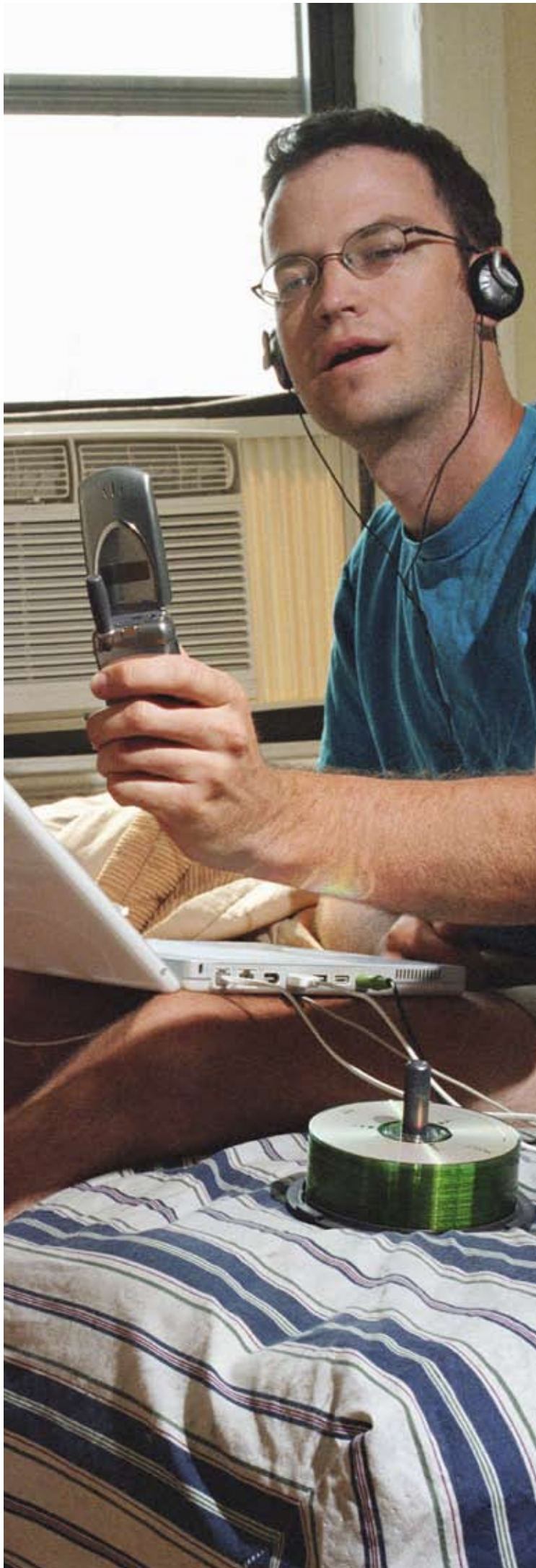


On Media

Recorded Music – Who benefits from digital?*





Strategy, regulation and valuation insights from PricewaterhouseCoopers (PwC) in the Communications, Entertainment & Media sector.

Summary

Recorded music has seen the growth of digital distribution transforming the economics of the industry. Over the last decade, consumers, artists and technology companies have gained from this digital disruption. In the middle of this state of flux, we believe it is a good time to re-assess the outlook for the industry. Who benefits from the digital age, and what are the opportunities open to key players in the industry?

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Introduction – The “Digital Disruption”

Over the last decade, the music industry has seen the emergence and rapid growth of digital distribution at the expense of physical formats. Many record labels have suffered falling revenues and profits in recent years. Contrary to popular belief, people are not tuning out of recorded music - far from it. Digital technology has enabled recorded music to proliferate, and people are listening to it more often and in more places than ever before. Revenues, however, have not kept up with the pace of listening growth, as consumers are buying less “pre-packaged” music, especially in permanent, physical formats. We assess this changing landscape, particularly focusing on the economics of music, in order to speculate as to whom might benefit in the digitally-driven industry.

The Changing Landscape

Consumers are consuming more music than ever before, both in old and new media. Since MTV appeared on our TV sets in 1981, there is now a plethora of music channels on satellite, cable and digital terrestrial television offering 24hr-a-day music that appeals to all tastes. Radio has diversified further, particularly through the development of digital, satellite and internet radio, offering almost unlimited choice. Video games, films and advertising use music extensively and can now provide an alternative springboard to success for artists (e.g. the use of a song in a commercial or game can drive chart success).

