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BMG Entertainment

Forty floors above Times Square, Strauss Zelnick and Kevin Conroy met in Zelnick's corner office. As president and CEO of BMG Entertainment, one of the world's leading record companies, Zelnick faced a tough set of decisions about how to organize and operate the company. He knew he could count on Conroy, senior vice president of worldwide marketing and new technology, for a clear opinion.

The discussion came in August 1999 as the global music industry faced a period of potentially tumultuous change. Two of the six companies that dominated the industry had merged a year earlier, and at least one other was rumored to be looking for a buyer. Customer tastes and buying habits were in flux. The Internet brought the promise—or specter—that consumers would buy much of their music online rather than purchase it from storefront retailers. Soon, customers might download music rather than buy prerecorded compact discs or cassette tapes. With this change, the traditional chain linking artists through record companies and retailers to consumers might take on an entirely new form. Certain industry analysts and participants even predicted—some gleefully—that the new technology would spell the end of the major record companies. Chuck D of the rap group Public Enemy took an extreme position:

Soon you'll see a marketplace with 500,000 independent labels—the majors can co-opt all they want, but it's not going to stop the average person from getting into the game. Today a major label makes a CD for as little as 80 cents, then sells it wholesale for \$10.50 so retailers can charge \$14—that's highway robbery. . . . The true revenge will come when the major labels start dropping their prices. I can see the public saying, "OK, I could go to the store and pick up the album I want for \$5, but I can get it on the Net for . . . \$3."¹

Among major music companies, BMG had been one of the most eager to embrace the new technology, despite the threats it might pose. Conroy and Zelnick had steered BMG toward online opportunities as early as 1995. BMG was the first major record company to create a set of branded websites tailored to particular genres of music in order to attract music fans. It was also the first to use downloading technology to promote the sale of conventional, prerecorded CDs and cassettes.² Via an innovative agreement with America Online, consumers who played the CDs of certain BMG artists on their computers were linked automatically to relevant websites.

Changing technology created a new set of "digital customers" for BMG: online retailers such as CDNow, which shipped CDs and tapes to consumers; storefront retailers such as Tower Records that

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were establishing online operations; websites that enabled consumers to download music directly from the web; and individual consumers who were visiting BMG's music websites. Zelnick now had to decide how to organize BMG to serve its digital customers. One option was to give the existing distribution organization responsibility for the new class of customers. Alternatively, BMG could set up a separate division to handle digital distribution. The mandate of the digital organization was also at stake. How loyal would BMG remain to its traditional customers, storefront retailers? How eagerly would it pursue other retailers or consumers themselves? Regardless of its structure and mandate, the digital organization would soon face difficult choices about technology. A number of companies such as Microsoft, Liquid Audio, and IBM were developing technologies to support the downloading of music over the Internet. Should BMG continue to forge nonexclusive partnerships with a wide range of technology vendors, or was it time to focus on a smaller number of exclusive relationships? Zelnick and Conroy knew that others in the industry would watch BMG's moves carefully.

Development of the Global Music Industry³

Before the advent of the phonograph, music was disseminated by means of printed sheet music. Sheet music was published much as books were: Publishing companies bought the works of composers and lyricists, printed the works, and sold them through retail concession stands and licensed agents. Composers and lyricists often tried to bypass publishing companies and go directly to the consumers by playing their music in piano bars and public places, or if they were able to afford it, having their music sung by professional singers in evening dance halls and restaurants. As publishing companies forged relationships with retail outlets and developed mail-order lists, however, composers and lyricists increasingly relied on publishers. By the late nineteenth century, the music-publishing business was centralized in New York City, particularly in an area of lower Manhattan called Tin Pan Alley. The first popular song to sell 1 million copies, "After the Ball" (1892), sparked rapid growth in the industry. Composers and lyricists were hired to turn out simple, memorable, emotionally appealing songs for a mass market.

Sound-recording devices were invented in 1877 by Thomas Edison in the United States and Charles Cros in France. Edison's cylinder-based talking machine was first sold to the public in 1889. Edison soon faced competition from Alexander Graham Bell's American Graphophone Company and Columbia, a maker of coin-operated music cylinders. In 1901, the Victor Talking Machine Company launched disc recordings. Victor's discs, invented by Emil Berliner, quickly displaced cylinders. Edison continued to produce his fragile, lower-capacity cylinders until 1913, when he introduced his very own "Edison Diamond Discs." Edison discs required a different player, used different material, and ran at a different speed than Berliner discs. Although Edison discs provided better sound quality than Berliner discs, consumers and most popular artists had already switched to Berliner discs and remained with them.

The early oligopoly Protected by patents, Edison, Columbia, and Victor maintained an oligopoly in the recording market for many years. Through alliances and partnerships with smaller companies, the trio extended their reach around the globe. For instance, the newly established Gramophone Company became Victor's European representative. Edison, Columbia, and Victor initially produced and distributed records in order to convince consumers to buy phonograph machines. By the 1920s, however, the companies focused on records, not machines, as their primary products. Sheet music shrank to account for about 15% of music-publishing revenues, and recording royalties became the major revenue stream of the music business. The music publishers of Tin Pan Alley continued to manage the copyrights of composers and lyricists. Record companies took on the

job of finding talented performers to make records as well as the tasks of manufacturing, marketing, and distributing recordings.

The U.S. music industry saw significant growth until 1923, when broadcast radio, a new technology, posed a serious threat. As consumers purchased radios, record sales declined dramatically for a couple of years. Columbia, for instance, came perilously close to bankruptcy. The electric microphone and amplifier, new technologies developed alongside the radio, made it possible to record music with much greater fidelity. Record companies initially refused to promote electrical recording because their warehouses were full of old acoustic discs. Soon, however, they adopted the new technology. The higher quality associated with electrical recordings and a widespread economic boom brought strong growth to the industry during the late 1920s.

In 1929, the Depression hit the recording industry at its peak, sparking consolidation. Edison went out of business, and the Radio Corporation of America (RCA), which had prospered as a result of radio's popularity, acquired Victor. In 1931, rivals Columbia, Parlophone, and the Gramophone Company merged to become Electric and Musical Industries (EMI), based in England. The American operations of EMI passed into the hands of CBS, another radio network. The companies that emerged from the consolidation—RCA/Victor, EMI, and CBS Records—led the music industry in the following decades. Indeed, they formed the core of three of the five major music companies that dominated the industry in 1999.

Industry leaders continued to experiment with new formats for distributing music. In 1948, CBS Records introduced a long-playing (LP), 33-rpm disc pressed from vinyl and an affordable phonograph that could also play older, 78-rpm shellac discs. One year later, RCA/Victor launched the 45-rpm single and a longer, extended-play (EP) disc. Confused by the competing formats, customers bought neither. In a compromise, the two companies agreed to sell players for the 33-rpm and 45-rpm discs, and they discontinued the EP.

A few new, significant record companies—including Decca, Mercury, and Capitol—joined RCA/Victor, EMI, and CBS Records during the 1930s and 1940s. Despite the arrival of new competitors, the production, marketing, and distribution of music remained concentrated among a handful of firms. Between 1946 and 1952, the six largest companies produced 158 of the 163 records that achieved "gold record" status, and RCA/Victor and Decca represented 67% of *Billboard's* Top Pop Records chart.

The impact of rock and roll The 1950s brought a host of new styles of music targeted at the newly affluent teenage market—most famously, rock and roll. Hundreds of record companies were founded within a few years. With an endless supply of young musical talent, any start-up record company that specialized in the right genre at the right moment and kept overhead and production costs low could make a profit on a single release that sold only a few thousand copies. Many of the new companies proved short-lived, but a handful enjoyed lasting success. For example, the sons of the Turkish ambassador to the United States used a \$10,000 loan from their dentist to found Atlantic Records. Older record companies such as RCA/Victor and CBS Records long ignored the opportunities posed by the teenage market and rock and roll. These new genres originated far from Tin Pan Alley, with which the established record companies had long-standing relationships. Moreover, some record company executives felt that, by selling to teenagers, they would risk the goodwill they had built up over the years with parents.

