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Is there a future? An Analysis of the Music Industry through its History and its Strategy for Survival in the Age of Peer to Peer & File Sharing Technologies

By

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Submitted to the MIT Sloan School of Management in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration

At the

Massachusetts Institute of Technology

June 2007

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MIT Sloan School of Management, June 2007

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Is there a future? An Analysis of the Music Industry through its History and its Strategy for Survival in the Age of Peer to Peer & File Sharing Technologies

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ABSTRACT

The recorded music business is presently at a crossroads: new technologies have forever changed the way business is conducted, revenues are getting smaller every year, the conversion of revenue origin from sales of physical products to digital ones is not happening at a rate anywhere near what would be needed for one format to subsidize the other, the major players are merging at the same rate that their sales decrease and the old adage that claims "in business, one plus one does not always equal two" has proven to be truer than ever in each one of the mergers.

What follows aims to introduce readers to the history of the so called "music industry", analyze its growth and expansion throughout the twentieth century, its crisis in the late 1990's as new technologies changed the playing field and its struggle for survival in the new century.

The behavior of the corporate powers in the business has been replicated throughout their subsidiaries worldwide in scaled versions, making it possible to "generalize" on the use of certain examples from around the world, and the response of music consumers -the end users- has been extremely massified, almost homogeneous as well. Meaning, examples from different parts of the world normally apply to the business in general.

An ample research study of music downloaders based in the Argentinean music market was designed and carried out for the purpose of this paper, and its results are exclusively commented here. It is the author's belief that this study does very well in representing the Latin American region's outlook for the legitimate music business going forward and to a moderately large extent, the global one.

In the end, personal conclusions from the author will set a critical point of view from within the music industry, with an emphasis on what principles are applied by me daily in my present position as Managing Director of a major label in the region formed by Argentina, Bolivia, Chile, Paraguay and Uruguay.

THESIS SUPERVISOR
Roberto Rigobon
Associate Tenured Professor
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First of all, I want to thank Professor Roberto Rigobon for his time, help, and above all his passion for music and desire to understand this business that made it possible for me to expand on the subject knowing I had his full support and guidance.

My classmates and friends at the Sloan School of Business for your patience and dedication to pushing me further than I ever imagined going -- and making sure I learned in the process! -- Special thanks go out to Yulia Schpilman, Bryant Vernon, Scott Roberts & Tal Ben-Shahar from my core team, Gabriel Papandrea from my ocean and the rest of the great people in the class of 2007. You guys are and will always be my family overseas.

Tara Walor, thank you so much for all your help!

Debbie Berechman and Catherine Gamon, thanks for finding the flexibility to realize that this is not how I meant my Sloan experience to be but that sometimes things happen for a reason. I went to Sloan to be able to do exactly what I am doing and I do hope you are happy knowing you helped me do it!

Everyone at New Line Cinema who helped with my applications: Tracy, Rob, Nestor. This is what we talked about for so long while working together and there is no way I could have done this without you. I do hope to get to work with you guys again one day.

Marco Bissi, for believing in me enough to give me a chance I thought I was going to have to wait a few years for -- if ever! --. Every time I heard you say that I was part of the solution and not of the problem I knew you realized how hard I will work to prove you were right.

Everyone at EMI, especially Joe McCollum for all the trust and advice, and the wonderful team at EMI Argentina for coping with me while I tried to pull off this wonderful and apparently impossible feat of moving halfway across the world, balancing MIT, being a newlywed and managing the company through an extremely complicated year for our business.

Mom & Dad, I hope you are proud of me. Everything I have tried to do in life is to make you happy and proud and I will continue trying, always.

And above all, to Paulina, my wife. It is because of you that I get up every day and get through everything that threatens to defeat me. I will always look to you for guidance, support and a smile... So keep smiling! I love you, always.

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WHAT IS THE RECORDED MUSIC BUSINESS

There are different players in the market, from record labels (majors or independent), music publishers, songwriters, performers, media, retailers – bricks and mortar or online-, and clearly, consumers. Each player had a defined role for many years, but technology is quickly making the lines blurry; it is now very common for each player to take on more than one role in the market in an attempt to capture more value for itself. This is why record labels are signing publishing deals directly or using the “full rights” model, publishers are signing artists, retailers are creating their own record labels and consumers have become –arguably and unbelievably for the first time- the key players in this game.

The “music business” or “music industry” –terms you will see mentioned quite often in this paper- can best be explained by the following value creation chart:

---

1 The “full rights model” as we have chosen to refer to it, is the new “model” contract that record labels are increasingly signing with artists. It provides the labels with a stake in all of the artists' revenues, not just the recorded music ones.

2 Constructed from a model found on EMI Music International's website

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Value Creation in the Recorded Music Business

Sheet music publisher

License

The song

Copyright royalties

Performance royalties (writer’s share)

Songwriter & recording artist may be one and the same

Recording artist

Performance royalties

Overhead

Record Label

Wholesale price

Retail price

Retailers, (CD retailers & online/mobile)

Performance royalties

Performance royalties

Recording

Synchronisation license

Synchronisation fees

Synchronisation

(film & TV production, Companies, ad agencies, Computer games, etc.

Public performances (broadcasters, live, venues, etc)

Music Publisher

Overhead

Collection societies

Performance rights

Mechanical royalties & performance royalties

Performance license

Master use royalties

Consumers

License

Fees royalties

Music

Revenue

Licenses

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HISTORY OF THE RECORDED MUSIC BUSINESS

In July of 1877 the American inventor Thomas Alva Edison discovered a method of recording and replaying sound having followed a somewhat different line of research from Scott or Cros (they had invented the phonautograph which translated fluctuating air pressures into a scribed trace on a smoked cylinder by means of a stylus attached to a membrane. The resulting transcription could not reproduce the sound). Edison filed a provisional specification for British patent 2909/1877 and on December 24, applied for the US Patent 200521 which covered talking machines and sound writers to be known as Phonographs. The first phonographs used tin foil cylinders.

Later on in the 1870's, Jesse Lippincott, a financier, took over the commercial exploitation of the Phonograph and the Graphophone as dictating machines on a lease and service contract. The Graphophone had been developed by Edison's rivals, Chichester Bell (the brother of Alexander Graham Bell) and Charles Tainter at the Volta laboratory and in terms of ease of operation and fidelity of sound reproduction it was a vast improvement on the phonograph. The use of either machine as an entertainment medium was still seen as a novelty.

