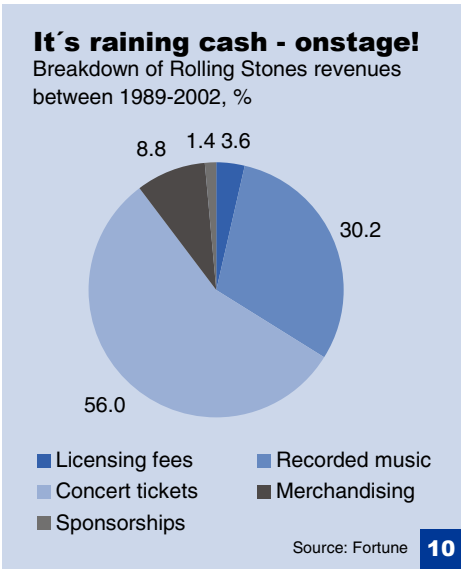
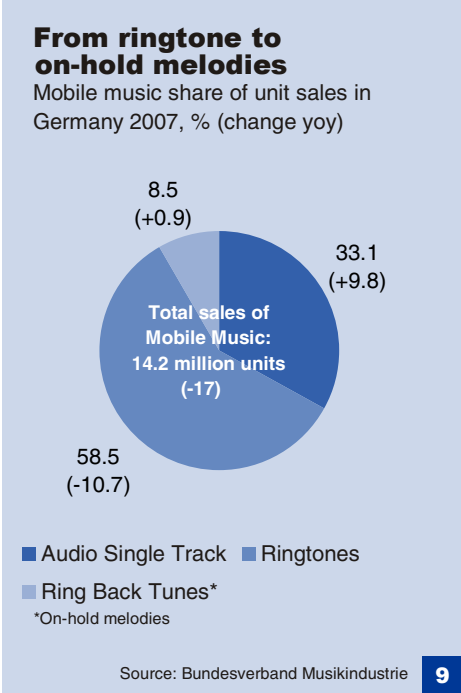
One of the keys to the success of iTunes was the migration of the existing large customer base to the new music platform. The story is similar at the online retailer Amazon, which started its own internet music service in September 2007. Here, too, there is already a broad customer base that is now being offered an additional portfolio of music. One advantage is the company’s existing expertise in the online retail business. In contrast to iTunes, the Amazon music store is the first to offer the catalogues of the four big labels without copy protection and can thus be regarded as taking the iTunes concept to the next level.

Choosing a close alliance with distribution partners instead of developing their own sales concept for online music is a risky strategy for the record companies. They are thereby making themselves dependent on these partners. Nevertheless, the potential of already existing customer portfolios can be fully exploited, thereby saving costs.

⁵ Schaaf, Jürgen and Jan Hofmann (2003). Copyright reloaded: The attempt to protect technology from itself. Deutsche Bank Research, E-economics 41. Frankfurt am Main.

⁶ According to market research conducted by the NPD Group. Press Release on March 14, 2007.

⁷ This number is based on a survey of 10,000 people conducted in 2007, see GfK: Brennerstudie 2007. According to other estimates illegal downloads outnumber legal downloads by a factor of between 10 and 20.



Music on the move: record companies go mobile

Mobile handset makers like Nokia are also potential partners for the recording industry, as they have many customers who are interested in online music.⁸ The "Mobile Music" segment promises high growth rates: on the one hand, continuing strong demand for mobile end-user devices can be expected from emerging markets in particular, and, on the other, in saturated markets like western Europe entertainment packages are becoming an important instrument for companies to underline their uniqueness. Initial successes are already apparent. In 2007, 5.2 million songs were downloaded to mobile phones in Germany – a 53% year-on-year increase.⁹ This business model was only made possible by the increase in memory capacity in mobile phones and higher data transfer rates of the UMTS network. The billing options being tried out are subscription models as well as flat-rate tariffs in which the subscriber pays a single fee and then has unlimited access to the music catalogues of the respective partner record companies.