In 1955, RCA's country section paid \$35,000 for the contract of a little-known rock-and-roll artist from Sun Records, a small company established in 1952. RCA's strong marketing organization placed the artist, Elvis Presley, in prominent venues such as the Ed Sullivan Show in 1956. Elvis earned his first gold records the same year. RCA's signing of Elvis along with Decca's contracts with

Bill Haley and Buddy Holly signaled the full entry of the major record companies into the rock-and-roll market. Still, between 1955 and 1959, small independent record companies accounted for 101 of the 147 records that made it into the U.S. Top Ten chart. In 1962, the records of 42 different labels appeared on the *Billboard* album charts, and the six largest corporations accounted for less than half of the *Billboard* albums.

With the advent of rock and roll and FM stereo broadcasting, radio and disc jockeys (DJs) became the paramount tools for record companies to promote their products. Especially during the 1950s and 1960s, the number of new songs released each year grew to be far more than radio stations could feature. Record companies actively encouraged DJs to play their records, and rumors of "payola"—bribery—spread widely. Senior managers of record companies became, and indeed remained, concerned that they had no direct control over their most important promotional medium.

The distribution system linking record companies to consumers became more elaborate during the 1950s and 1960s. Earlier, record companies had signed exclusive deals with distributors to deliver records to retailers. With the advent of rock and roll, the introduction of jukeboxes, and the growth in retail outlets, a layer of subdistributors that carried products from all record companies developed. Rack jobbers began to buy records from distributors and manage shelves, or racks, in leased locations or departments. The largest retail chains built warehouses of their own. In 1955, CBS Records' Columbia division launched the first record club, allowing consumers to purchase records directly from the record company by mail.

Reconsolidation With developments in the distribution network and promotional channels, small, independent record companies increasingly sold out to major companies or reached agreements under which major companies distributed records on their behalf. It became common during the 1960s for music corporations to operate multiple "labels"—separate divisions with distinct operations and images, sharing certain overhead, manufacturing, and distribution activities. Labels within a corporation were managed largely as separate organizations in order to preserve creative talents and distinct images. By 1972, although the top five *labels* accounted for only 31.4% of the charts, the top five *corporations* distributed 58.2% of industry output. The distinctive musical styles of the 1970s—disco, glam rock, punk rock, new wave, reggae, and funk—were pioneered by independent labels and musicians far from the mainstream but were quickly adopted by the major music corporations.

Industry revenue declined in the late 1970s and early 1980s but revived in the mid-1980s. The debut of Music Television (MTV) in 1981 and the introduction of the digitally recorded compact disc (CD) in 1983 sparked a surge of consumer interest in music. The CD had an especially large impact on industry revenue, as owners of LPs and tapes replaced their entire collections with the new format.

Mergers and acquisitions, which had played a role in the music industry since the Depression, accelerated during the 1980s and 1990s. By 1999, nearly 85% of the global market for recorded music rested in the hands of five corporations—the "majors": BMG Entertainment, EMI, Sony Music Entertainment, Warner Music Group, and Universal Music Group. Exhibit 1 describes each of the majors.

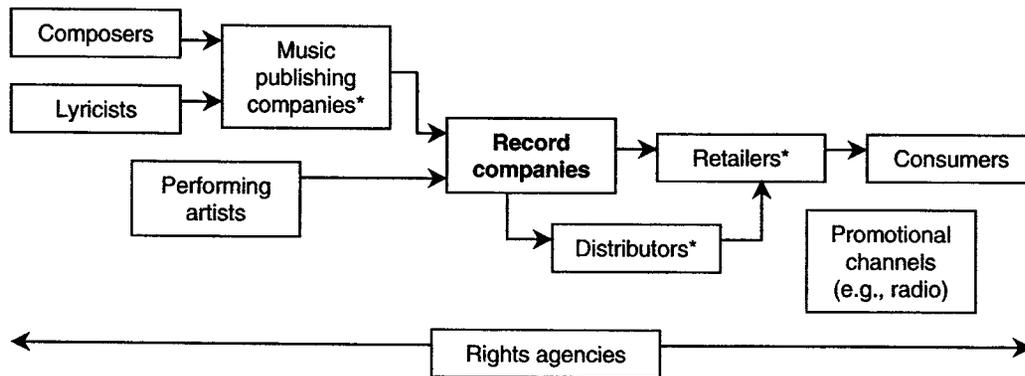
Organization of the Music Industry in 1999

Businessmen, they drink my wine.

— Bob Dylan, "All Along the Watchtower," 1968

In 1999, the major record companies stood at the center of a complicated industry. Composers, lyricists, and performing artists provided the raw artistic input for the business. Music-publishing companies mediated between composers and lyricists on one hand and record companies on the other. Retailers and distributors delivered products from record companies to consumers. Radio and music television stations provided the primary promotional channels for record companies. Rights agencies saw to it that royalties were distributed properly. (See Figure A.) Exhibit 2 shows the size and geographic distribution of the global industry over time.

Figure A Music Industry Roles



* Major record companies owned their own music publishing and distribution operations. Some majors also had retail interests, as described in the text

Source: Casewriters.

Composers and lyricists Composers created the score for a piece of music, while lyricists wrote the words for a composition. If not the same person, the composer and lyricist of a song shared the copyright. During the time of sheet-music distribution, composers and lyricists were often contractors hired by publishing houses, writing songs on demand. Over the years, they became more independent. Composers and lyricists were compensated through advances or one-time fees from music publishers, from royalty payments that accrued when their music was sold downstream, or by both means.

Performing artists Artists either performed their own compositions, in which case they were also composers and lyricists, or used repertoire created by others. A countless number of unknown artists performed live gigs and made demo recordings in hopes of being signed—that is, taken under contract—by a record company. Artists typically signed for five or more albums at a time. As a result, artists tended to stay with a single company for some time.

Once signed, an artist enjoyed a degree of creative and economic freedom that depended largely on his or her popularity. Record companies could largely dictate the creative moves of newcomers like Britney Spears. Superstars like Whitney Houston, in contrast, had extensive creative freedom. When contracts lapsed, established artists sometimes switched record companies in search of better contractual arrangements or more creative latitude.

Artists earned income primarily from royalty fees paid by record companies for the sale of their recordings. Concerts and merchandise provided additional income. A cadre of personal and business managers, assistants, agents, and lawyers typically accompanied a successful artist. The artist paid this entourage out of his or her royalty income. Artists differed dramatically in how successful they were and how long their successes endured.

Music publishers Music publishers purchased the partial or total rights to pieces of music from composers and lyricists. The publishing houses then promoted the music vigorously through a variety of channels. Key to success was striking the proper balance between selling the same piece through multiple channels and regulating content tightly so as not to cheapen the content. This balance often raised tensions between the artists and the businesspeople who ran the publishing houses. Over time, each of the majors had acquired or created a publishing arm to be part of its operations.

Record companies Record companies were widely considered the central players in the music industry. In addition to the five majors, "indies," or independents, played this pivotal role. Each record company took performing artists under contract, purchased musical rights from publishing houses, managed the recording process, manufactured CDs and cassettes, distributed CDs and cassettes to retailers and other channels, and promoted its products aggressively. During this process, the company paid for all costs associated with launching new music. In return, it received the wholesale price of the CD or cassette, less the royalty fees paid to the artists and the publisher and other costs associated with each sale.