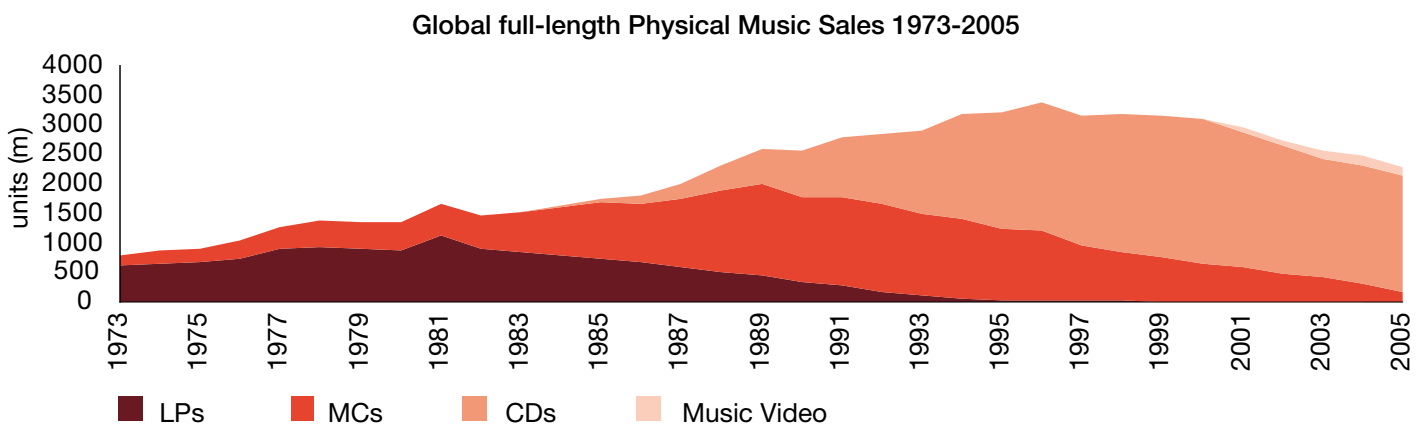
But the move to digital has not stimulated a significant purchase (replacement) cycle, unlike prior format changes. In the 1980s the technical superiority and greater convenience of cassettes, the replacement technology for LPs, stimulated a wave of buying where consumers re-purchased their existing collections in the new format; the same pattern emerged in the 1990s in relation to the replacement of cassettes by CDs. Now, the ease with which consumers can ‘side-load’ their CD collections onto computers for transferring onto digital MP3 players at the same, or even

higher quality than the digital download products offered by the majors, means that there will be no comparable “replacement cycle” with digital. As Chart 1 illustrates, overall physical format sales (unit volumes) have been in sharp decline following the phasing out of LPs, cassettes and CDs.

While volumes have declined, the negative effect on revenue has been multiplied by declining real prices and more fragmented purchases. Supermarkets have established themselves as a major channel for music retailing, stocking a smaller range of music, at lower prices than specialist retailers. Music online purchases tend to be in lower volumes at lower prices – online retailers have unbundled the album.

In addition, record companies have experienced a loss of revenue through piracy, or simply through more music being freely available. Piracy, both physically in the form of CD-R duplication, and digitally, has been a feature of the industry. And the proliferation of channels allows people to consume, both actively and passively, without purchasing music.

