BAIN & COMPANY

Cutting through the digital fog

By Ashish Singh

Music industry's rare chance to reposition for greater profit

Reduced to ones and zeros, sounds become clearer, lines grow sharper. The only quality digitization does not seem to improve is strategic vision. When it comes to the Internet, the media industry is still wandering blindly, lost in a fog at least partially of its own making. Yet, a holistic look at the technology's likely impact on the entertainment industry reveals an unprecedented opportunity to boost revenues, cut costs, and increase profits.

Sometime soon, digitization will lead to major changes in the way companies create, market, and distribute entertainment. The process of creating and selling music, already largely a digital medium, will undergo the earliest transformation, followed by movies, followed, finally, by books. Music labels, distributors, and consumers will begin to feel these changes sometime over the next two years; the movie industry, in two to four; and books, in four to seven. These changes will impact the music business, but much of the same strategic thinking applies to other media as well.

In 1999 content creation and promotion accounted for only 14% of the music industry's total profits, versus 71% for radio programming and concert tickets and 11% for retail stores.

In 1999, the major labels captured only 12% of all music profits. Today, even that small fraction may be at risk. The industry faces a challenge: either let new intermediaries and independent labels whittle away its current cut, or use the Internet to defend and even expand its profit share. But to move ahead, music executives need to think out of the box —specifically, out of a thin plastic case about four inches wide. After 100 years as wholesalers of physical recordings on records and compact discs, the industry must redefine its core business or face slow extinction.

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Fortunately, that fate is highly unlikely. As Napster's 72 million users showed, the core value of the industry is in music, not discs. While piracy is likely to be a real cost, Bain analysis suggests that modest security measures will hold losses to under 10% of all usage, about average for most kinds of intellectual property (IP). In fact, we believe the industry's current focus on piracy simply masks a strong—and to some degree, healthy—resistance to change. Soon, the major labels will see digitization as a rare chance to fundamentally redefine their businesses in ways that will leave them much more profitable than ever before.

Napster: The world's largest focus group

Music may be the only major industry that still fears destruction by a virtual adversary. But, the chance that Napster, or a Napster clone, will "Amazon" the music industry is actually quite slim.

Although Napster presents two challenges that most dot-coms did not—namely, a service that is wildly popular and fulfillment that is cheap—the music industry should not see Napster primarily as a threat. Instead, we recommend that executives look at Napster as free test marketing. The test was wildly successful; now the industry needs to find a way to fulfill the demand profitably.

Easier said than done, of course, but we are confident that the industry will quickly meet this challenge. Historically, this kind of shift in a delivery system is much more likely than a general loss in the value of IP. Our research shows that corporations whose core businesses rely heavily on IP tend to overestimate the risks raised by new technologies, while simultaneously underestimating their profit potential.

For example, a few years ago, many observers predicted the worst for Microsoft, Oracle, and the other big players when a host of start-up application service providers (ASPs) hit the market. "The dinosaur software companies are doomed!" said the pundits. Yet today, the so-called dinosaurs still walk the earth, while the start-ups run scared, having realized too late that an improved delivery system is not in itself a competitive advantage.

Even if pundits overrate the threat of insurgency, media firms should not underrate the value of thoughtful experimentation. For a company that learns early on how to translate its core values into a new medium, such a shift could be a huge strategic opportunity. As authors Chris Zook and James Allen note in *Profit from the Core: Growth Strategies in an Era of Turbulence*, by moving early onto the Web, Charles Schwab & Co. transformed itself in just a few years from an upstart discount broker into an industry leader.[1] Zook and Allen estimate that Charles Schwab now collects more than 70% of online brokerage profits—compared to its 12% profit share of traditional accounts.

We believe the shift to digital distribution of music represents a similar opportunity. In 1999 content creation and promotion accounted for only 14% of the music industry's total profits, versus 71% for radio programming and concert tickets and 11% for retail stores. ***(See Figure 1: Music industry profit pool)*** A label taking the initiative today could change that mix and gain a much greater share of the revenue and, more importantly, the profit now captured by broadcasters and retailers. Best of all, the risk of failure is relatively low compared to the risks of a conventional challenge.