"Breaking" new artists—that is, bringing them to commercial success—and managing their life cycles were keys to a record company's profitability. Having prominent artists under contract not only brought greater sales directly but also helped a record company gain precious retail shelf space for lesser known acts. Promising new artists tended to be attracted to record companies that had the best artists under contract and showed a strong history of successful management. Sometimes the demands of premier artists could undermine the profitability of a record company for that specific act. Consequently, product managers had to balance the benefits of an artist's big name with the cost of holding the artist under contract. In an effort to escape his contract with Warner Music, the well-known artist Prince tried various tactics, including changing his name to ♣, an unpronounceable symbol, and claiming that his old contract did not apply to The Artist Formerly Known as Prince. During subsequent disputes, he appeared in public with the word "slave" inscribed on his cheek to reflect his relationship with Warner Music. Warner released him from his contract in 1995. The Artist's next albums were distributed by his own label and promoted primarily via the Internet. Though sales volumes were low, The Artist claimed that his net proceeds were higher than they had been with Warner. In 1999, he returned to a major record company, signing with BMG's Arista label.

The major record companies shared a basic organizational structure (Exhibit 3). With the exception of EMI, each was part of a larger diversified corporation. Within the record company itself was a central manufacturing division that made and packaged cassette tapes, a central distribution system that delivered CDs and cassettes to retail outlets and independent distributors, a music-publishing operation that managed copyrights, and a number of distinct "labels." Several of the majors also had retail interests. BMG, Time Warner, and Sony operated record clubs. All three had interests in online retailers, as did Universal. EMI had only recently divested itself of retailer HMV.

Historically, the majors had carried out manufacturing locally in order to reduce transportation costs and avoid duties and taxes during export and import. With the development of economic free-trade zones, the record companies consolidated their production plants. Sony, for instance, manufactured products for the European market in the Netherlands, while Warner produced in Germany. Worldwide, a major record company such as BMG might maintain 10 or more production facilities.

Each of a record company's labels operated largely autonomously, with a separate president, profit and loss (P&L) responsibility, and brand identity based around genre and artist roster. Usually, there were four functions under each label: artist and repertoire (A&R), marketing, business affairs, and accounting. A&R was responsible for finding new artists and developing new repertoire.

It also found songs for artists who did not write their own. Marketing, usually the largest function of a label, handled sales, promotion, advertising, publicity, and artist relations. Business affairs dealt with legal issues such as artist negotiations, producer agreements, and licensing arrangements. This function also finalized foreign licensing and distribution deals.⁴ Accounting played a crucial role because of the numbers of parties involved in each recording project. The accounting department handled the order-to-cash cycle, financial and managerial reporting, and the payment of royalties. Historically, most labels were split between U.S. and international operations, with the four functions sometimes duplicated in the two regions or even in specific countries.

Independent distributors Although major record companies often distributed their product directly to large retailers using their own trucks and resources, a handful of distribution companies remained independent of the majors in 1999. For example, Koch International distributed indie products to retailers. Indies, however, increasingly struck distribution agreements with the distribution arms of the major record companies. BMG, for instance, distributed on behalf of the independent labels Beyond, Logic, Milan, Razor & Tie, Restless, V2, Wind-Up, and Jive. Although independent distributors were often regional, some distributors had national reach, supported mainly through cross-regional alliances and mergers.⁵

Retail channels In 1999, music was sold to consumers through brick-and-mortar storefronts, record clubs, mail order, and increasingly, online retailers. Exhibit 4 shows the breakdown of sales in the United States by type of retail outlet. International chains such as Tower Records, HMV, and Blockbuster and national chains such as WOM in Germany and fnac in France played leading roles in the distribution of music. The number of small independent retailers had declined rapidly during the 1980s and 1990s as investments in stores and retail technology grew. The largest eight chains in the United States accounted for 17.5% of all retail sales in 1982 and 57.8% in 1992. Over the same period, total retail sales increased by 55%, while the number of store locations declined by 15%.⁶ The number of products offered at retail had grown even more rapidly than the size of the average store, leading to a shortage of retail shelf space.

Under "cooperative advertising" arrangements, record companies paid for part of the advertising efforts of retailers. In return, retailers agreed not to advertise prices below certain levels. Antitrust authorities were currently reviewing these arrangements. Despite such practices, retail price wars were common in the mid-1990s.⁷

Consumers The activities of all of these businesses and artists were directed at individual consumers. Consumers had widely different tastes in music, and the range of genres had broadened over the years. Genres from classical music to hard-core rap enjoyed loyal audiences. Exhibits 5 and 6 show the popularity of genres and shifts in buyer demographics during the 1990s.

Promotion Consumers were likely to buy music they heard on the radio or saw on music television stations. In a typical week, record companies released 135 singles and 96 albums, each averaging 10 tracks, while most popular radio stations added only three to four new songs to their playlists.⁸ Consequently, record companies aggressively lobbied radio and music television stations to get their new releases aired. Tales of illegal incentives were legendary. Allegedly, record companies had paid for DJs' vacation rentals and listed DJs as royalty-receiving co-composers of songs, for instance.⁹

Rights agencies Many composers, lyricists, performing artists, and music-publishing houses were paid in the form of royalties: payments tied to the actual use of music. Accordingly, a set of rights agencies arose around the world to monitor the use of music. Performing-rights agencies surveyed radio stations, television broadcasts, live concerts, and many other venues in order to keep tabs on the performance of copyrighted music. Mechanical-rights agencies supervised the use of

music in the production of CDs, cassette tapes, and other mechanical formats. These agencies delivered reports and payments to member composers, lyricists, artists, and publishers. With few exceptions, one performing-rights and one mechanical-rights agency operated in each country, either separately or together. Examples included ASCAP/BMI and the Harry Fox Agency in the United States, GEMA in Germany, and PRS/MCPS in the United Kingdom.

Industry economics The flow of money within the music industry was as complicated as the set of actors. Exhibit 7 lays out the way in which revenue from an average CD was divided among various players. The average figures, however, mask important variation from one album to another. Some recordings were far more successful than others. A hit album could sell more than 10 million copies, while a flop might sell only a few thousand. It was extremely difficult for music industry executives to predict which albums would be hits before investing heavily in development and promotion. This was especially true of albums by new artists. Accordingly, making a recording was a risky venture. Many labels stated that less than 20% of the recordings they released recouped their costs.

A system of "recoupable costs" affected who bore the costs of an album's failure and who enjoyed the fruits of success. During the production and marketing of a record, some of the costs incurred by the record companies were classified as recoupable from the artist's royalties. These costs were deducted before any payments were made to the artist. For a typical recording, a record company might spend \$300,000 up front in production and marketing costs. Of this, \$200,000 might be classified as recoupable. If the artist's royalty rate were \$2 per unit sold, then the artist would receive nothing until 100,000 units had been sold. Thereafter, he or she would earn \$2 per unit. This arrangement put the burden of a failed recording on the record company but also made it possible for the company to earn a profit before the artist received any payment.

BMG Entertainment

BMG Entertainment was a subsidiary of Bertelsmann AG, a German media conglomerate. The world's fourth-largest media company, Bertelsmann had interests in book publishing and clubs; music labels and record clubs; professional information; magazines and newspapers; television, film, and radio; print and media services; and online services and multimedia. The corporation was privately owned by the Bertelsmann Foundation, the Mohn family, and the Zeit Foundation. Exhibit 8 shows the composition of Bertelsmann's 1998-1999 revenue of 26 billion Deutsche marks (DM).