Chart 1: Global Trends in Physical Music Sales



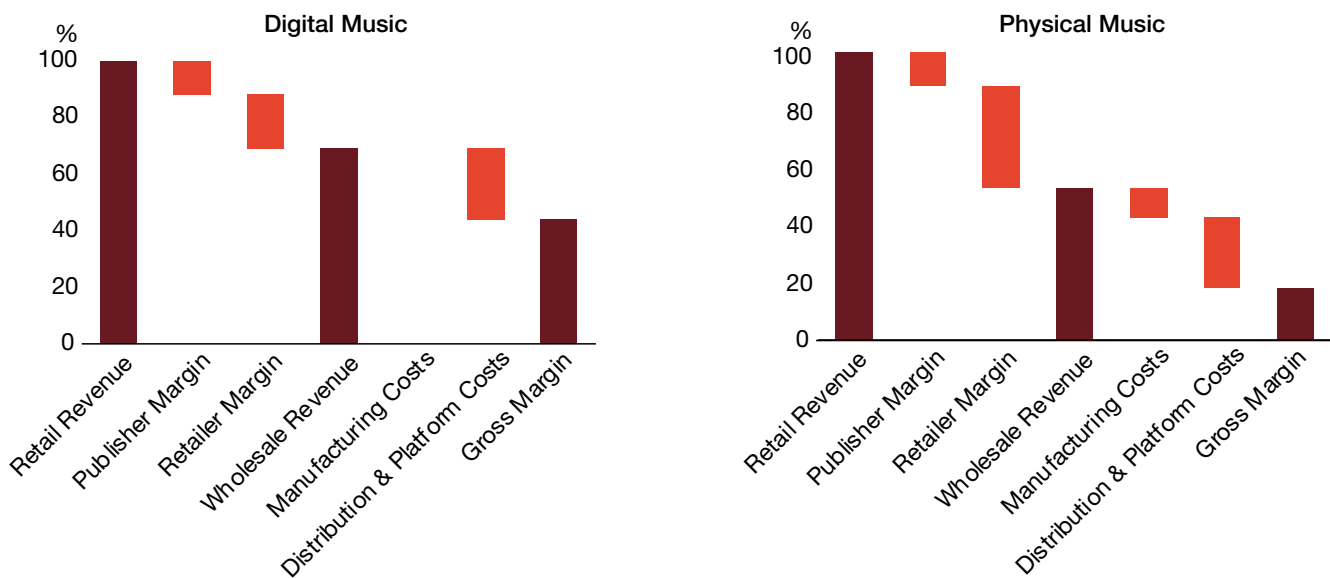
Source: International Federation of Phonographic Industries

Industry Economics

In light of the changing industry landscape, we consider below the economics of recorded music, with particular reference to the relative economics of digital versus physical music products, and the impact of piracy.

Digital distribution of music is typically more profitable than physical distribution, as a result of lower retailing and manufacturing costs. As Chart 2 below illustrates, we estimate digital margins are c.15ppts higher than physical margins; and record labels receive a higher share of the selling price than non-digital products.

Chart 2: Margin Analysis for Physical vs. Digital Music (Percentage of ex VAT retail revenue)



Source: PwC Analysis

However, the unbundling of the album by online distribution networks has reduced revenues. The single-track download model, whereby users choose to purchase only songs they wish to, has proved to be an appealing proposition (especially where discounts for buying the whole album have been minimal). User reviews, opinions and song-matching tools allow users to sort the 'killer' from the 'filler' tracks, and the fixed-price model operated by online retailers such as iTunes currently prohibits the price discrimination within an album that could make less appealing album content sell better. Consumers therefore purchase less, and more selectively, online than they do with physical formats. There have been some efforts to improve the lower volumes that unbundled albums create. For example, Warner released Madonna's 2005 album 'Confessions on a Dance Floor' as an entire bundle initially, then released the individual songs for download. But generally, in digital, the customer has been granted the right to 'pick and choose' specific tracks, a significant customer benefit compared to prior formats.

There generally appears to have been some mis-match between online pricing of singles versus albums. The highly competitive

headline pricing of digital song downloads – c.79p in the UK on Apple's iTunes service, against £2-£4 for CD singles (on which consumers typically want only one track), compares with only small differences between physical and online album pricing (c.£9 for CDs on Amazon versus c.£9.50 for a 12-track album on iTunes), notwithstanding the differences in physical characteristics of the products. We believe there is scope for the industry to improve the incentives to purchase packaged album products online, hence addressing the volume decline.

Piracy is a significant problem, but one that arose in digital as pirates took control of the online distribution platform sooner than the music majors. Annual trading updates from the music majors continue to mention piracy as a key factor in lower revenues and profits. In the courts, record labels have stepped up measures to dissuade users from pirating material, and closed down popular file-sharing services. The industry is fighting a difficult battle on two fronts: it faces a strong and entrenched network of physical format pirates who create and sell illegal versions of cassettes and CDs, and the more recent challenge of online piracy.