Full arenas – empty record shops: Implications for the music industry

One thing is clear to the big record companies: making huge investments in the marketing of artists in order to turn them into superstars and then simply bringing out record after record and making profits from their distribution is a thing of the past. The money is now to be made elsewhere. The example of the perennially popular band The Rolling Stones clearly illustrates how great a shift there has been in the relative significance of their individual sources of revenue. Between 1989 and 2002 the band generated sales of recorded media totalling some USD 522 m. Adding the receipts from concerts and merchandising swelled revenues to no less than USD 1.5 bn or so.¹⁰ It should be noted that this period also included the golden age of CD sales.

This example shows the dilemma facing the major labels: although they pump money into establishing artists their cut of the largest sources of income is relatively small. That is because to date only a few business models in existence guarantee that record companies directly obtain a large share of concert revenues. The logical conclusion is that record companies will muscle into the live concert market going forward.

On the other hand, promoters see an opportunity to strengthen their commercial ties with artists and assume functions traditionally performed by record companies: production, marketing and distribution of recorded media. So for their part they are positioning themselves in the recorded music market and are becoming rivals to the music labels.

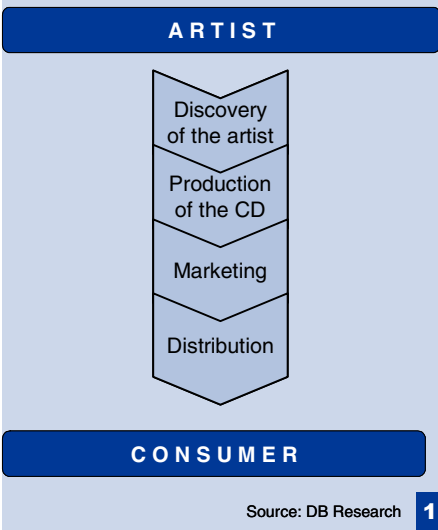
This competitive situation has given rise to the new concept of total marketing of an artist, the so-called "360-degree deal". In such deals artists are managed by just one company that handles not only the licensing, production and distribution of CDs/DVDs but also the marketing of concerts, merchandising and TV appearances. In return the company takes a cut of all the artist's sources of income. Not so long ago in 2007 the promoter Live Nation caused a

⁸ Schaaf, Jürgen and Jan Hofmann (2005). The future of the music industry: a concert of distribution channels. Deutsche Bank Research. Frankfurt am Main.

⁹ Media Control (2008). Legal Musikdownload weiter auf dem Vormarsch. Press Release on April 11, 2008.

¹⁰ See Fortune (2002). Inside the Rolling Stones Inc. September 30, 2002.

Value chain in the recording industry



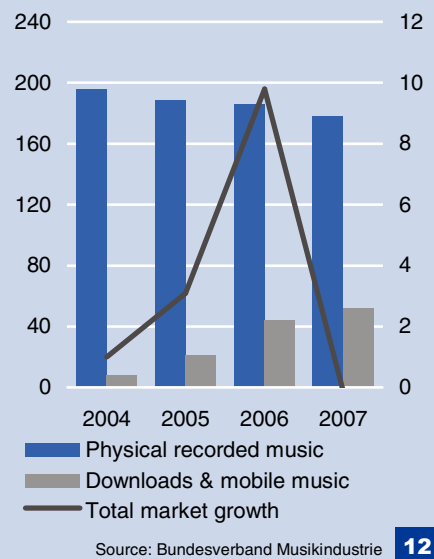
sensation when it landed a major coup by signing the singer Madonna in a 360-degree deal and thereby seriously ruffling feathers in the record labels' territory. But that was not all: the company also set up a division called Artist Nation that aims to sign up other artists. Apart from taking a cut of the profits at all stages of the value chain this model also allows the exploitation of those segments where there is a crossover between the recorded music and the live concert markets. For example, at the end of the show concertgoers could be sold recordings of the evening's performance in addition to the artist's standard studio repertoire.¹¹

It's not only America searching for an Idol

Corporate marketing strategies are also in the process of changing. Some companies are being slimmed down and rigorously focusing on the core functions of a record label: discovering and marketing artists. Sales and distribution of physical recordings then assume secondary importance. The aim is to sign up artists with the potential to become superstars at the earliest possible stage. The commercial links with such potential stars are extremely important to the record labels, given that only a very small percentage of the artists under contract generates the lion's share of profits.¹² The major importance of these few moneymakers justifies huge investments in marketing a portfolio of artists that is believed to contain potential superstars. The situation is similar in the pharmaceuticals industry, in which huge sums are invested in R&D in the expectation of hitting the jackpot with at least one blockbuster product. The record labels by contrast cannot, however, rely on effective patent protection, so signing up artists in a timely manner on long-term contracts is essential to their success. Of course there is nothing new about this strategy; discovering and marketing artists has always been a key occupation of the recording industry. The new aspect, however, is that the stiff competition is forcing companies to constantly re-evaluate their portfolio of artists with an even more critical eye on its financial performance.