BMG Entertainment was managed autonomously from its headquarters in New York City. In 1999, it was a \$4.6 billion music and entertainment company with more than 200 record labels and operations in 53 countries. Its revenue was derived from North America (51%), Europe (32%), Latin America (9%), and Asia-Pacific (8%).¹⁰ Among its worldwide superstars were Christina Aguilera, Carlos Santana, Whitney Houston, Sarah McLachlan, Puff Daddy, Dave Matthews, and a long list of other gold and platinum artists. BMG distributed five of 1999's 10 best-selling albums.

Strauss Zelnick took the helm of BMG in July 1998 after leading BMG's North American operations for three and a half years. Prior to joining BMG, Zelnick had worked in a series of film, television, video, and multimedia companies including 20th Century Fox and Columbia Pictures. When he arrived at BMG North America in 1995, he found a division that had diversified, largely unsuccessfully, into businesses such as video distribution and apparel licensing. All but three of 25 units within the division were losing money. Zelnick rapidly withdrew from loss-making positions, cut the costs of operations, and refocused the division on music. BMG's North American music market share soon began to grow.¹¹ In the eyes of many observers, Zelnick typified a new type of

music executive. Traditionally, individuals had risen in record companies based on their creative talents and track record of breaking new artists. In contrast, Zelnick was best known for his strong business background and his focus on efficiency and profitability. Zelnick held MBA and law degrees from Harvard.

Much of BMG's business activity took place within its more than 200 labels, which included Arista Records, Ariola, RCA Records, the Windham Hill Group, Buddha Records, and BMG Classics. Manufacturing, distribution, music-publishing, and some sales and marketing activities were centralized and coordinated across the labels.

Manufacturing Led by CEO Uwe Swientek, the Storage Media division of BMG manufactured compact discs, cassettes, and related packaging. Facilities in Argentina, Brazil, Germany, Hong Kong, Ireland, Mexico, South Africa, Spain, and the United States produced more than 2.5 million CDs each day. A technology group within the division, established in 1994, tracked the development of new-media products and served as a contact point within BMG for technology questions.

Distribution BMG Distribution, led by Pete Jones, lay at the center of the music-marketing process, linking BMG's labels to brick-and-mortar retailers. Distribution personnel called on major retailers, promoted BMG's latest products, negotiated prices and terms, took orders, oversaw shipments, visited retail sites to assist with product placement, and handled credit and collection. The division not only served BMG's own labels but also distributed on behalf of a number of independent labels.

Music publishing BMG's music-publishing division, under Nick Firth, controlled the copyrights to more than 700,000 songs. Through some 150 acquisitions, it had accumulated the catalogs of diverse artists such as the Beach Boys, B.B. King, Barry Manilow, and Santana. The division's primary role was to acquire rights to songs and administer those rights. It also sought to generate royalties from its copyrights by placing its songs in films (e.g., *The Runaway Bride* and *The Matrix*), television (e.g., *Friends* and *Buffy the Vampire Slayer*), and advertising campaigns (e.g., Cadbury and Mercedes).

Sales Millions of consumers enrolled in one of BMG's music clubs, the largest collection of music clubs in the world. Club members ordered a set of introductory CDs or cassettes at a very low price. Subsequently, they received a selected album each month, which they could decline to purchase, as well as a catalog of other available albums. BMG Special Products developed specialty albums to assist companies such as Avon, Coca-Cola, AT&T, and Shell Oil in their marketing efforts.

Marketing At BMG and other major record companies, marketing had traditionally been managed entirely within individual labels. BMG's labels continued to be responsible for day-to-day marketing activities and the promotion of individual artists. Recently, however, BMG had placed Kevin Conroy in charge of corporate marketing. In this new role, Conroy coordinated the marketing activities of separate labels and established strategic alliances and partnerships with other companies (e.g., Visa, AT&T). As the Internet became a promotional tool that spanned label boundaries, Conroy increasingly led BMG's approach to digital distribution, e-commerce, new-music formats, and other emerging technologies. BMG's approach to the Internet is described in greater detail below.

The Other Majors

The five major record companies represented different artists and operated under diverse labels (Exhibit 1). In many ways, however, they resembled one another closely. All were organized in the same fashion. All operated around the globe and were large enough to do so effectively. All had

labels that covered the full spectrum of musical genres. All performed the same basic functions, though with different degrees of efficiency. Artists chose among the majors largely on the basis of characteristics of particular *labels*, not corporations. Personal relationships between label managers and artists were especially important in attracting and retaining artists.

Universal Music Group, the world's largest music company, emerged from Seagram's acquisition of Universal Studios in 1995 and Seagram's purchase of PolyGram in 1998. Industry observers believed that the merger had been difficult. Beyond music, Seagram participated in the production and distribution of spirits and wine, film and television production, the operation of theme parks, and specialty mall retailing.

Sony Music Entertainment was part of Sony, the Japanese entertainment and electronics giant. Sony produced not only music but also hardware to play music, such as the Walkman. Other divisions made video games, films, television programs, computers, wireless telephones, semiconductors, and magnetic media. The corporation prided itself on its cutting-edge technology.

Warner Music Group was a member of Time Warner, a U.S. media conglomerate. The corporate parent operated a set of cable channels including CNN and HBO, published magazines and books, produced feature films and television programs, and provided cable television connections to more than 12 million homes. With its cable system, one of the most technologically advanced in the United States, Time Warner was providing high-speed Internet access to roughly 300,000 households and was experimenting with services such as video on demand, high-definition television, and interactive television.

Among the majors, only the U.K.-based EMI was not part of a diversified corporation. EMI's current lineup of artists was arguably weaker than that of its rivals; the company had fewer current global superstars than other labels. Nonetheless, EMI had a strong history with bands like the Beatles, and EMI's music-publishing division was the largest music publisher in the world. Its catalog included some of the industry's most valuable copyrights, including songs by the Beatles, the Rolling Stones, Pink Floyd, and Frank Sinatra. In 1999, many observers felt that EMI was looking for a buyer.

The financial results and market shares of the five major record companies are shown in Exhibits 9 and 10, respectively.

The Internet

Music was one of the categories of merchandise most affected by skyrocketing use of the Internet in the late 1990s. The Internet accounted for 0.3% of all music sales in 1997 and 1.1% in 1998, and it was forecast to account for 10% by 2005.¹² Music was marketed and sold over the Internet in several ways. Through sites such as CDNow and Amazon.com, consumers could purchase conventional, physical CDs and cassettes and have them shipped to their homes. Downloaded music was a more radical departure from convention: new technology allowed surfers to transfer files containing music directly over the Internet to their computers. Thousands of sites posted illegal, pirated copies of songs. Supported by new software and hardware, a growing number of sites offered legal digital downloads.

Online Sale of Physical Products

A number of Internet retailers offered consumers a comprehensive selection of prerecorded CDs and cassettes. CDNow was typical of this new type of retailer.¹³ In late 1999, CDNow boasted a selection of 390,000 CDs, cassettes, and related items. Visitors to its site could browse the selection by genre; search for favorite artists, albums, or songs; listen to music samples; and read countless articles related to music. Once shipping charges were included, CD and cassette prices at CDNow were comparable to those posted by storefront retailers.^a

CDNow held virtually no inventory and relied on Valley Media, a music distributor, to ship products to customers. Valley Media also handled the 1%–2% of merchandise that customers returned to CDNow. A third-party credit card processor managed CDNow's billing operations. The company focused its own internal efforts on the development of its website and aggressive marketing to consumers. Its 1999 marketing expenses were anticipated to approach \$90 million. Analysts expected CDNow to lose more than \$110 million in 1999 on sales of \$150 million.