Music Retailing

The move to producing and selling music digitally has altered the traditional industry structure. Prior to this 'digital revolution', music majors held significant power, selecting and promoting artists and exercising immense influence over what became popular. Similarly, in retail, restrictions allocated over shelf-space and the policies set by retailers also strongly influenced which products were available for purchase. However, the development of mechanisms to share recommendations, feedback and build networks of similarly linked products (be it songs, artists or books) has made providing consumers with practically unlimited choice a viable proposition.

In contrast, online retailers, such as Amazon, provide the means for consumers to find the 'Long Tail' niche songs and artists. The key facilitator in this development has been the Internet, allowing services to build up significant databases of consumer preferences, opinions and suggested products they may wish to purchase. Preference-driven internet radio such as Last.fm is perhaps the most well-known example of a music discovery tool.

Less popular artists, who may have struggled to gain a major record label deal, are leveraging these recommendation networks and alternative marketing tools such as social networking to achieve success independently. Large bands and solo artists have released records without major labels (and even without formal pricing - Radiohead released their 2007 album 'In Rainbows' online first, with fans choosing how much to pay (reports suggest that on average, buyers paid £4)). Since 2003 Magnatune, a label featuring unknown artists, has allowed full streaming of tracks prior to purchase – a study of purchasing behaviour revealed consumers paid c.\$8 (£4) per album, significantly above the minimum price once the uncertainty over the product's quality was removed (through streaming access).

Online subscription models have met with customer resistance. Consumers have been offered arrangements through which they can gain wide access to providers' music catalogues, conditional upon continued subscription.

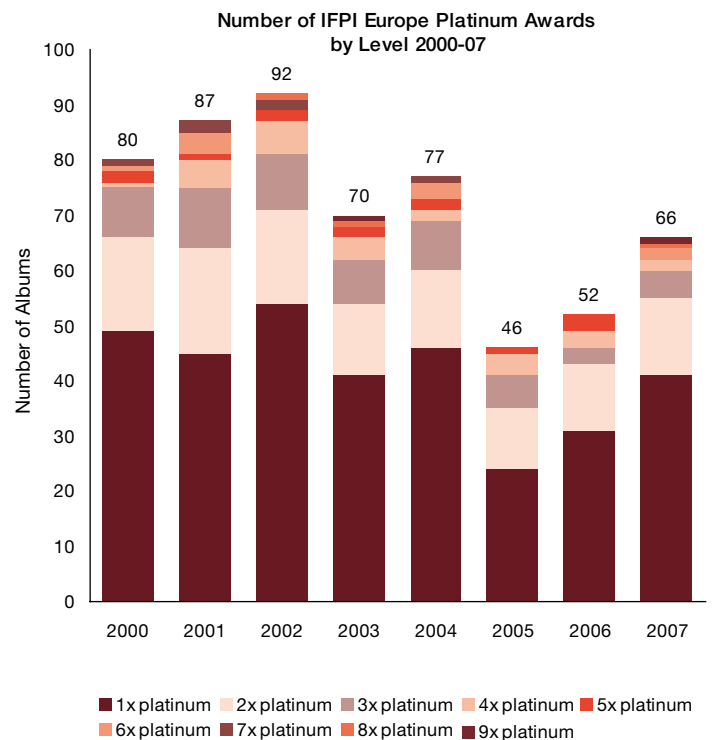
To date, subscriber growth for such services has been slow for a number of reasons:

- Subscription models represent a significant departure from the traditional concept of purchasing and owning music – unlike in TV, a subscription does not necessarily guarantee access to otherwise unavailable content
- Incompatibility between portable music players (absence of common standards, which in other industries such as subscription TV have facilitated growth)
- More limited selections of product: eMusic, the second largest catalogue, offers 3m tracks compared to market leader Apple iTunes Store's 6m tracks, music videos, TV shows and podcasts.

Mobile music downloads constitute half of global digital music market revenues. Mobile has opened the market to new players, but may offer majors a strong source of new revenues.

Historically sales of ringtones have driven mobile revenues, but more recently synthesised tones have been evolving into "real" songs. The rollout of music-focused handsets supported by higher network speed will help drive sales, particularly of full track downloads.