In 1884, Emile Berliner, an American of German origin, recorded "The Lord's Prayer" on an Edison cylinder machine (the original recording is preserved by the BBC in London) By 1889, coin-in-the slot public access replay facilities, a primitive form of juke box, which could be used in amusement arcades, had become immensely popular in the US creating a demand for entertainment recordings, mainly comic monologues. By 1895, the public was very well aware of the existence of recorded music as a form of home entertainment, the first
recording studios were built and in 1919 Paul Whiteman and his Orchestra produced the first million selling piece of recorded music with "Japanese Sandman" coupled with "Whispering" and began a major new popular music craze that boosted the record industry throughout the decade.

The first record labels appeared by 1920 with the Victor Company (who went from producing the "Victrola" model gramophone in the early 1900's to producing records to be used with the victrolas in the 20's) Legendary recordings were made at the Victor Company's studios in New Jersey. In 1926, Edison experimented with two-sided discs which could play for twenty minutes each side, but his technique would not become popular until the late 1940's with vinyl discs.

In 1921 General Electric acquired the American branch of Marconi Wireless Telegraph and renamed it "Radio Corporation of America" (RCA). In 1924 the Music Corporation of America (MCA) was founded in Chicago as a talent agency, and the German record company Deutsche Grammophon (DG) opened the Polydor Company to distribute records abroad. In 1929 Decca was founded in Britain by Edward Lewis, and RCA purchased Victor Talking Machines. That same year, the depression hit the incipient music industry, sparking the first wave of mergers the industry would know of. In 1931 EMI (Electrical and Musical Industries) was formed by the merger of rival companies Gramophone (HMV), Parlophone and the British subsidiary of Columbia, by far the largest record label in the world (as it will be for the next 50 years) and opened the largest recording studio in the world at Abbey Road in London.

In 1895 Italian inventor Guglielmo Marconi had invented radio broadcasting, but it took a while for people to realize that it could be used beyond the maritime realm (initially, for about 20 years it was mainly used by ships). When the USA entered World War I, the government decided that radio broadcasting was a
strategic technology and helped perfect it to the point that, at the end of the war, in 1920, Westinghouse Electric established a commercial radio station, "KDKA". It also played records.

In 1926 General Electric started the "National Broadcasting Company" (NBC), run by David Sarnoff, and in 1928 the United Independent Broadcasters (later renamed Columbia Broadcasting System, or CBS, which would much later be purchased by the Sony Corporation and become Sony Music), run by William Paley, was created by 47 affiliate stations.

The first magnetophonic recording was carried out in 1936, and in 1942, the first ever Gold Record award was presented by RCA to Glenn Miller for a million copies sold of the all-time classic “Chattanooga Choo Choo”. Decca, Mercury and Capitol joined EMI, CBS and RCA/Victor as the “major labels” that would concentrate 97 % of “Gold” albums in the 30’s and 40’s.

The 1950’s saw the birth of Rock & Roll, the musical genre that brought teenagers into the “music market”. Hundreds of record companies were founded during this decade when fierce competition for radio broadcasting space and lack of scruples played a vital role in generating practices that have long haunted the music industry, such as “payola” (bribing radio programmers to get airplay).

For the first five to ten years, the majors doubted whether Rock & Roll was a definitive tendency or a passing trend. The independent labels did not hesitate and dominated the market: 69 % of singles to make it into the Top 10 Chart in the U.S. did not come from the majors. In 1962, 42 different labels had albums

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that charted in Billboard and the six majors combined had less than half of the total entries.

After a short format “battle” over the size and rpm’s of the discs to be used (with the 78 rpm, the 45 rpm and the 33 & 1/3 rpm in the dispute), the 78 rpm is largely discontinued in favor of the other two formats. In 1956, stereo recordings are introduced and become the norm in the early 1960’s. Before the end of this decade, the best recording studios in the world are equipped with 48 track consoles, allowing for new mixing techniques and entirely new sounds.

Phillips invented the cassette –which would create a new standard- but failed to secure a patent and subsequently lost Billions because of this as by 1965 virtually every major record by hit recording artists was released as an LP and cassette, every large record company had a cassette manufacturing plant in each one of its biggest selling territories worldwide, there were over 100 manufacturers of players, and 2.4 million cassette players had been installed in cars in the United States alone.

In 1966 Dr. Ray Dolby introduced the Dolby Noise Reduction System which became a universal standard by enormously reducing the background noise associated with the format and was used by the music, film and overall home entertainment industries.

The cassette business generated roughly $ 150MM in 1968. The number of releases in the format grew exponentially and by the early 1970’s, every album was released on cassette as sales surpassed those of LP albums in 1977.

A major technological landmark was introduced in 1979 by Sony, one that would revolutionize the music industry as a whole: the “Walkman” portable

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cassette player made the cassette king of home and on-the-go entertainment by 1981, when a newer, smaller model was presented.

It was also in 1981 when Music Television (MTV) first aired "Video Killed the Radio Star" by the Bugles, its first ever video clip. Some argue this was the single largest factor in the massification of music. Whether one agrees or not, it goes without saying that the way the music industry promoted its products was altered and its reach expanded drastically.

Perhaps by being a combination of great content released at the perfect time, Michael Jackson’s "Thriller" album —released in 1982- became the largest selling recording ever, with over 60 million copies sold to date of the full length album and around 100 million copies sold including the single albums. This album produced seven promotional singles (including Thriller, Billie Jean, and Beat It)

In Japan, the first CD players were sold that very same year in October. They would not reach the US and Europe until March of 1983. The format grew quickly, presented as the highest quality medium that would last forever. Consumers began to convert their LP and cassette collections to CD, and in 1986, over 52 million CDs were sold worldwide. Two years later in 1988, CD sales reached 200 million units and surpassed those of vinyl, which was beginning to disappear.

The CD proved to be a worthy format for the industry, surviving until this day, although sales have declined in the last few years due to increased physical piracy and new technologies allowing digital copies of albums to be stores in computers and portable music players.
1996 was the record year: the retail value of recorded music hit US$ 39.8 BN, a number it has yet to be close to since. 1998 was the year MP3 was introduced. It quickly became a popular format, and the music business proved to be unprepared for dealing with something like this. As internet bandwidth grew, so did file sharing applications which allowed PC users worldwide to pass files on to each other without the need for the content sitting on a physical support medium; as the internet became better, faster and more readily available this practice intensified.

The mid-nineties saw big brand logos sponsoring cultural events and soon, events were created by the brands themselves, with the act relegated as the backdrop to the brand. From albums to concerts, the brand took over. IEG Sponsorship Report shows a 700% increase in US corporate sponsorship spending since 1985. Corporations now upstaged the bands or the artists. The success of MTV as a brand is shown by our everyday use of the word.