Downloaded Music

Technology of downloading Thousands of websites gave surfers the opportunity to download copies of songs or albums directly over the Internet. The downloading of music involved software and hardware beyond a computer, an Internet browser, and an Internet connection. The first element of additional software was a compression protocol—basically, a standard for reducing the computer file that contained a song to a size that could be downloaded quickly. MP3 was the most common protocol. A typical MP3 file containing a three-minute song could be downloaded by a computer with a 56K modem in seven minutes or by a computer with a cable modem in less than one minute.

A second element of software, a player, opened the compressed file and played the downloaded song. Internet users could download the most popular players—including RealJukebox, Winamp, Liquid Player, and Microsoft's Media Player—to their computers for free.

To play a downloaded song someplace other than on one's computer, a user needed additional hardware. Computers were increasingly equipped with CD drives that could write files to a compact disc, not simply read from a disc. For about \$200, Diamond Media offered a Walkman-sized gadget that could store up to one hour of downloaded music, typically in an MP3 format. Sony's Memory Stick stored up to two hours of music on a device smaller than a stick of chewing gum. One could plug the stick into a computer, download music, then move the stick to a portable player. The Memory Stick and associated player retailed for roughly \$500. Empeg's Empeg Player, an MP3 player for cars that could store up to 70 hours of music, retailed for about \$200.¹⁴

Because MP3 files could be copied repeatedly, many record companies associated MP3 with illegal music piracy. "MP3" was the term most commonly submitted to Internet search engines, and most of the 150,000 MP3-formatted songs on the Internet circulated without any compensation to the artist or copyright holder.¹⁵ Forrester Research estimated at the beginning of 1999 that over 3 million infringing MP3 files were being downloaded every day.¹⁶

A number of companies vied to provide software that would make downloading easy and piracy difficult. Liquid Audio, for instance, marketed a complete system to companies that wanted to sell downloadable songs. Consumers who registered with Liquid Audio received a free "passport" in

^a Shipping charges were typically \$2.95 for one CD and \$3.95 for two or three CDs.

exchange for personal contact information and credit card details. Passport holders could then go to any site using Liquid Audio's system, purchase a song, download it (in MP3 format or an alternative), and play it on their computers. Liquid Audio managed the billing of the customer. Songs downloaded via the Liquid Audio system were remastered using proprietary technology. Such "Liquid tracks" could be copied only once digitally to a CD. Copies carried a "digital watermark" that would allow authorities to trace any illegal copy back to the original purchaser. Competing systems, or components of such systems, were offered by technology giants such as IBM and Microsoft and new ventures such as Intertrust and Reciprocal.

Industry groups were also working to enable downloading without piracy. Most prominently, the leading music trade associations, record companies, and technology companies launched the Secure Digital Music Initiative (SDMI) in December 1998. Involving dozens of companies, SDMI aimed to set open technology standards that would ease digital distribution while protecting copyrights. The organization intended to have a full set of standards in place by March 31, 2000.¹⁷

Downloading entrepreneurs A host of new ventures sought to tap the opportunities posed by music downloads. MP3.com, perhaps the best known of the start-ups, aimed to create a meeting ground for consumers and musicians.¹⁸ The company helped artists set up web pages on its site at no charge. Each page included free, downloadable samples of music posted by the artist. If a consumer liked the samples, he or she could use a credit card to purchase the artist's entire album. Once an order was placed, MP3.com arranged for an outside contractor to manufacture a CD and ship it to the customer. Artists set their own album prices within a range of \$5.99 and \$14.99. MP3.com and the artist shared the proceeds of each sale, net of manufacturing costs, 50/50.

MP3.com provided artists a set of computer tools that made it very easy for them to set up web pages and load samples. The company also gave artists daily information on the numbers of visitors to their pages, numbers of downloads, and rankings within genre. The website guided consumers to artists by genre and by online popularity. As of late 1999, MP3.com's site contained more than 180,000 songs from more than 31,000 artists. The most popular musicians, however, were absent from the site, in part because the major music companies did not allow participation.

MP3.com was founded in March 1998 by Michael Robertson, formerly the CEO of a company involving digital photography. In 1999, MP3.com was projected to lose more than \$40 million on sales of approximately \$20 million. More than 90% of its revenue came from advertisements placed on its site. CD sales accounted for the rest of its revenue. In the first few months after its July 1999 initial public offering, its market capitalization fluctuated between \$1.5 billion and \$7 billion.

As of late 1999, **EMusic.com**, a second start-up, had secured exclusive rights to sell digital downloads from 140 independent record labels.¹⁹ These indie labels represented 1,500 artists with over 300,000 songs, of which 27,000 were already available for downloading from EMusic.com's site. Consumers paid \$0.99 to download a song or \$8.99 for an entire album. Half of the proceeds, net of administrative costs, were paid to the label. The labels currently under contract represented 12%-15% of the indie market. EMusic.com's management team hoped to increase this share to 40%. The company had recently inked agreements to offer its downloadable music library through Yahoo! and America Online. It had also acquired the Internet Underground Music Archive, which hosted the home pages of 5,000 artists.

EMusic.com was founded in June 1998 by Robert Kohn, an entertainment attorney, and Gene Hoffman, a developer of privacy software. In the year ended June 30, 1999, EMusic.com lost \$18 million on revenues of \$92,300. In late 1999, its market capitalization was roughly \$500 million.

Listen.com aimed to be the comprehensive directory of legal, downloadable music.²⁰ Although Listen.com did not sell music itself, its online directory classified music into 600 genres and subgenres and led Internet users to hundreds of sites that did sell music. The company directed users only to sites it believed to be selling music legally. Its team of editors wrote independent reviews of artists' work and pointed users to favored artists. Its site also featured guides that helped users learn how to download music.

Founded in December 1998 by Rob Reid, a former venture capitalist, and launched on the web in June 1999, Listen.com soon struck a wide array of alliances. In June 1999, it announced partnerships with leading online music-selling sites such as EMusic.com to get their artists into Listen.com's directory as soon as possible. Soon afterwards, seven leading independent labels agreed to work with Listen.com to increase their artists' Internet exposure. By then, Listen.com had signed deals to syndicate its music directory through the portals of Excite@Home, Snap, and HotBot. The company was allegedly in investment discussions with all five of the major record companies.

Napster, founded by 19-year-old Shawn Fanning, enabled Internet users to tap one another's music collections. Each user of Napster's free software indicated which of the MP3 files on his or her computer hard drive were available to others. Napster maintained a list of the users currently online and the titles those users were making available. A user could search the list for a song, then download the desired file directly from another user's hard drive. Copyright holders received no payments for such downloads.

Retailer Reaction

Traditional brick-and-mortar retailers saw both the online sale of prerecorded music and the downloading of music over the Internet as serious threats. By the end of 1998, 70% of the members of the National Association of Recording Merchandisers (NARM), the trade association of U.S. music retailers, had established some web presence. Another 15% expected to do so in 1999. Retailers used their sites primarily to promote music and provide customers with information. Many sold prerecorded CDs and cassettes through their sites. Of those that did, most allowed customers to return unwanted CDs and cassettes purchased online to traditional storefronts. One-third offered some ability to download music, and another quarter expected to add downloading capabilities during 1999.²¹

The websites of major retail chains such as Virgin, HMV, and Tower Records were similar in character. Tower, for instance, went online in 1996 but relaunched its site in the middle of 1999 with new features that matched those of CDNow and Amazon.com. Through its site, Tower sold new, used, and out-of-print CDs. It offered music reviews, columns, and a function that let shoppers know what other customers were buying. The site also included a catalog of downloadable Liquid Audio songs.²² Many industry experts were skeptical of Tower's online prospects. Analysts pointed to the lower margins associated with Tower's online sales and the hefty expenses it was incurring related to e-commerce.²³

While developing their own websites, traditional retailers asked the major record companies for assurances that the majors would continue to support storefront retailing. At the same time, retailers were considering a full range of options. Simon Wright, managing director of Virgin's retailing group, commented, "At the moment, the view in Virgin is that the terms being offered by the record companies would not justify further investment in music. Ultimately we could pull out of music altogether."²⁴ Pamela Horovitz, president of NARM, took a more combative stance: "If the record companies want to start marginalizing the retailers, then retailers will start looking to become labels themselves and signing up bands themselves."²⁵

The Majors' Actions

As entrepreneurs pursued the opportunities posed by the Internet and traditional retailers coped with the technology's potential threats, the major record companies responded with a flurry of initiatives, deals, and alliances that reached a fever pitch in 1999.