Chart 3: Fewer "Big Hits" Are Being Produced



Source: IFPI

Increasingly sophisticated handsets such as SonyEricsson's Walkman range and Apple's iTunes-integrated iPhone allow storage of large volumes of music, and further rollout of 3G networks is allowing faster over-the-air downloads. The purchase of ringtones and music has brought new content companies, handset vendors and mobile network operators into the music market. The labels' share of this platform is not insubstantial, with services such as Nokia's proposed 'Comes With Music' unlimited subscription to Universal Music artists believed to offer around £60 per year per subscriber to labels. This type of arrangement has the potential to create a real "win-win" – it generates new revenues for the music majors and provides a degree of certainty to new entrants over content costs, underpinning their marketing initiatives.

Who benefits?

The shift from physical to digital formats has fundamentally changed the way consumers access and consume recorded music, the prices they pay, and the underlying margins for the music companies. The outcomes are far from clear; however, we speculate below as to the potential winners (and possible losers) if existing trends continue to play out.

Consumers win... The undoubted winner has been the music consumer: Supermarkets and online retailers have greatly reduced the price of CDs, while digital music stores have led to more informed, selective purchasing, offering generally lower prices than for physical product. Online radio, a vast selection of music television, unsigned artists distributing for free online, and of course, piracy, mean that consumers no longer need to pay to listen to music. PwC expect this trend to continue.

...And so do the Artists. Artists are benefitting from the growth and range of new distribution channels for both recorded and live performances. Tour revenues have gone from strength to strength, particularly for established artists with a large fan base. Recently, Madonna signed an innovative deal with a concert promoter that combined recording and touring rights, ending her deal with Warner. Some artists, such as 'The Artist formerly known as Prince', have distributed their music freely to incentivise tour sales, highlighting the increasing importance of tour revenues for established acts relative to recorded music sales. Newer artists have benefitted from the major's continued desire and ability to break new talent, but also from the plethora of alternative distribution created by on-line and TV.

The industry remains open and attractive to digital innovators. Despite widespread reports of an industry apparently in decline, we have seen the rapid emergence of new innovative players:

- **Online portals**, such as Yahoo and P2P pioneer-turned-subscription service Napster, have developed their own music services, whilst music download leader Apple has secured its position through linking iTunes to the successful iPod player
- **Mobile operators** have used music to grow content revenues, facilitated by faster network technologies, whilst handset vendors such as Sony Ericsson have targeted the mobile music market effectively using the Walkman brand. Handsets have emerged as a key platform for music listening on the move, with operators keen to grow content revenues from over-the-air music downloads
- Online marketing is allowing **independent labels** and emerging artists to gain publicity and success without major A&R investment, allowing social networking and video websites such as MySpace and YouTube to claim a share of music industry revenues
- **Internet radio** has enjoyed strong growth in recent years
 - leading service Last.fm was purchased by CBS in 2006
 - though it is uncertain how lucrative revenues from users watching adverts whilst listening to radio will prove.

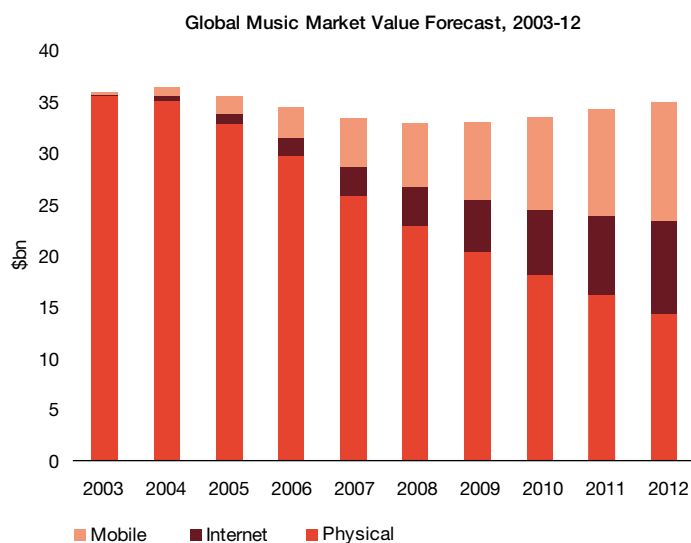
Music majors are bruised, but live to fight another day. The music majors have suffered most, with reduced demand as a result of greater piracy and the end of the CD replacement cycle reducing revenues. The higher margins on digital music present a significant opportunity if volumes can make up for declining physical sales, and the low costs of digital distribution allow record labels to sell artists' back catalogue more effectively. The majority of digital download retailing is now controlled by third parties who take a significant share of revenue. There is significant potential from new digital initiatives: subscriptions, if the industry can overcome customer resistance, or perhaps more promisingly, growth via mobile.