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[1] Chris Zook with James Allen, *Profit from the Core: Growth Strategies in an era of Turbulence* (Boston: Harvard Business School Publishing, 2001).

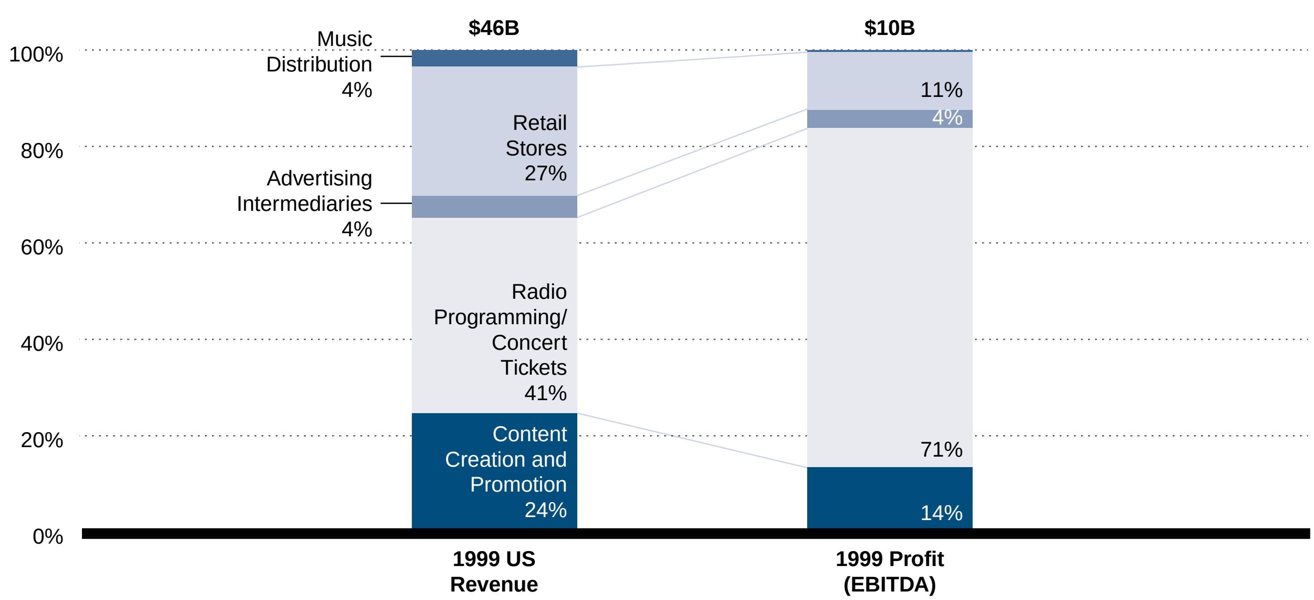
How can this be done? Three ways. First, by boosting revenue through a variety of new online offerings. Second, by reducing costs in marketing and distribution. Third, and perhaps most importantly, by developing a direct relationship with the listener. We will look first at the revenue potential.

Disney does not identify itself with a specific medium. Of the 1.7 billion of cumulative profit Disney has earned so far on *The Lion King*, box office sales accounted for just $150 million.

Pump up the volume: Why digitization will increase revenue

Twenty years ago, movie studios faced a terrible scourge: a monstrous device called the videocassette recorder. Many predicted disaster. The studios claimed commercial and home piracy would destroy the economics of motion picture distribution. In fact, video did change the movie business, but in only one respect: it made movies much more profitable by letting the industry resell films in a secondary format. Today, domestic video revenue is nearly 2.5 times box office receipts—which

***Figure 1*: Music industry profit pool**



reached $7.7 billion in 2000—and the spread grows wider every year. Even with the introduction of the DVD, video revenue is still climbing by 10% annually while box office revenue creeps upward by 5%, in line with its 20-year average.

The video example is not an isolated case. As book publishers learned when they began selling paperbacks fifty years ago, a strategy of releasing multiple formats with staged timing and pricing can lead to a significant expansion of the market. We believe that the same principle will apply when the major labels embrace digital distribution.