The industry today is dominated by four major record companies: Vivendi's Universal Music Group, Sony Corp and Bertelsmann's joint venture Sony BMG Music Entertainment, EMI Group and Warner Music Group.

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ALL-TIME BEST SELLING RECORDINGS

These are the Top 10 selling records worldwide through history. It is important to note that the total sales figures vary depending on the source, but this is the list most sources agree on.

<table>
<thead>
<tr>
<th>ARTIST</th>
<th>ALBUM</th>
<th>YEAR</th>
<th>UNITS (MM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Michael Jackson</td>
<td>Thriller</td>
<td>1982</td>
<td>60.0</td>
</tr>
<tr>
<td>AC/DC</td>
<td>Back in Black</td>
<td>1980</td>
<td>42.0</td>
</tr>
<tr>
<td>The Eagles</td>
<td>Greatest Hits 1971-75</td>
<td>1976</td>
<td>41.0</td>
</tr>
<tr>
<td>Pink Floyd</td>
<td>The Dark Side of the Moon</td>
<td>1973</td>
<td>40.0</td>
</tr>
<tr>
<td>Bee Gees</td>
<td>Saturday Night Fever OST</td>
<td>1978</td>
<td>40.0</td>
</tr>
<tr>
<td>Shania Twain</td>
<td>Come on Over</td>
<td>1997</td>
<td>39.0</td>
</tr>
<tr>
<td>Meat Loaf</td>
<td>Bat Out of Hell</td>
<td>1978</td>
<td>37.0</td>
</tr>
<tr>
<td>Various Artists</td>
<td>The Bodyguard OST</td>
<td>1992</td>
<td>37.0</td>
</tr>
<tr>
<td>The Beatles</td>
<td>Sgt. Pepper's Lonely Hearts…</td>
<td>1967</td>
<td>32.0</td>
</tr>
<tr>
<td>Various Artists</td>
<td>Dirty Dancing OST</td>
<td>1987</td>
<td>32.0</td>
</tr>
</tbody>
</table>

Table 1 - All-time Best selling records

WORLDWIDE RECORDING INDUSTRY ANALYSIS: 1996 - 2005

As we have already mentioned, 1996 was the record year for the industry in terms of total value creation. It has never again been able to hit the numbers of that year, and it is difficult to predict if and when it ever will. Some analysts believe that by 2010, legal digital sales will have grown enough to bring the

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3 Compiled by the author from several sources.

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market back up to where it was before physical sales began to erode; however, it is my personal opinion that there is general failure to recognize or interpret the impact that slowing music DVD sales will have on the faster than expected-demise of physical formats.

DVD sales grew abnormally during the 2001 – 2004 period (340 % in total) but only 9 % from 2004 to 2005. While 9 % may appear to be good, healthy growth for a developed market, I see it as a sign that consumers have finally built up their libraries with catalogue items—something that would explain the growth in the 2001 – 2004 period—and now the market will depend on the quality and quantity of new titles made available yearly. It is not far fetched to think that the music DVD will sooner than later begin to take the same path the CD is on and as broadband becomes, well, broader, consumers will download video directly to their computers and personal video players much in the same fashion they do songs.

Table 2 - Retail Value of Recorded Music Business (1996-2005)

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Although IFPI is still processing final market figures for 2006, once those numbers are analyzed it is not expected that they will be a positive signal for the industry: the tendency in the first six months clearly points out that digital sales, although growing steadily, are not yet a one-on-one replacement for decreasing physical sales, and the market will show a decline of around 5% as compared to 2005.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>RETAIL VALUE</th>
<th>% VAR FROM PREV. YEAR</th>
<th>% VAR FROM 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>39.812</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>1997</td>
<td>38.473</td>
<td>-3.36%</td>
<td>-3.36%</td>
</tr>
<tr>
<td>1998</td>
<td>38.298</td>
<td>-0.45%</td>
<td>-3.80%</td>
</tr>
<tr>
<td>1999</td>
<td>38.802</td>
<td>1.32%</td>
<td>-2.54%</td>
</tr>
<tr>
<td>2000</td>
<td>36.858</td>
<td>-5.01%</td>
<td>-7.42%</td>
</tr>
<tr>
<td>2001</td>
<td>34.787</td>
<td>-5.62%</td>
<td>-12.62%</td>
</tr>
<tr>
<td>2002</td>
<td>32.538</td>
<td>-6.47%</td>
<td>-18.27%</td>
</tr>
<tr>
<td>2003</td>
<td>32.340</td>
<td>-0.61%</td>
<td>-18.77%</td>
</tr>
<tr>
<td>2004</td>
<td>33.507</td>
<td>3.61%</td>
<td>-15.84%</td>
</tr>
<tr>
<td>2005</td>
<td>33.456</td>
<td>-0.15%</td>
<td>-15.97%</td>
</tr>
</tbody>
</table>

Table 3 - Retail value of Recorded music business and variations since 1996

“PHYSICAL” SALES AS OPPOSED TO “DIGITAL” ONES

Physical sales include audio formats (LPs, cassettes, CDs, DVD Audio, SACD, MiniDisc) and music video formats (DVD, VHS, VCD).

In reality, there are only two formats being used today, the cassette, CD and DVD—music videos—, with cassettes accounting for 7.67% of total sales, CD and DVD for 85.21% and 6.54% respectively, leaving a mere 0.58% for all other formats combined.

Digital sales include single track downloads (from the internet to home computers, to be used with PC speaker systems or MP3 portable players such as Camilo Kejner

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as Apple’s iPod), album downloads (full albums to be used in the same way), music video online downloads, streams (not an actual download, the content can only be played in real time over the internet but no files are sent to the listener), master ring tones (portions of a real recording used as cell phone ring tones and downloaded by users), full track audio download to mobile (for MP3 capable cell phones), ring back tunes (much like a master ring tone, except it is heard in lieu of a “calling” tone by callers trying to reach the user of the phone in which the ring back tune sits) and music video downloads to mobile. Midi files (monophonic and polyphonic ring tones, which are low quality and oftentimes computer generated or cover versions of popular recordings) and other content to mobile (including logos/wallpaper) are excluded from the market figures we will discuss below.

THE MARKET IN 2005

Overall recorded music sales (physical and digital) fell by 3.0 % in 2005 as compared to 2004.

Global digital and physical sales totaled US$ 21 billion in record companies’ trade revenues. On a retail price basis, the global recorded music market is estimated to be worth US$ 33.4 Billion.