In the interim, the industry is taking urgent and overdue action to reduce its cost base, and de-risking of their businesses through reduced / re-structured advance payments to artists. Two of the majors (EMI and Warner Music Group) have moved from public to private ownership in recent years, and industry consolidation remains a significant possibility. The growth of digital (mobile and online) today is not sufficient to address physical declines, but

as the relative weight of each category changes, the current rate of decline may slow and even reverse. Chart 4 below illustrates a scenario of how industry revenues may eventually turn-around, driven by the newer digital formats, showing the growth of mobile and internet music consumption in particular.

Beyond the CD and download lie new revenue streams for majors. For the majors, the turnaround strategy may require redeveloping new and attractive business models that do not depend so heavily on physical CD sales, and this may include licensing artists' tour rights even if there will be strong competition from the specialist promoters or artists themselves for this mandate. Historically, music majors have used radio and TV as key marketing vehicles to drive LP and the CD sales; now the picture is far more complex, and majors may need to actively participate in a broader spread of activities to secure future revenues.

Chart 4: Industry Revenues Driven by Digital



Source: PwC Market Estimates

Lessons for the future

The lessons from the last decade for the music industry are numerous. Innovation by new entrants, attracted by the enduring popularity of music, has profoundly impacted the industry by:

- (a) launching new distribution platforms – mobile phones, portable devices, on-line music players
- (b) unbundling the album
- (c) re-defining the relationship between the tour and recorded music.

In this context, the challenge for the majors may well boil down to how well they tackle the following key questions:

1. Can they re-design their core competencies to encompass the rapid growth revenues in concert / events promotion, and come to dominate this activity?
2. Will the majors, mobile operators and technology providers continue to let customers “cherry pick” and leave significant value uncaptured now that the quality and usability of internet and mobile music has approached CD levels?
3. Can the industry develop and maintain more flexible pricing models (e.g. a menu based approach based upon the quality/popularity of the artist/track), or continue with uniform pricing within a genre?
4. Can the majors effect significant cost reductions (as targeted by EMI) without undermining their traditional role, or core competency, as developers of talent and creators of the hit?
5. Can majors themselves successfully utilise online to break/promote their roster more cost-effectively?

Ultimately, such is the power and widespread appeal of music, the appetite amongst consumers for the “product” should remain strong. The challenges to the industry are significant, but not insurmountable, principally in developing cost and distribution structures that evolve to match the new technology and changing preferences amongst consumers over how they consume music. As with other sectors in media, managing the digital transition is proving to be the key strategic and operational challenge facing executives. Painful as the transition has been, we expect a leaner industry to emerge, but one better orientated to capturing the substantial value being created.



PricewaterhouseCoopers produces a range of thought leadership publications related to the Communications, Entertainment & Media industry, a selection of which are summarised below. If you are interested in viewing these publications, please visit www.pwc.co.uk/eandm or www.pwc.com/convergence.



Global Entertainment & Media Outlook 2007-2011 Now in its 7th year, this leading annual Entertainment and Media industry forecast covers the US, Europe, Middle East, Africa, Asia Pacific, Latin America, and Canada. It provides in depth global analyses and five-year growth projections for 14 industry segments.



The convergence monitor: Enterprise Mobility (2008) This is the second in a series of global surveys aimed at understanding preferences and use around converged services. Enterprise mobility focuses on workforce use of mobile technologies and perceived demand for converged enterprise solutions in the near future. Approximately 75% work out of the office some or all of the time and 92% have a mobile phone. They want to be connected 'anytime, anywhere, anyhow'.