BMG Entertainment BMG launched its first online efforts in 1995, soon after Zelnick's arrival. Though Zelnick was focused at the time on stemming losses in numerous units, Conroy convinced him to invest \$1 million per year in the nascent World Wide Web. With the funds, BMG set up a series of websites dedicated to particular genres of music: Peeps.com for hip-hop and rhythm and blues, Bugjuice.com for alternative, TwangThis.com for country, Connect2music.com for adult contemporary, Rockuniverse.com for rock, and so on. The sites linked fans to exclusive information about BMG artists, interviews with the artists, live broadcasts, chat rooms, and promotional downloads. By placing the sites' web addresses on albums and other media, BMG attracted hundreds of thousands of unique visitors to the sites without a distinct advertising campaign.²⁶

Initially, the sites were not designed to sell music to consumers. Rather, they focused on promotion. Peeps, for instance, began to publicize pop sensation Britney Spears eight months before her first album was released. The site gathered the names of 100,000 potential fans, 80% of whom later bought the album.²⁷ The CDs of certain BMG artists included the software of America Online (AOL), the online service provider. When played in a computer, the CDs would enable consumers to sign up for AOL service. Customers who signed up would then be directed to BMG's websites.²⁸ BMG hoped to develop the genre sites as distinct brands that could stand on their own. The goal, Conroy explained, was both to "create a digital connection between our artists and their fans" and to "test the conventional wisdom that consumer branding isn't relevant in the music business."²⁹

Universal Music artists were added to the sites in April 1999 after BMG and Universal announced a new venture, Getmusic.com. Getmusic not only served as an umbrella for the genre sites but also included an online store comparable to CDNow or Amazon.com. The store's selection included albums by all the major labels, but BMG and Universal artists were featured most prominently. Links on the genre sites directed surfers who wanted to buy an album to the Getmusic store. Prices in the store were often 20% higher than at CDNow or Amazon.com.³⁰

BMG had experimented with downloaded music since November 1997, when it became the first of the majors to use downloads for promotional purposes.³¹ It did not sell downloaded music routinely, however. In June 1999, BMG announced that it would begin selling music directly over the Internet by late in the year. It did not make public which artists and works it would sell, what technology it would use, or what prices it would charge.³² At the same time, along with the other majors, it began a trial in San Diego to sell music over the Internet using Time Warner's cable service and IBM technology.³³

BMG took an active role in industry initiatives such as SDMI. Through a large number of relatively small arrangements and partnerships with companies such as Microsoft, Liquid Audio, Real Networks, AT&T, and IBM, it maintained relationships with all of the players involved in setting the technological standards for downloadable music. Senior executives tried to stay very much in the center of the industry's "deal flow" related to the Internet. As a result, they had hundreds of due-diligence files on potential deals. Zelnick explained some of the rules he used in sorting through opportunities: "Don't sell your copyrights or license them exclusively. Don't make long-term deals that you can't change. Once you've followed those rules, be willing to take risks and try things out. If God forbid you're wrong, you still own your copyrights."³⁴

Sony Music Entertainment Like BMG, Sony Music Entertainment was among the first and most eager of the majors to embrace new technology for music distribution. Its Columbia House subsidiary, jointly owned with Warner Music, launched Total E, an online store selling conventional CDs and cassettes, in mid-1998. In July 1999, Sony and Warner announced plans to acquire CDNow and merge it into Columbia House.³⁵

The company also pursued digital downloads. In May 1999, Sony publicized plans to sell singles directly over the Internet using compression and copyright-protection technology from Microsoft. Fred Ehrlich, Sony's general manager for new technology and business development, said that download prices would be comparable to those of singles purchased in retail stores.³⁶

At nearly the same time, the company announced that it would help a start-up firm install "digital kiosks" in retail stores. At the kiosks, shoppers could select among 4,000 albums, roughly half of Sony's catalog. The kiosk would then download the album via a proprietary computer system, imprint the album on a CD, and print liner notes and packaging within 10–15 minutes. The kiosk, said Danny Yarbrough, chairman of Sony Music Distribution, "offers the retailer the ability to offer titles they wouldn't be able to physically carry. . . ." ³⁷ An initial test of the kiosk was expected in the fall of 1999.

Sony Music's corporate parent had broader interests in new-music technology. Its consumer electronics division hoped to establish its Memory Stick as the leading portable device for downloaded music. The music division's initial hesitation to make its music available for downloading—because it feared piracy—had allegedly created a serious rift in the corporation. Sony Corporation was the first to propose specific copyright-protection methods for approval by SDMI.³⁸

Universal Music Group Through Getmusic, its venture with BMG, Universal sold conventional CDs and cassettes and promoted its artists online. Universal also took part in SDMI. In early May 1999, however, while SDMI was still hashing out standards for digital downloads, Universal announced that it would soon distribute music online using technology developed in conjunction with a Silicon Valley start-up. In doing so, it became the first of the majors to commit itself to digital downloads. Industry observers felt that Universal had "broken ranks" with the other majors. Larry Kenswil, head of electronic commerce at Universal, offered a different interpretation. Universal's efforts, he said, would "run in parallel" with SDMI and be flexible enough to comply with the standards that eventually emerged.³⁹ Soon afterwards, Sony and BMG announced similar plans for music downloads.

Warner Music Group Through its stake in Columbia House, Warner Music participated in Total E and the pending merger with CDNow. It also took part in industry forums such as SDMI and the San Diego downloading trial. In 1999, the company offered promotional digital downloads featuring some two dozen artists, and it was conducting market research to assess the impact of the promotions.

Overall, however, Warner's migration toward the Internet had been slow, in part due to its corporate parent Time Warner. Since 1994, Time Warner had championed a corporate-wide Internet initiative dubbed "Pathfinder." An ambitious effort to combine all of Time Warner's publishing, film, cable, and music interests in one portal, Pathfinder collapsed under the weight of corporate bureaucracy and conflicts of interest. By 1999, Time Warner was scrambling to catch up in the online arena.⁴⁰

EMI Among the majors, EMI had been the last to announce plans for online activity. In June 1999, it reached an agreement with musicmaker.com, a start-up company that made customized CDs and sold songs over the Internet. For five years, only musicmaker.com would be allowed to use EMI

songs in customized CDs.⁴¹ In return, EMI received a 50% stake in the venture. Soon afterwards, EMI announced that it would use Liquid Audio's technology to encode its songs for future digital delivery.⁴²

Organizing for Digital Distribution

Amidst the moves of competitors, customers, and entrepreneurs, Zelnick and Conroy considered how to organize BMG to serve the emerging set of "digital customers." Such customers would want to purchase bytes from BMG but might not buy a physical product such as a CD or a cassette. It was unclear who these customers would be. They might be online merchants, traditional retailers, consumers, or altogether new intermediaries, for instance.

One option was to set up a separate division within BMG to serve the new customers exclusively. According to recent rumors, Universal was pursuing this path: A distinct organization would dedicate itself to making music available through computers, kiosks, TV set-top boxes, and portable devices.⁴³ Skeptics felt that Universal was doing this primarily to create a division that it could later spin off in an IPO.