Zero growth in 2007

Sales (million units, left) and market growth (%) in Germany

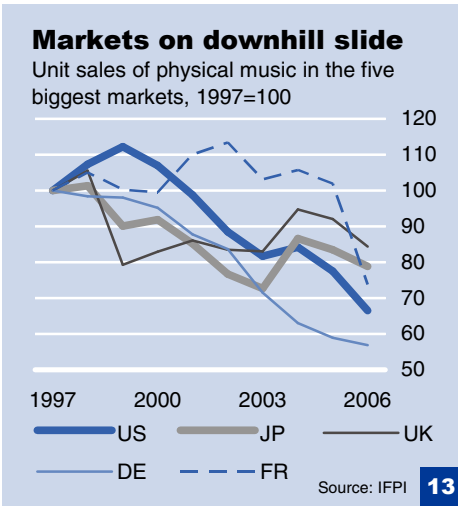


One countertrend in which the record companies have only managed to play a much smaller part is the successful phenomenon of casting shows. These shows market newcomers who cost nothing to be discovered; on the contrary during the televised casting phase huge profits can be generated via advertising revenues, merchandising and the sale of magazines tied in to the TV show. Once that phase is over alternative sources of income open up in the form of appearances on other shows, CD sales and live concerts. Given the usually temporary popularity of the winners of casting shows one series is quickly followed by the next in order to ensure that each artist is promptly replaced by a "fresh face".

By contrast, the traditional marketing strategy of establishing artists with a view to longevity is focused on longer careers for performers which promise higher revenues from live concerts. Overall, this model is more risky because large investments have to be made at the outset, profits are a more distant prospect and are less certain – but these profits are however exceptionally large in the case of success.

¹¹ According to the most recent survey (conducted in 2004) just 1% of CD sales were generated at live shows in Germany. See GfK (2004), Studie zum Veranstaltungsmarkt in Deutschland, Hamburg.

¹² For example, according to estimates only 3% of the artists signed to EMI generate profits. See Financial Times: Creative types must face the music. March 6, 2008.

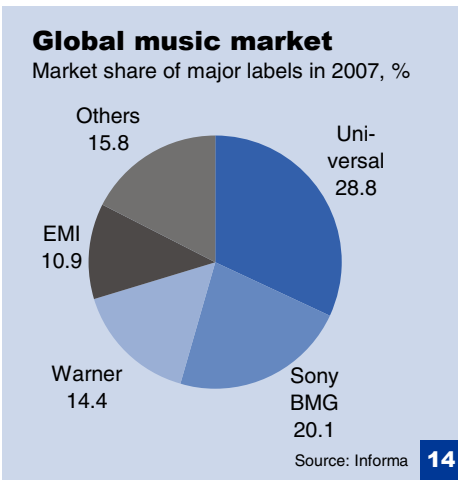


The aim of both strategies is to develop stars. They can then be marketed via recorded media sales, concerts or on television.

Learning from the print media

The print media face problems similar to those in the music industry. The online information overload resulting from digitisation is reducing consumers' willingness to pay for news.

In the newspaper business – in contrast to the music industry – some companies have responded faster to technical innovations and clung on less to traditional distribution channels. Newspaper publishers have provided comprehensive online offerings largely free of charge. They have also allowed users to access archive material. At the same time they have encouraged users to actively participate online by posting their own comments. This is how online communities have become established and users have become faithful supporters of news portals. In order to communicate within these communities users have to register and divulge information about themselves, which opens the way for personalised advertising. More vigorous targeting of advertising at specific groups minimises wastage, thereby making it more valuable and an appealing source of income for online news providers. In addition, opening up one's archives increases the likelihood of getting noticed during an online information search. This increases the number of page impressions and boosts advertising revenues. The newspaper segment has thus used technological changes to generate new sources of income.¹³