Niche audiences will be easier to serve and satisfy as well. In a marketplace with no shelf-space limitations and minimal distribution costs, the major labels will be able to satisfy an even wider range of tastes. Just as a Blockbuster video shop with 500 titles satisfies more customers than an eight-screen multiplex, so too will digital distribution make more customers happy more often.

But the greatest revenue gain for this "new new" thing may be in old recordings. Today, catalog titles account for 40% of sales for a typical label, but over 70% of profits. Tomorrow, digital delivery may make catalog titles even more profitable, by increasing their availability and cutting out the costs of manufacturing and distributing physical CDs. Nostalgia-focused cable stations and the oldies sections of video stores have made film libraries more valuable today than ever before; we think the same phenomenon should hold true for music.

But increased revenues are only part of the story. From artist and repertory (A&R) costs through marketing and distribution, every aspect of the content life cycle will soon be cheaper and more efficient.

Hits without the misses

A&R today is still a matter of guts and hunches. Perhaps the only major change since the days of Tin Pan Alley is that the odds of picking winners keep getting worse. In the past decade alone, according to figures from the Recording Industry Association of America, the business grew significantly tougher. In 1992, music labels released 18,400 new albums. Only 132 became hits, a hit being defined as sales of more than 1 million copies. In 1999, the number of new albums released climbed to 38,900—but the number of hits only grew to 206, meaning that the chance of a song hitting the mark had declined from 0.7 % to 0.5 %.

Besides becoming scarcer, the hits themselves now earn less money. The share of profit for the 20 top sellers declined from 22% of worldwide sales in 1990 to 17% in 1999. It is much more difficult now for a given artist to hit the mark twice in a row, particularly as genres continue to fragment. And to make matters even bleaker, the cost of making such bad bets keeps climbing.

How can the music industry escape this downward spiral? The leaders of another equally hit-and-miss industry, pharmaceuticals, have cut their risks dramatically through the thoughtful application of information technology. The best performers, a group that includes GlaxoSmithKline and AstraZeneca, now use a selection of e-business tools and newly acquired genomic know-how to steer researchers toward the most promising therapeutic areas. Paradoxically, narrowing their focus has actually increased their chances of creating a "blockbuster" drug. And those additional blockbusters earn the market leaders greater margins, faster growth, and a shareholder value ratio nearly double that of their competition.

But that is not the end of the good news: It's forecasted that the full profit potential of this new therapeutic focus will not crest before it reaches five times the current industry average.

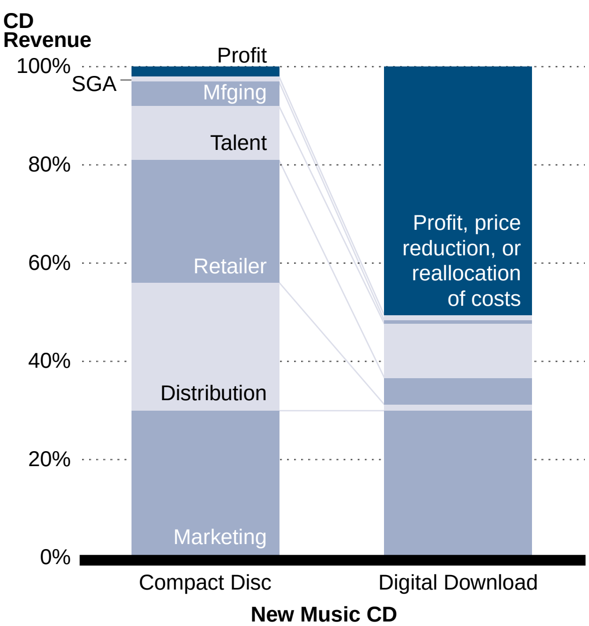
Digital distribution will give music executives a similar edge. In nearly real-time, for example, executives will be able to learn all kinds of details about their customers that they can only discover at a great expense now, if at all. If Ermine fans have a latent fondness for Patsy Cline, A&R will know about it sooner rather than later. Trends will be something first read in log reports, not *Billboard*.