Another option was to give BMG's current distribution organization responsibility for digital customers. For years, the distribution division had successfully managed accounts, generated orders, overseen collections, reported sales, and delivered physical products. Pete Jones, the head of the organization, had little experience with digital technology, but then no one in the company had such experience. By all accounts, Jones was one of the few people in a contentious industry who was uniformly trusted and liked by retailers and artists.

However it was structured, the digital organization would soon need to choose a posture toward technology partners. To date, BMG had maintained relationships with the full array of companies—such as Liquid Audio, Microsoft, and IBM—involved in setting the standards and clearinghouse mechanisms for downloaded music. It was unclear whether BMG should continue to play the field in this manner or place a firm bet by backing one partner.

Zelnick and Conroy knew that their decisions would be highly visible in the close-knit music community. Competitors and customers alike would view the choices as signals of BMG's longer-term intentions. As Zelnick spoke, Conroy glanced at a painting across the office. In big bold letters, the painting carried a slogan: "A Man of Vision."

Exhibit 1 The Majors

Record Company	Parent	Origins	Major Labels	Selected Major Acts
BMG Entertainment	Bertelsmann, a German media conglomerate	<ul style="list-style-type: none"> Built on Bertelsmann's 1986 purchase of RCA 	<ul style="list-style-type: none"> Arista, Ariola, RCA, BMG Records, Red Seal, Windham Hill Group 	<ul style="list-style-type: none"> Christina Aguilera, Dave Matthews Band, Grateful Dead, Kenny G, Barry Manilow, Notorious B.I.G., Puff Daddy, Santana, Sarah McLachlan, Whitney Houston, ZZ Top
EMI	None	<ul style="list-style-type: none"> Formed from Depression-era merger of Columbia, Parlophone, and the Gramophone Company 	<ul style="list-style-type: none"> Chrysalis, Capitol, Virgin, Parlophone, Blue Note, Priority, EMI Classics 	<ul style="list-style-type: none"> Beastie Boys, Blur, Garth Brooks, Snoop Dogg, Lenny Kravitz, Smashing Pumpkins, Spice Girls, Robbie Williams, Hikaru Utada
Sony Music Entertainment	Sony, a Japanese entertainment conglomerate	<ul style="list-style-type: none"> Built on Sony's 1988 purchase of CBS Records 	<ul style="list-style-type: none"> Sony Records, Columbia, Epic 	<ul style="list-style-type: none"> Aerosmith, Mariah Carey, Miles Davis, Celine Dion, Plácido Domingo, Gloria Estefan, Aretha Franklin, Lauryn Hill, Billy Joel, Yo-Yo Ma, Wynton Marsalis, Pearl Jam, Bruce Springsteen
Universal Music Group	Seagram, a Canadian distiller	<ul style="list-style-type: none"> Formed from Seagram's 1995 purchase of Universal Studios from Matsushita and 1998 purchase of Polygram from Phillips. Universal descended from MCA, Decca, others. 	<ul style="list-style-type: none"> A&M, Geffen, MCA, Universal, Interscope, Mercury, Island, Polydor, Motown, Def Jam, Decca, Phillips, Deutsche Grammophon 	<ul style="list-style-type: none"> Bryan Adams, Beck, George Benson, Boyz II Men, Melissa Etheridge, Elton John, Limp Bizkit, LL Cool J, Marilyn Manson, Luciano Pavarotti, Sting, Shania Twain, U2
Warner Music Group	Time Warner, a U.S. media conglomerate	<ul style="list-style-type: none"> Formed primarily from independent labels acquired in the 1960s and 1970s 	<ul style="list-style-type: none"> Reprise, Atlantic, Elektra, Asylum, Rhino, EastWest, Warner Brothers Records 	<ul style="list-style-type: none"> Barenaked Ladies, Eric Clapton, Phil Collins, Goo Goo Dolls, Madonna, matchbox20, Natalie Merchant, Alanis Morissette, R.E.M., Third Eye Blind

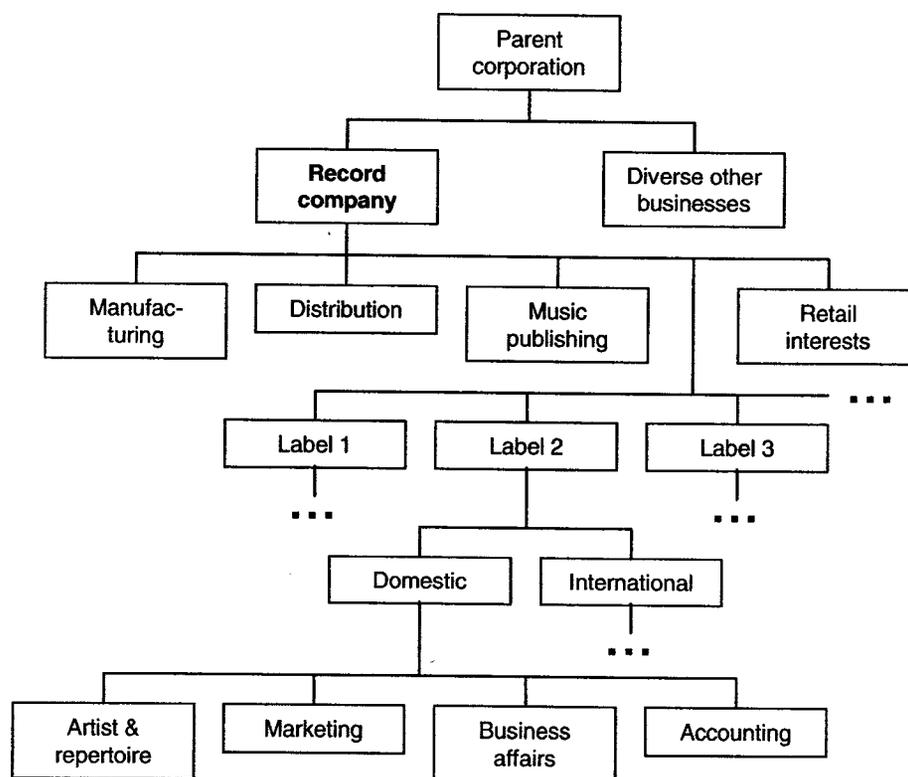
Source: Company annual reports and websites; P. Gronow and I. Saunio, *An International History of the Recording Industry* (London: Cassell, 1998).

Exhibit 2 Size and Geographic Distribution of the Global Music Industry

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Retail value of sales (US\$ bn)	27.8	29.5	31.2	36.1	39.7	39.8	38.6	38.7	38.5
Units sold (bn)	2.8	2.9	3.0	3.3	3.4	3.6	3.6	3.6	3.6
Percent of retail value of sales									
North America	30.4	32.6	34.0	35.2	32.9	33.1	33.4	36.6	39.4
Europe	39.7	37.8	35.0	33.3	34.8	34.5	33.3	33.6	33.8
Asia	20.4	21.8	22.6	23.3	24.5	22.9	22.6	20.3	19.2
Latin America	4.2	4.2	4.7	4.8	4.3	5.4	6.6	6.1	5.8
Rest of world	5.3	3.7	3.6	3.4	3.6	4.1	4.0	3.4	1.9

Source: International Federation of the Phonographic Industry, *The Recording Industry in Numbers*.

Note: Units include CDs, cassettes, and LPs.

Exhibit 3 Organizational Structure of a Major Record Company

Source: Casewriters.