Singles sales (digital and physical) increased by more than 75.0 % globally in units in 2005. Singles are now largely a digital format, with digital singles (online downloads and full track downloads to mobile) accounting for three quarters of total singles sales, compared to 45.0 % in 2004.

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Sales of physical formats fell by 6.7 % in value (record company trade revenues) and 8.0 % in units. CD album sales were down 6.0 % in value and 3.4 % in units. DVD music video dropped by 4.3 % in value but remained flat in unit terms.

The record industry released more than 120,000 albums in 2005, including new titles, re-issues and digital only recordings. The number of albums released is growing in major markets – by 36 % in the United States in 2005, for example.

THE MARKET IN 2006

In the largest music market in the world, the US, the continuing sales drop of music compact discs accelerated to nearly 13 % in 2006 with digital sales, while although fast-growing, failing to make up for the sales shortfall.\(^4\)

Though sales of music in digital formats such as downloads and mobile ringtones more than doubled in some cases during the year, digital sales did not grow fast enough to cover the revenue gap caused by the downturn in CD sales. Consequently overall music sales were down by 6.2 % to $11.51 Billion.

More than 615 million CDs were shipped to retail and specialty outlets in 2006 according to the RIAA, a 12.8 percent drop from the previous year. It said sales of CDs fell by 8.1 percent in 2005.

\(^4\) According to figures published by the Recording Industry Association of America, April 10, 2007.

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According to the RIAA, sales of digital songs were up by 60 percent while sales of digital albums more than doubled. Overall digital sales rose by 74.4 % to $878 million. Sales of digital music for use on mobile phones were up by 83.7 % to $774.5 million.

Globally, sales of digital music in the first half of 2006 rose 106.0 % to US$ 945 million when compared with the first six months of last year, with digital sales now accounting for 11 % of the total recorded music market worldwide, up from 5.5 % in December 2005.

The US is still leading the digital sales surge, with 18.0 % of recorded music sales now being made through digital channels. Digital music sales in the US increased by 84.0% to US$ 513 million in the first six months of 2006.

Digital music also accounts for a significant part of the overall market in South Korea (51%), Japan (11%), Italy (9%) and the UK (8%).

The explosion in digital music services, spurred by consumer demand and a widening array of delivery channels, has seen online and mobile music sales grow from $ 134 million in the first half of 2004 to the quoted US$ 945 million in the first half of 2006.

Physical music sales declined in the first half of the year, down by 10.0 % worldwide, leading to total music sales falling by 4.0 % in the period to $ 8.4 billion in trade values ($ 13.7 billion in retail values).

There was growth in some markets, such as Japan (12%), South Korea (5%) and Australia (6%), counter-balanced by declines in Germany (-4%), the US (-7%) and France (-9%).

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Digital sales are split roughly 50/50 between online and mobile at the global level, but there are big regional differences. In Japan and parts of continental Europe, mobile dominates the digital music market, while online sales are relatively stronger in markets such as the US, UK and Germany.

Master ring tones are currently the largest segment of the mobile market accounting for 87% of mobile sales. However, new mobile formats such as full track downloads to mobile and music videos grew faster (180% increase in trade revenues) than master ring tones (120%). Most of the global online market comprises a-la-carte sales and is led by Apple’s iTunes. Online a-la-carte downloads account for 86% of online sales globally.
A MARKET STUDY: DOWNLOADING HABITS

The purpose of the study\(^5\) to be included on this paper was, broadly, to obtain information about music consumers in the digital age by profiling and characterizing people who choose to download music illegally and establishing how they choose to relate to legal ways of purchasing music, whether physically or digitally.

The methodological strategy designed for the study was to have a qualitative quantitative characteristic with three very distinct modules:

A qualitative one consisting of 6 focus groups carried out in September 2006. From these focus groups, indicators were identified that would then be used to quantify different aspects of the study matter. The focus groups' information also helped in providing elements contributing to the interpretation of the results.

Based on the original set of goals for the study and flexibility in incorporating issues arising from the focus groups, a questionnaire was designed for the second –quantitative- module which consisted of 600 personal interviews \((n=600)\) with people aged 11 to 35 in the key urban conglomerates of Argentina. Two simple questions were asked as introduction to the rest of the questionnaire: do you connect to the internet? And if so, do you download music from the internet? Only if the answer was “yes” in both accounts did the interview continue. The issue of legality was not brought up at this point.

\(^5\) As a member of CAPIF’s (Cámara Argentina de Productores de la Industria Fonográfica - Argentinean Chamber of Producers of the Phonographic Industry-) board and serving in the role of Executive Vice President, I was in charge of designing the basis of the study that was carried out by the reputed Argentinean consulting firm Knack.

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Simultaneously to these two modules, 9 in-depth interviews were carried out with well known opinion makers and referents of the music and "digital" worlds. The goal here was to identify the key “expert” interpretations for the downloading phenomenon.

The lack of a previous framework to benchmark against made it hard for us to have a “measure” of accuracy in our study. Also, being the first study of its kind, we had zero degree observations of the “downloader” population, which made for a groundbreaking study but at the same time made it exponentially more difficult.

MUSIC AND DOWNLOADERS

Amongst people who download music we found that it (music) ranks first (3.85 average on a scale from 1 to 5) in their list of primary interests as compared to the other noteworthy mentions: clothes, sports, television and movies, with a very significant statistical difference.

<table>
<thead>
<tr>
<th>Interests</th>
<th>1 to 5 (Average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Music</td>
<td>3.85</td>
</tr>
<tr>
<td>Clothes</td>
<td>3.45</td>
</tr>
<tr>
<td>Sports</td>
<td>2.89</td>
</tr>
<tr>
<td>TV</td>
<td>2.71</td>
</tr>
<tr>
<td>Movies</td>
<td>2.11</td>
</tr>
</tbody>
</table>

Table 4 - Interests of People 11 to 35

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74% of downloaders listen to music daily in media other than in the radio— to which 84% of them tune into daily— with only 2% listening to music less than twice a week.

There is literally no legal download business in Argentina, so the discovery that 95% of internet users who download music make this the primary use they give the net (far from emailing’s 80% and chatting’s 78%) should come as a rather worrisome figure for the industry.