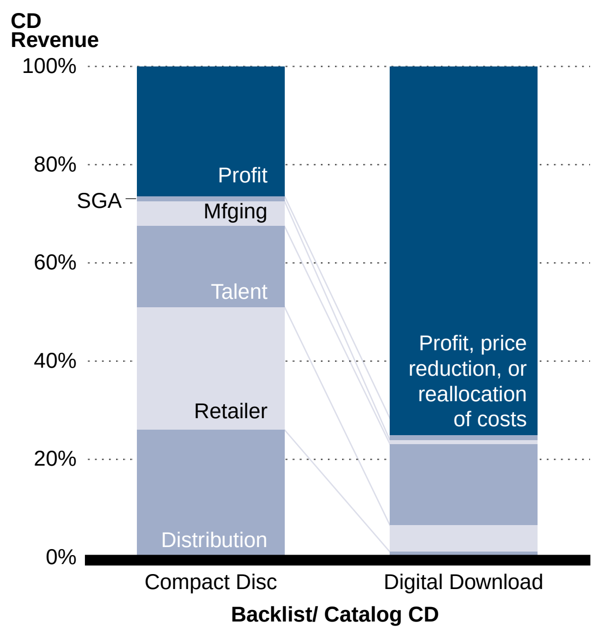
Can this really be done? No less an authority on marketing than Procter & Gamble thinks so.

P&G now uses the Internet as a vehicle to test-market new products, interview customers about their preferences, and even whip up a cost-effective buzz for new products via e-mail. If online marketers can do this for a product as mundane as soap, imagine what they will do for a product as emotionally charged as music.

Last but not least, physical distribution costs will go down. These costs are not insignificant, even for something as light as a CD. At present, manufacturing and distribution account for nearly 30% of the cost of a typical CD—more than $4 of the $13.81 charged. Subtract the retailer's 20% from that as well, and it's easy to see why digital delivery will be a winner. ***(See Figure 2: Physical vs. digital economics)***

***Figure 2*: Physical vs. digital economics**





Conclusion

Thanks to digitization, tomorrow's music lovers will be better served at a lower cost than they are today. At the same time, the major labels should find themselves in better shape, not worse. Hits will be easier to replicate, since A&R executives will have greater understanding of the conditions and attitudes that made the originals popular. Non-hits will also stand a greater chance of being profitable, thanks to the reduced costs of manufacturing, marketing, and distribution. For the same reasons, catalog recordings may become even more profitable than they are today. By any measure, and even allowing for a degree of piracy, digital delivery will make the music industry much healthier than it is at present.

But the rewards of deploying the new technology will be unevenly distributed, as they are now between Charles Schwab and the other online brokerage houses. Whether a label chooses to be a leader or a fast follower, the lion's share of profits will go to those companies that understand the strategic significance of the new technology and act decisively on that knowledge.

As Walt Disney learned more than 70 years ago when he added a sound track to an animated cartoon called *Steamboat Willie*, it can be very profitable to push the frontiers of technology and entertainment. The collapse of the Go Network notwithstanding, Disney is still doing well by defining its value proposition in terms of entertainment "magic." Disney does not identify itself with a specific medium, profitably exploiting new opportunities whenever they arise. The result: traditional box office sales are now just a modest contribution to a much larger enterprise. Of the $1.7 billion of cumulative profit Disney has earned so far on *The Lion King*, for example, box office sales accounted for just $150 million.

Fewer than 10% of all major companies experience steady growth for 10 years or more. As Chris Zook wrote in *Profit from the Core*, 78% of those companies that did succeed in sustaining growth focused their attention on one or two core businesses. For a major label that wants to keep its place, the core should now be defined as distributing music, not physical recordings. To their credit, the major labels are all in the early stages of creating digital offerings. But that is just the way to keep up, not lead. Leading this industry will require the courage to seize the full potential of this transitional moment, and cut through the digital fog.

Five easy pieces

How should a music executive prepare for the transition to digital delivery? While the exact response will vary by label, here are five basic guidelines:

1. Focus on the treasure, not the pirates. The revenue potential of digitization far exceeds its risks.
2. Teach your team to define your core business as the distribution of music, not discs.
3. Consider digitization as an opportunity to redefine the boundaries of your business.
4. Study how other hit-driven industries, such as pharmaceuticals, now incorporate technology into their strategies.
5. Keep in mind that the rewards in the historic shift to digital delivery will flow largely to the player that best understands its strategic potential—and acts decisively on that knowledge.

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