Exhibit 4 Music Sales by Type of Outlet in the United States (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Record store	69.8	62.1	60.0	56.2	53.3	52.0	49.9	51.8	50.8
Other store	<u>18.5</u>	<u>23.4</u>	<u>24.9</u>	<u>26.1</u>	<u>26.7</u>	<u>28.2</u>	<u>31.5</u>	<u>31.9</u>	<u>34.4</u>
Total stores	88.3	85.5	84.9	82.3	80.0	80.2	81.4	83.7	85.2
Tape/ record club	8.9	11.1	11.4	12.9	15.1	14.3	14.3	11.6	9.0
Mail order	2.5	3.0	3.2	3.8	3.4	4.0	2.9	2.7	2.9
Internet	N/A	0.3	1.1						

Source: National Association of Recording Merchandisers—1994 and 1998 Annual Surveys.

Note: Totals may not add up to 100% due to "don't know/no answer" responses. Percentages reflect dollar sales, not units sold.

Exhibit 5 Music Sales by Genre in the United States (%)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Rock	36.1	34.8	31.6	30.2	35.1	33.5	32.6	32.5	25.7
Country	9.6	12.8	17.4	18.7	16.3	16.7	14.7	14.4	14.1
R&B	11.6	9.9	9.8	10.6	9.6	11.3	12.1	11.2	12.8
Pop	13.7	12.1	11.5	11.9	10.3	10.1	9.3	9.4	10.0
Rap/Hip-Hop	8.5	10.0	8.6	9.2	7.9	6.7	8.9	10.1	9.7
Gospel	2.5	3.8	2.8	3.2	3.3	3.1	4.3	4.5	6.3
Classical	3.1	3.2	3.7	3.3	3.7	2.9	3.4	2.8	3.3
Jazz	4.8	4.0	3.8	3.1	3.0	3.0	3.3	2.8	1.9
Soundtracks	0.8	0.7	0.7	0.7	1.0	0.9	0.8	1.2	1.7
Oldies	—	—	—	—	0.8	1.0	0.8	0.8	0.7
New age	—	—	—	—	1.0	0.7	0.7	0.8	0.6
Children	0.5	0.3	0.5	0.4	0.4	0.5	0.7	0.9	0.4
Other	7.5	6.5	7.4	6.6	5.3	7.0	5.2	5.7	7.9

Source: National Association of Recording Merchandisers—1994 and 1998 Annual Surveys.

Note: Totals may not add up to 100% due to "don't know/no answer" responses. Percentages reflect dollar sales, not units sold.

Exhibit 6 Demographics of Music Purchasers in the United States (% of purchases)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Gender									
Female	45.6	45.9	47.4	49.3	47.3	47.0	49.1	51.4	51.3
Male	54.4	54.1	52.6	50.7	52.7	53.0	50.9	48.6	48.7
Age									
10-14	7.6	8.2	8.6	8.6	7.9	8.0	7.9	8.9	9.1
15-19	18.3	18.1	18.2	16.7	16.8	17.1	17.2	16.8	15.8
20-24	16.5	17.9	16.1	15.1	15.4	15.3	15.0	13.8	12.2
25-29	14.6	14.5	13.8	13.2	12.6	12.3	12.5	11.7	11.4
30-34	13.2	12.5	12.2	11.9	11.8	12.1	11.4	11.0	11.4
35-39	10.2	9.8	10.9	11.1	11.5	10.8	11.1	11.6	12.6
40-44	7.8	6.7	7.4	8.5	7.9	7.5	9.1	8.8	8.3
45+	11.8	12.5	12.9	14.8	15.4	16.1	15.1	16.5	18.1

Source: National Association of Recording Merchandisers—1994 and 1998 Annual Surveys.

Note: Totals may not add up to 100% due to "don't know/no answer" responses. Percentages reflect dollar sales, not units sold.

Exhibit 7 Average Revenue and Cost of a Compact Disc Sold at a Retail Outlet

		Notes
Retailer economics		
Retail price	\$16.98	
Wholesale price (COGS)	10.75	
Gross margin	6.23	
Staff cost	1.36	
Distribution cost	1.36	
Rent (in a shopping mall)	2.55	As low as \$1.53 for a free-standing store
Operating profit	0.97	
Record company economics		
Wholesale price	\$10.75	
Cooperative advertising	0.86	
Manufacturing of CD	0.60	
Manufacturing of CD booklet	0.15	
Distribution and sales	1.40	As high as \$2.15 for independents
Marketing and promotion	2.15	Advertising, video clips, PR, tour promotion, etc.
Artist and repertoire	1.08	Includes production studio costs
Royalty payment to performing artist	1.29	15% of wholesale price minus 3% recoupment
Royalty payment to composer and lyricist	0.70	7¢ per song x 10 songs
Overhead and mailing	1.94	
Operating profit	0.59	

Source: "Is Biz Poised for Renewed Price Wars?" *Billboard*, January 8, 2000.

Exhibit 8 Composition of Bertelsmann Revenue, 1998-1999

By business segment:		By geographic segment:	
Books	30.8%	United States	34.7%
BMG Entertainment	30.1%	Germany	28.1%
Print and media	14.0%	Rest of Europe	29.6%
Magazines and newspapers	19.9%	Rest of world	7.6%
Professional information	3.4%		
Multimedia	1.8%		

Source: Bertelsmann public documents.

Exhibit 9 Financial Results of Major Record Companies, FY 1999

	BMG Entertainment	EMI	Sony Music Entertainment	Universal Music Group	Warner Music Group
Revenue (\$ mm)	4,306	3,596	6,336	3,751	3,834
Assets (\$ mm)	NA	2,950	6,298	16,392	7,483
Operating income (\$ mm)	177	367	320	-439	179
Return on sales	4.1%	10.2%	5.1%	-11.7%	4.7%
Return on assets	NA	12.4%	5.1%	-2.7%	2.4%

Source: Company annual reports, casewriter calculations.

Notes: For BMG, Sony, Universal, and Warner, results are for music business segment only. Because corporations differ in how they classify revenue, revenue totals shown here are not reliable for calculating market shares; see **Exhibit 10** for market share information. BMG revenue figure differs slightly from figure given in text because fiscal year is different from calendar year. Universal asset figure is inflated by recent purchases. Universal operating income figure includes \$313 million restructuring charge.

Exhibit 10 Music Industry Market Shares (% , U.S. only)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total albums^a									
BMG	9.2	10.7	12.0	12.9	12.4	13.5	14.5	14.2	17.3
EMI	13.4	11.6	11.8	11.2	9.8	7.9	11.9	12.3	9.3
Sony	16.5	17.2	17.3	15.3	13.9	14.3	12.8	16.6	16.9
Universal ^b	25.0	24.8	22.8	23.6	23.2	23.9	25.4	24.3	25.5
Warner	26.5	24.0	21.7	21.1	21.6	20.8	19.3	18.2	15.8
Others	9.5	11.7	14.6	15.9	19.1	19.6	16.1	14.3	15.3
Current albums^a									
BMG	—	—	—	—	13.5	16.5	17.6	16.8	20.8
EMI	—	—	—	—	9.8	7.2	12.3	12.5	8.2
Sony	—	—	—	—	13.4	14.5	11.9	17.3	17.8
Universal ^b	—	—	—	—	22.6	23.3	25.6	23.9	25.5
Warner	—	—	—	—	22.0	20.6	18.6	17.5	14.0
Others	—	—	—	—	18.7	17.9	13.9	11.9	13.7

Source: SoundScan, BMG.

^a "Current" albums exclude sales of old albums from a company's catalog. "Total" albums include both current albums and catalog sales.

^b Universal figures incorporate Polygram sales prior to purchase of Polygram.

Endnotes

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- ¹⁹ Information on EMusic.com comes especially from V.A.G. Vickers and J.C. Ignalls, "EMusic.com," ING Barings, October 11, 1999, and EMusic.com's Form 10-K, June 30, 1999.
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