Consumption à la carte

In the print media it is standard practice not to sell articles individually but as a complete package (newspaper). This enables the readers' differing levels of willingness to pay for individual articles to be exploited and a higher price to be extracted. On the internet, however, news stories are available individually; the consumer can procure specific information. On the internet news providers have thus been compelled to abandon their traditional practice of bundling their product. It is a similar story in the music industry. File-sharing networks led to the establishment of an online offering of individual tracks. The incentive to buy a whole album declined as consumers could buy their favourite songs one by one. Newspapers used the unbundling of the product to draw conclusions about their readers from the articles accessed and to increase the personalisation of their advertising. There is a strong need for music providers to create models that tailor advertising to consumers based on their musical tastes.

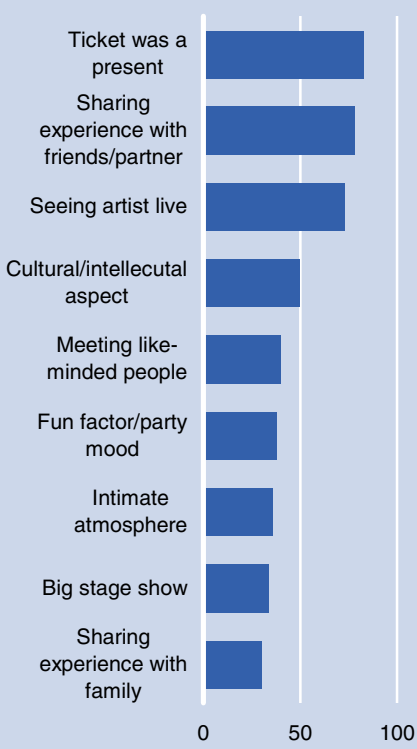
Conclusion: Music from the electric socket – is that the future?

Music is ubiquitous in everyday life and is virtually like electricity from the socket. For consumers it is increasingly becoming a commodity, a universally available good without distinguishing characteristics. This makes it difficult for record companies to establish customer loyalty via music content. In addition, the number of alternative entertainment options is constantly on the increase. That is why the willingness to pay for music – whether physical recording or a download – has declined significantly. There is a

¹³ Technological changes also benefit the media industry of course. Personalised advertising is thus made easier by the internet, and the reach of the media is increased.

Meet people – enjoy the experience

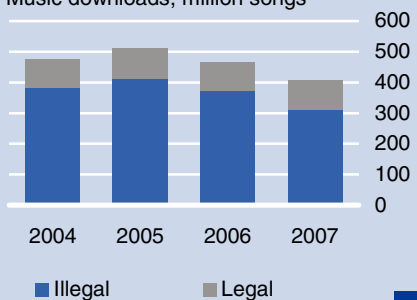
Reason for going to a concert 2007, %



Source: GfK **15**

Germans like it illegal

Music downloads, million songs



Source: GfK **16**

trend towards concert-related music becoming increasingly highly valued. This trend explains the differing growth rates of the recorded music and live concert markets. Nevertheless, the live concert is not a replacement for home consumption; there are differing motives for both pursuits: with concerts the experience of a live performance and the social element are the main aspects – at home it is the pure musical enjoyment. Rather, this trend was triggered by the technological changes that have made music so much cheaper (albeit illegally in some cases). This created the financial scope that consumers could utilise for going to concerts, among other things.

Media convergence (of internet, computers, mobile phones and MP3 players) makes a common format for all storage media increasingly important. That is why digital data is cementing its success, whereas the physical medium CD is losing ground. In the long term we will probably see the CD becoming a collector's item in just the same way as the traditional record did.

The music business is seeing a shift in its sources of income: money is no longer made in the studio but instead onstage. For the record labels this means that they are increasingly becoming service providers: besides marketing they are performing in some cases the important function of promoting concerts. By contrast, production and distribution of recorded music are becoming less important. At the same time, as well as the labels, event promoters are playing an ever greater role and newcomers are entering the market. New business models are being created, new alliances are being set up, e.g. by record companies that are distributing music online via social networking sites (Facebook) or via flat-rate music offerings for mobile phones (Nokia) or concert promoters collaborating with the hospitality industry. The traditional value chain is changing more and more into a complex value creation network.

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