How to capitalise on lifestyle advertising in a customer centric world (2007) The most fundamental shift in the history of media usage is upon us. Consumers are empowered by new technology and distribution platforms to engage with media and advertising in new ways. They are interacting with content, not just taking it in. Advertisers can now gain far greater insight into consumer preferences, interests, and the consumer point of view than ever before. PricewaterhouseCoopers believes that we are experiencing a technology-driven social renaissance that is creating unprecedented opportunities for the advertising industry to execute its core principles in powerful new ways. This is an opportunity that we term Lifestyle Advertising.



The convergence monitor: The Digital Home (2007) More and more communications and media companies are pushing forward with their triple - and quadruple - play strategies. For consumers, the possibilities are endless - an unprecedented explosion of choices and new services where they can call the shots and have the power to influence others, the organisation, and the marketplace. For organisations providing content and distribution services, it is an increasingly complex marketplace. For this survey about the digital home, our first of a series of global Convergence monitor surveys, PricewaterhouseCoopers surveyed 8,000 of our employees in 17 countries. The report discusses some key findings, including what consumers are willing to pay for, how they access content, the importance of security and customer service.



How to manage your rights in a converged world (2006) Examines how to implement an effective, cross-functional rights management strategy to better exploit new business opportunities for bottom-line benefit. This brief document outlines a seven-step process to managing digital rights in the digital world.



Media Insights 2008 (6th edition)

Media Insights Series PwC analyses the trends driving M&A activity in the European media sector. We also take time to review predictions from preceding editions, and set out our thoughts for the upcoming year and beyond. According to the latest Media Insights report released by PricewaterhouseCoopers, the UK market produced record results for the year as a whole, and mainland Europe held steady. The total number of European media deals last year increased by 3% to 178 compared with 173 transactions in 2006. This performance approaches the levels seen at the market's peak in 2000, when 186 deals were recorded.

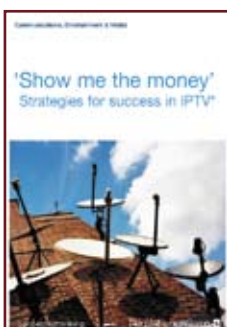


On Media: UK TV advertising: structural decline or cyclical blip? (2006) The first edition of On media, a publication for senior executives in the media industry, focuses on the future of the UK TV advertising market and asks whether it is in structural decline or is the recent decline merely a cyclical blip.



On Media: Stay...just a little bit longer (2007) This second edition provides input to the debate on copyright extension for sound recordings and describes some of our work on this topic.

We report our findings that, in short, copyright extension means more money for record companies and performers, and possibly more value for shareholders and/or more re-investment into the industry. Originally carried out as a study for the BPI's submission to the Gowers Review of Intellectual Property, the debate has moved to the European Commission as it considers the duration of copyright protection for sound recordings as part of a wider review.



Show me the money: Strategies for success in IPTV (2007) As everyone races to be the consummate provider of entertainment and communications to the customer in the home, IPTV is regarded by some as the silver bullet to achieving this goal. However, those choosing to launch IPTV services are entering an already crowded and competitive market characterised by established players and ongoing innovations. For operators competing in the market – from telcos, to broadcasters, advertisers, and content providers – there are a number of considerations that need to be taken into account in order to navigate a profitable route. This report examines the different drivers and strategies that companies can employ to achieve this type of success.

About PwC

PricewaterhouseCoopers LLP is a leading professional services organisation for the Communications, Entertainment & Media industry, providing industry-focussed advisory, assurance and tax services to help clients manage risk, maximise shareholder value, and support M&A activities. Our practice offers a deep and diverse industry-dedicated team of professionals that provide solutions to critical issues facing companies across this convergent industry.

PwC provides services to content and communications companies across the world, including content producers, rights holders, distributors (fixed and mobile telecommunications, internet, satellite, cable, broadcast and publishers), investors (advertisers, advertising agencies and financial institutions), regulators and governments. We work with clients to provide advice and assistance based on our strategic, economic, financial, analytical and business process skills in the development and implementation of their strategy focusing on:

- Creating/acquiring/financing business
- Integration into the business
- Enhancing performance
- Improving management and control (e.g. through rights management)
- Valuing their assets (e.g. intellectual properties)
- Dealing with crises (e.g. litigation, financial distress)
- Restructuring and realising value

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