<table>
<thead>
<tr>
<th>Use of the Internet</th>
<th>% (multiple answers allowed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Download Music</td>
<td>95%</td>
</tr>
<tr>
<td>Email</td>
<td>80%</td>
</tr>
<tr>
<td>Chat</td>
<td>78%</td>
</tr>
<tr>
<td>Seek Information</td>
<td>68%</td>
</tr>
<tr>
<td>Play Games</td>
<td>32%</td>
</tr>
<tr>
<td>Read News</td>
<td>20%</td>
</tr>
<tr>
<td>Work</td>
<td>15%</td>
</tr>
<tr>
<td>Purchase Products</td>
<td>7%</td>
</tr>
</tbody>
</table>

Table 5 - Uses of the Internet

While almost half of downloaders engage in the practice from home (45%) there are is large number (38%) who download music at public places like cybercafés.
<table>
<thead>
<tr>
<th>Download Music From</th>
<th>% (one answer allowed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home</td>
<td>45 %</td>
</tr>
<tr>
<td>Cybercafés</td>
<td>38 %</td>
</tr>
<tr>
<td>Friend’s House</td>
<td>12 %</td>
</tr>
<tr>
<td>Work</td>
<td>3 %</td>
</tr>
<tr>
<td>Other Places</td>
<td>2 %</td>
</tr>
</tbody>
</table>

Table 6 - Where do you download music from?

The fact that there is a large incidence of public-place downloading in lower socioeconomic levels of society is not surprising, but the facts that it is also largely skewed towards 11 to 15 year olds and that 62 % of downloaders have only begun to download in the past 12 months are. That this statistic would come to light in the midst of all the anti-piracy, anti-downloading activities that the music industry has and is undertaking is discouraging to say the least.

IS THE CD DEAD? PHYSICAL HABITS OF DOWNLOADERS

No, it isn’t. But it agonizes a slow —or fast, depending on whom you are talking to- death. Alain Levy, former Chairman of EMI Music said "power is shifting everywhere from manufacturers, content providers and retailers to consumers. In this age of empowerment, the consumer is king". Levy went on to say “recording companies must make CDs more appealing to people by adding value that compels individuals to buy physical media” and that “the CD as it is right now is dead”\(^6\). Did he mean that the music industry should discontinue the manufacturing and distribution of CDs altogether? Probably not. More than likely, he was referring to the need to incorporate “added value” —more, better content- to the format in order to entice customers to continue purchasing CDs.

\(^6\) From Levy’s keynote speaker address to the London Media Summit, October 27, 2006.
The people we interviewed for our market study said that they would be interested in an “added value proposition” CD. 57% of them said they would be more willing to buy if original CDs came with wallpapers, interactive tracks, or photos. But, this is in contrast to 36% of people who said they would not buy more CDs regardless of what is in them. And worse, amongst those who do not buy CDs as it is, disinterest grows. People who do not buy recorded music now are a lost market for physical products: 42% of non-buyers are not interested in having an original CD collection.

If we consider downloaders to be a representative group for music consumers in general one can quickly come to the conclusion that while the CD must still be a supported format for the industry as it represents over 90% of worldwide legitimate sales, there is a new generation of consumers who don’t care about the CD and to them it doesn’t have any appeal whatsoever. Pretending to prolong the life of the full “artist” CD indefinitely is a perfect strategy for failure. However, thinking of an outlet that allows users to create their own CDs from a list of songs should work: the concept of CD burning kiosks must be explored: 65% of all downloaders prefer songs to artists and 34% of all downloaders say that “regardless of price they don’t want original CDs because they only like one or two songs from each album”. Further, 35% of downloaders say that “they don’t care about artwork, booklets, photos or jewel boxes”.

As a matter of fact, downloaders have, in average, more legally purchased, original CDs than burnt ones (34% vs. 28%). The numbers to worry once again, come from the younger age groups, as 11 to 15 year olds have more burnt and pirated CDs (59%) than originals (26%).
There is still a physical habit amongst those who download music: asides from whatever small music purchasing habits they have, 76% of them burn CDs with the music they download. The “mix tape” of the 1980’s is back as a burnt CD that younger audiences make as means of expressing feelings or as a creative outlet.

FREQUENCY OF DOWNLOADING

Given the intensity of their downloading habits, we can talk about three types of downloaders: intermittent (about 50% of them, download an average of 5 tracks per week), stable (35%, download an average of 12 tracks per week) and permanent (15%, download an average of 28 tracks per week).
MIT Sloan School of Management
Is There a Future for Analys of the Music Industry
Camilo Kehre

Radio Stations

Question: Which one of these stations is your favorite? Single Answer:
Question: Which radio stations do you usually listen to? Multiple Answer:

Interpreted from the image, the data shows the percentage of interviews where each radio station was preferred. The stations include:
- No Preference: 9%
- Others: 10%
- Other Stations: 10.7%
- X: 7%
- C: 7%
- Blue: 1%
- Del Sol: 10%
- 108.9 Ramen: 3%
- Passion Tropical: 1%
- Passion: 3%
- 100.5: 3%
- Pop Radio: 2%
- Kabel Rock: 2%
- Aspen Classic: 1%
- Metro: 1%
- Mtv: 1%
- Radio Disney: 6%
- F'M Hill: 6%
- Rock & Pop: 1%
- L.A. Mega: 6%
- L.A.: 100%

Interpreted interviews from the image, 45% of the interviews preferred a specific station.
Most listened to Music

QUESTION: What are the three artists or bands you have been listening to lately?

Local rock is the #1 Segment

Local rock

Latin

Cumbia/Cumbia villera

How do you get to know the music you listen to?

52% "RECEPTIVE": get to know their music from friends or media

25% "EXPLORERS": constantly searching, browsing, for new music to get to know.

Camilo Kejner
Is There a Future? An Analysis of the Music Industry
MIT Sloan School of Management
Where do you connect to the internet?

- Internet hub
- Most used internet hub

Half of the interviewees connect to the internet from at least two different hubs

Base: Total interviewees

Cybercafes facilitated lower SEL access to music downloading hubs

Camilo Kejner
Is There a Future? An Analysis of the Music Industry
MIT Sloan School of Management
How they connect from home

52% connects from home, which is the main hub for 47% of them.

QUESTION: What type of internet connection do you have at home?

84%

Broadband penetration amongst downladers 45%

Home downloading and broadband go hand in hand.

