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Napster Detractors Miss a Beat

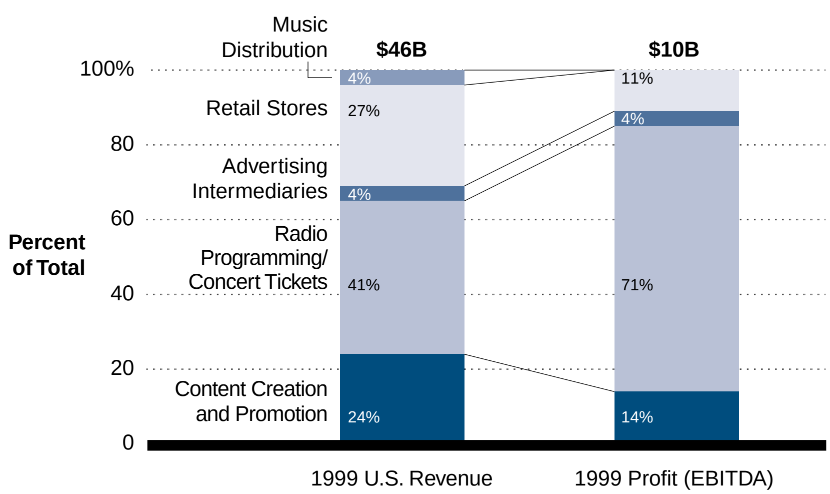
By Ashish Singh

Threat of piracy pales compared to opportunity for greater profits

Now that the Napster decision is in, music producers should abandon their obsession with Internet piracy. Yes, it is a problem, estimated to cost $4.5 billion by 2005. But it is not as big a problem as the producers think. And their obsession with piracy is obscuring the bigger picture—the giant opportunity the Internet presents for content providers in music, books and film to cut out the middlemen and take home a bigger slice of a very profitable pie.

Today, record labels rely on radio and music television to break their artists, and on retailers to deliver compact disks (CDs). Because the radio stations and music television channels get their content for free from the labels, they enjoy huge profit margins. Our analysis shows that programmers of radio and television take home a whopping 71% of total music industry profits, distributors another 11%. Ironically, record labels take home only 14% of industry profit, and artists a meager subset of that.

Music industry profit pool



Forrester Research, Inc., *Content Out of Control*, Sept. 2000

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Yet, a flurry of recent deals, aimed at wooing some of Napster's 70 million listeners, shows the content kings are missing a beat. Sony, Universal, EMI Group, AOL Time Warner and Bertelsman have all announced some kind of Napster-like subscription service, now that lawsuits against the upstart will force Napster to license tunes and charge fees. But the major labels have yet to define the new digital landscape less as a threat to their intellectual property and more a chance to greatly increase profits by doing what they do best: finding talent and engaging fans. If the big five focus on expanding their core business of helping artists reach audiences they could acquire $5-to-$15 billion in new revenue, according to a Bain & Company study.

Ironically, other Internet companies may have a clearer notion of this opportunity. Microsoft recently announced that it would launch a radio-like service, MSN Music, which will offer CD-quality music that can't be picked, packed or copied. Meanwhile, MTVi, the Internet arm of MTV, announced it would broaden its offerings in music distribution. MTVi plans to become the first one-stop-web-shop for all five major labels where customers can download for a price.

Content makers can use the Internet to help artists reach their audience directly and, thereby scoop profits from radio and music TV.

The potential prize from these innovations is huge. Seventy percent of Napster's 70 million college-aged users say they would subscribe for a fee. Yet, a Napster-style service is only a good first step toward greater profitability for the majors. Subsequent steps should move major labels from a world where each tries to grab the largest chunk of a small slice of profits, to one where they claim profits from other parts of the broader music industry. To see what the future might hold for music makers, flash back on an un-jazzy industry: financial services. By putting customer relationships at the core, single-product companies like American Express, founded on express payments in 1850, have grown revenue around a variety of related services and claimed profits from banks, travel agencies and credit consortia.

So, too, can content makers use the Internet to scoop profits from radio and music TV, by becoming audience-centric. They can aggregate talent and reach fans via the landline Internet, wireless Web and other platforms. And, while they're at it, they can cost-effectively re-activate a unique, core asset—their vast back-catalogues of content. They can grab profits from retailers by offering subscriptions and from concert promoters and ticket agents by bringing recording studio talent live online. They can even branch into adjacent businesses—artist-linked accessories, clothing or scores—that bring artists closer to their audience. And they can use the technology to develop entirely new, richer products.

Why aren't labels jumping?

The first concern is cannibalization, the potential for the new Internet product to cut sales distributed through other channels. But our analysis shows that music can be delivered over the Internet at less than half the cost of delivering physical CDs. In a free market, whenever an innovation has lowered the cost of something by half, the innovation has fundamentally altered the old system, no matter how many entrenched giants tried to stop it.

Furthermore, historical analysis of the music and film industries shows that cannibalization by new technologies and formats (such as CDs for cassette tapes and home video rentals for box office tickets) have not hindered overall industry growth. Content providers should position themselves to take advantage of growth in any format, and to aggressively cannibalize themselves, rather than let new players do it.

Ways big labels could evolve their offerings

Reach Consumers	Order content on-line
	Direct sale of download
	Subscription to download library (back catalogues)
	Subscription to streaming audio
	Consumer data sales (concerts, artist clothes)
	Bundling on non-content sales
	Direct Marketing
	Licensing
Broaden and Deepen Consumer Experience	Advertising

Content providers should seek to make it hard for the average consumer to pirate material, but not so hard that it hinders industry development or makes services cumbersome to use.

The second concern is piracy. The Internet does create an increased risk of piracy. But if history is any guide, piracy, though costly, will not debilitate content providers. According to a report by Lehman Brothers, music piracy rates in developed countries have historically hovered around a tolerable 10%, despite the ease of taping a cassette or burning a CD.

This doesn't mean that content providers should ignore piracy. But it does mean they should take a balanced approach to it, and then learn to live with a moderate amount. Skilled hackers will eventually break any encryption code, but the average consumer has neither the motivation nor the skill to pirate. Content providers should seek to make it hard for the average consumer to pirate material, but not so hard that it hinders industry development or makes services cumbersome to use.

Digitization and web-enabling content (and with it, piracy) will happen: The economics are simply too compelling. And although the dramatic changes in the works may be scary to established industry forces, the ball is in their court. It won't be easy, but it's up to the labels, studios, and publishers to decide whether they want to control the industry's evolution—and its profits—or simply react.

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