47%

5%

Main hub
Alternate hub

Connects from home
Uses broadband

REGION
BA 56% 54%
Interior 37% 35%

SEL
High 77% 74%
Mid 56% 52%
Low 33% 32%

Base: interviewees who connect from home (52%)

Camilo Kejner
Is There a Future? An Analysis of the Music Industry
MIT Sloan School of Management
How frequently they connect to the internet

84% connects daily

Listen to Music

<table>
<thead>
<tr>
<th>PRINCIPAL (%)</th>
<th>Total</th>
<th>SEL</th>
<th>Age</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>C1</td>
<td>C2</td>
</tr>
<tr>
<td>EVERY DAY</td>
<td>43%</td>
<td>69%</td>
<td>48%</td>
</tr>
<tr>
<td>SEVERAL TIMES A WEEK</td>
<td>41%</td>
<td>24%</td>
<td>38%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>84%</td>
<td>93%</td>
<td>86%</td>
</tr>
</tbody>
</table>

Camilo Kejner
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MIT Sloan School of Management
Uses of Internet

QUESTION: Of the following list, what uses do you give the internet? MULTIPLE

- Download music: 95%
- Send / Receive emails: 80%
- Chat: 78%
- Seek information: 67%
- Play / download games: 32%
- Read news: 20%
- Work: 15%
- Purchase products or pay for services: 7%
- Others: 3%

Base: Total interviewees
## Most frequently used MP3 players

### QUESTION: Could you tell me if you own? MULTIPLE - GUIDED

<table>
<thead>
<tr>
<th>Device</th>
<th>Percentage</th>
<th>Has and uses often</th>
<th>Has but doesn’t use</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stereo</td>
<td>84%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other MP3 Player</td>
<td>38%</td>
<td>6%</td>
<td>44%</td>
</tr>
<tr>
<td>Discman</td>
<td>20%</td>
<td>14%</td>
<td>6%</td>
</tr>
<tr>
<td>Walkman</td>
<td>10%</td>
<td>16%</td>
<td>26%</td>
</tr>
<tr>
<td>Ipod</td>
<td>7%</td>
<td>1%</td>
<td>8%</td>
</tr>
<tr>
<td>Others</td>
<td>1%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**C1: 2 out of 10**

**Base: Total interviewees**

### QUESTION: Please think about the moments when you listen to music. Where do you listen to it?

<table>
<thead>
<tr>
<th>Device</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stereo</td>
<td>33%</td>
</tr>
<tr>
<td>Computer</td>
<td>32%</td>
</tr>
<tr>
<td>Radio</td>
<td>25%</td>
</tr>
<tr>
<td>Ipod/Discman/Mp3</td>
<td>10%</td>
</tr>
</tbody>
</table>

### SEL

<table>
<thead>
<tr>
<th>设备</th>
<th>C1</th>
<th>C2</th>
<th>C3/D1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stereo</td>
<td>21%</td>
<td>28%</td>
<td>40%</td>
</tr>
<tr>
<td>Computer</td>
<td></td>
<td>48%</td>
<td>33%</td>
</tr>
<tr>
<td>Radio</td>
<td>17%</td>
<td>23%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Camilo Kejner  
Is There a Future? An Analysis of the Music Industry  
MIT Sloan School of Management
Listening to music on the PC: Habits

QUESTION: Of all the possible ways of listening to music on the PC, you...

- 91% of 2 out of 3 people who listen to music on their PC listen to music from the HD.
- 65% listen to music on the HD
- 59% music from a CD
- 45% music from websites
- 14% music on the HD
- 20% internet radio

PC or Stereo?
- 50% prefers to listen from PC because it is more comfortable and easy
- 3% prefers listening from stereo because of the higher quality
- 47% no answer

How they listen through the PC?
- 66% listens through PC speakers
- 34% has PC connected to a stereo

Base: Interviewees who listen to music primarily from their computers.
Most often used downloading software

Organized by MP3 files. Saves downloaders time.

Ideal for downloading entire discographies.

CONCENTRATED: 6 out of 10 downloaders use Ares or Emule to get their music

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Intensity of downloading habits: segmentation

- Based on how often downloaders engage in the activity, we segmented them as follows:

Permanent
15%

Intermitent
50%

Stable
35%

* Indicators
- Frequency of downloads
- Average weekly downloads

Base: Total Interviewees

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<table>
<thead>
<tr>
<th>SEL</th>
<th>Interrupted</th>
<th>Stable</th>
<th>Permanent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lower SEL</td>
<td>Mid SEL</td>
<td>Higher SEL</td>
</tr>
<tr>
<td></td>
<td>Mostly less than once a week</td>
<td>3 to 5 times a week</td>
<td>Almost every day</td>
</tr>
<tr>
<td></td>
<td>5 tracks</td>
<td>12 tracks</td>
<td>28 tracks</td>
</tr>
<tr>
<td></td>
<td>Out of the home (mainly cybercafes)</td>
<td>50% at home and 50% outside the home</td>
<td>Mainly at home</td>
</tr>
<tr>
<td>Tracks in HD</td>
<td>201</td>
<td>303</td>
<td>1,014</td>
</tr>
<tr>
<td></td>
<td>Least</td>
<td>Some</td>
<td>Most</td>
</tr>
</tbody>
</table>

**Who they are**

Camilo Kejner

Is There a Future? An Analysis of the Music Industry

MIT Sloan School of Management
Where they download from

QUESTION: What percentage of your songs do you download from...?

The most often used connection hub and download hub coincide

| Most often used connection hub | 47% | 41% | 5% | 5% | 2% |
| Most often used download hub   | 45% | 38% | 12%| 3% | 2% |

- Home
- Cybercafe
- Friend's house
- Work

❖ 40% download exclusively at home.
❖ 28% download exclusively at cybercafes.

DOWNLOADS 100% OF THEIR MUSIC FROM...

<table>
<thead>
<tr>
<th>Total Interviewees</th>
<th>Inter</th>
<th>Stab</th>
<th>Perma</th>
<th>11 - 15</th>
<th>16 - 24</th>
<th>25 - 35</th>
<th>C1</th>
<th>C2</th>
<th>C3/D1</th>
</tr>
</thead>
<tbody>
<tr>
<td>HOME 40%</td>
<td>30%</td>
<td>41%</td>
<td>75%</td>
<td>35%</td>
<td>42%</td>
<td>42%</td>
<td>67%</td>
<td>49%</td>
<td>27%</td>
</tr>
<tr>
<td>CYBERCAFE 28%</td>
<td>33%</td>
<td>29%</td>
<td>5%</td>
<td>36%</td>
<td>27%</td>
<td>21%</td>
<td>11%</td>
<td>25%</td>
<td>34%</td>
</tr>
</tbody>
</table>

❖ 3 out of 4 permanents download music from home only.
❖ Cybercafes are the preferred download hub for lower income and under 15 yrs old downloaders.

Base: Total interviewees
How long have they been downloading music

QUESTION: For how long have you had the habit of downloading from the internet?

- 3 months
- 6 months
- 1 year
- 1 to 2 years
- Over 2 years

17% 15% 30% 21% 17%

Base: Total entrevistados

➤ Nearly 3 out of 5 started to download only on the last year! (62%).

HOW LONG HAVE THEY BEEN DOWNLOADING

<table>
<thead>
<tr>
<th>Total interviewees</th>
<th>Inter</th>
<th>Stab</th>
<th>Perma</th>
<th>11 a 15</th>
<th>16 a 24</th>
<th>25 a 35</th>
<th>C1</th>
<th>C2</th>
<th>C3/D1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1 year</td>
<td>62%</td>
<td>70%</td>
<td>56%</td>
<td>48%</td>
<td>74%</td>
<td>56%</td>
<td>58%</td>
<td>47%</td>
<td>61%</td>
</tr>
<tr>
<td>Over 1 year</td>
<td>38%</td>
<td>30%</td>
<td>44%</td>
<td>52%</td>
<td>26%</td>
<td>44%</td>
<td>42%</td>
<td>53%</td>
<td>39%</td>
</tr>
</tbody>
</table>

¿Just starting?

* The ratio of recent downloaders reveals the accelerated growth of the segment of people incorporating the habit of downloading. As broadband capabilities increase and the cost of internet connection lowers, cybercafes appear as the alternative for SEL without access to broadband at home.

Base: Total interviewees

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MIT Sloan School of Management
QUESTION: What is the time of day you normally download music at?

<table>
<thead>
<tr>
<th>Time of Day</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morning</td>
<td>5%</td>
</tr>
<tr>
<td>Afternoon</td>
<td>24%</td>
</tr>
<tr>
<td>Night</td>
<td>36%</td>
</tr>
<tr>
<td>Anytime</td>
<td>35%</td>
</tr>
</tbody>
</table>

Base: Total entrevistados

Younger downloaders are more heavily skewed towards earlier times in the day

Base: Total interviewees
What they do with the tracks

QUESTION: What do you generally do with the tracks you download from the internet?

39% Saves in HD

32% Saves and copies to MP3 Player

29% Saves and copies to CD and MP3 Player

“I transfer them to a CD so that my Dad doesn’t get on my case for using up all the space on the HD”

Base: Total interviewees

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MIT Sloan School of Management
Almost 4 out 10 downloaders also send songs to friends via MSN.

1 out of 4 sends songs via email

Habits associated with...

- **Age:** Amongst kids 11 to 15, this habit is much more widely spread (55%). They also email songs at a higher rate (35%).

- **Intensity of the downloader:** Amongst intermitents, MSN falls to 28% while half of the permanents sends songs via chat.

"Sometimes I am chatting with a girl and if I want to say something I'll send her a song”
11-15 yrs old

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Is There a Future? An Analysis of the Music Industry
MIT Sloan School of Management
### Reasons for downloading

**By ranking of attributes ("Strongly agree")**

<table>
<thead>
<tr>
<th>Reason</th>
<th>Rank</th>
<th>11-15</th>
<th>16-24</th>
<th>25-35</th>
<th>C1</th>
<th>C2</th>
<th>C3D1</th>
</tr>
</thead>
<tbody>
<tr>
<td>I love downloading because I can choose what I want to hear</td>
<td>1°</td>
<td>39%</td>
<td>36%</td>
<td>41%</td>
<td>46%</td>
<td>36%</td>
<td>36%</td>
</tr>
<tr>
<td>Song selection</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>What I like most about downloading from the web is that it is free</td>
<td>2°</td>
<td>29%</td>
<td>25%</td>
<td>32%</td>
<td>37%</td>
<td>31%</td>
<td>26%</td>
</tr>
<tr>
<td>No Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I like to download so that I can get to know more artists</td>
<td>3°</td>
<td>27%</td>
<td>24%</td>
<td>33%</td>
<td>23%</td>
<td>23%</td>
<td>27%</td>
</tr>
<tr>
<td>Exploration</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long tail</td>
<td></td>
<td>11%</td>
<td>8%</td>
<td>14%</td>
<td>17%</td>
<td>9%</td>
<td>10%</td>
</tr>
<tr>
<td>I love been able to get any song I want to have</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Base: Total interviewees
Downloaders say...

- The "no cost" attribute of illegal downloads is far from being its only lure

- Compile
  - "I make CDs to give to my friends"

- Explore
  - "Sometimes I'll find a band I didn't know and then get a bunch of songs from them"

- Rarities
  - "You can find live versions and other bootlegs not available anywhere else"

- Long tail
  - "Anything you want, it's there!"

- No boundaries
  - "Since we got broadband, I just leave my computer on all night downloading"
Weaknesses of downloading programs

The benefits downloaders recognize Ares and Emule far outweigh the cons

"The quality of Ares and Emule is low"

"The problem with downloading is that you can get viruses on your PC"

- 3 out of 10 downloaders dislikes the quality of Ares and Emule

- The threat of viruses is considered a risk of the use of the internet, not necessarily of downloading per se.

Base: Total interviewees
Burning and Compiling

Burners: copy songs to CD

Compilers: make CDs for friends, car, or other uses.

Burners: 76%

Downloaders who don't burn
24%

Burners who don't make mix CDs
20%

Burners who make mix CDs
56%

Average CDs per month:
3.7
Base: Burners

✧ The younger the downloader, the more often they burn CDs

"Every day mix CDs are getting bigger and bigger: the album loses ground to the song"

"I love to make my own mix CDs and put everything I like in them"

✧ In the vast majority of cases, burning mix CDs is associated with a creative action rather than the illegal copying of an already existing product. Compilers make their own CDs.

✧ Compiling is the way of expression a lot of downloadees choose. They "create" a new, inexistant, CD.

Base: Total interviewees

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MIT Sloan School of Management
Indicators of new links to music

QUESTION: Which phrase do you most identify with?

- When I listen to music I mainly listen to bands that I like or that play a genre I like
- When I listen to music I mainly listen to songs I like from various artists and genres
- Neither of the two

Kids 11 to 15 prefer “songs” (65%) to “bands or artists”

<table>
<thead>
<tr>
<th>Agree</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>“Regardless of price, I don’t want original CDs because I only want a few songs from each album”</td>
</tr>
<tr>
<td></td>
<td>“I don’t care about the booklet, the photos, the artwork, all I care about are the songs”</td>
</tr>
</tbody>
</table>
A new generation: Hardcore Downloaders (HCD)

- For HCDs, songs precede artists in importance.
- That's why they are no market for full original CDs
- The collective piece of music for these people is a mix CD
- 1 out of 4 downloaders is a HCD

The younger downloaders are, the more prone they are to being HCD

The habit of downloading determines a predisposition to being a HCD

<table>
<thead>
<tr>
<th></th>
<th>11-15</th>
<th>16-24</th>
<th>25-35</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inter</td>
<td>32%</td>
<td>25%</td>
<td>17%</td>
</tr>
<tr>
<td>Stable</td>
<td>21%</td>
<td>24%</td>
<td>31%</td>
</tr>
<tr>
<td>Perm</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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What does the volume of downloading depend on?

Multiple linear regression model

Independent variables 0-1 / F = 5.74 ; Sig: 0.000

Amount of songs a downloader gets per week

- Male
- Low Impact
  - Beta = 0.070
- Be explorative
  - Beta = 0.102
- Have broadband
  - High impact
  - Beta = 0.151
- Medium Impact
- Be a downloader
  - Beta = 0.089
- Live in Bs.As.
  - No impact
- Be younger Than 24
QUESTION: As you know, there are different types of CDs: originals, home made by you and pirate copies bought in the streets. Approximately how many of each do you own?

Out of every 10 CDs, subjects had:

- Legal CDs: 3.4
- Home made -burnt- CDs: 2.8
- Pirate CDs: 2.3
- Home copies of original CDs: 1.5

<table>
<thead>
<tr>
<th>Originals</th>
<th>11 - 15</th>
<th>16 - 24</th>
<th>25 - 35</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burnt</td>
<td>2.6</td>
<td>3.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Pirated</td>
<td>2.8</td>
<td>3.1</td>
<td>2.5</td>
</tr>
<tr>
<td>Burnt copies of originals</td>
<td>3.1</td>
<td>2.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Burnt copies of originals</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Base: Total interviewees

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QUESTION: Thinking only about the CDs you own which have music you downloaded from the web and burnt on them, how many have multiple artist mixes, how many full albums and how many more than one album complete discography?

Out of each 10 CDs subjects have

- Mixes: 5.2
- Full albums: 2.8
- More than one album: 2.0

BY AGE

<table>
<thead>
<tr>
<th></th>
<th>11 - 15</th>
<th>16 - 24</th>
<th>25 - 35</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mixes</td>
<td>6,3</td>
<td>4,8</td>
<td>4,5</td>
</tr>
<tr>
<td>Full album</td>
<td>2,2</td>
<td>2,9</td>
<td>3,1</td>
</tr>
<tr>
<td>More than one album</td>
<td>1,5</td>
<td>2,3</td>
<td>2,4</td>
</tr>
</tbody>
</table>

Base: interviewees that have at least a CD burnt by them with music from the web (304 interviewees)
### Type of CDs by Segment

<table>
<thead>
<tr>
<th></th>
<th>INTER</th>
<th>STAB</th>
<th>PERMA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originals</td>
<td>3.5</td>
<td>3.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Burnt</td>
<td>2.3</td>
<td>3.3</td>
<td>3.4</td>
</tr>
<tr>
<td>Pirate</td>
<td>2.6</td>
<td>2.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Full copies</td>
<td>1.6</td>
<td>1.4</td>
<td>1.7</td>
</tr>
</tbody>
</table>

**Out of 10 CDs subjects have**

<table>
<thead>
<tr>
<th></th>
<th>INTER</th>
<th>STAB</th>
<th>PERMA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mix</td>
<td>5.0</td>
<td>5.8</td>
<td>4.3</td>
</tr>
<tr>
<td>Full album</td>
<td>3.1</td>
<td>2.2</td>
<td>3.0</td>
</tr>
<tr>
<td>+ 1 Album</td>
<td>1.9</td>
<td>2.0</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Base: Total interviewees

Base: Interviewees with at least one burnt CD

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Original CDs: Fetichism?

- As the CD appears to fade as a format, there are still very valid reasons to hang on to it for now...

“fetichist” elements

"It is not the same to have a burnt CD to the original with artwork, not even close"

Symbol of better quality:

“Pirate CDs will ruin your stereo or last less”

RESPECT

“Artists I really like I want to have original”

Original CDs get renewed strenght, strangely, from the “lesser” digital format.

Favourites: original

“Of my favourite artists, I want original CDs”

Disagree 21%

Agree 60%

Neither 19%

Base: Total interviewees

“When I do buy an original, I make a copy of it and upload it to my computer. I never play the original”
Frequency of purchase of original CDs

QUESTION: How often do you go to record stores, regardless of whether you buy or not?

- Very often: 6%
- Usually: 17%
- Seldom: 33%
- Rarely: 32%
- Never: 12%

Total: 100%

QUESTION: Approximately how often do you buy original CDs at a record store?

- Only 1 out of 10 downloaders buy CDs often or very often at record stores:
  - Very often: 2%
  - Usually: 9%
  - Seldom: 27%
  - Rarely: 37%
  - Never: 25%

Total: 100%

*31% in the INTERIOR

No significant differences by age or SEL
Legal CDs: Purchasing habits

QUESTION: Approximately how many legal CDs have you purchased in the last three months?

1 out 2 downloaders purchased at least 1 legal CD in the last 3 months.

- None: 10%
- 1 CD: 14%
- 2 CDs: 4%
- 3 - 5 CDs: 17%
- 6 - 10 CDs: 54%
- Over 10 CDs: 0%

Legal CD purchases (last three months)
- Average CDs bought (base: total interviewees): 1.36 CDs
- Average of all purchasers (46%): 2.95 CDs

Those older than 25 buy the most legal CDs

Legal purchasing habits and downloading are not mutually exclusive practices and they coexist in downloaders.

Base: Total interviewees
## Reasons conspiring against higher legal CD sales

**QUESTION:** Why don’t you buy more legal CDs?

<table>
<thead>
<tr>
<th>Reasons</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Too expensive / don’t have the means</td>
<td>62%</td>
</tr>
<tr>
<td>Because I download</td>
<td>16%</td>
</tr>
<tr>
<td>Because I copy them</td>
<td>6%</td>
</tr>
<tr>
<td>I only like a few songs from each CD</td>
<td>5%</td>
</tr>
<tr>
<td>They are cheaper in pirate shops</td>
<td>4%</td>
</tr>
<tr>
<td>I don’t buy music / don’t want to have more</td>
<td>2%</td>
</tr>
<tr>
<td>I buy strictly what I like</td>
<td>3%</td>
</tr>
<tr>
<td>Don’t go to record stores</td>
<td>3%</td>
</tr>
<tr>
<td>My favourite band hasn’t released a new CD</td>
<td>2%</td>
</tr>
</tbody>
</table>

Base: Total interviewees

---

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Relative interest in original CDs

QUESTION: If original CDs came with wallpapers, photos or other materials would you be more interested in buying them?

- Yes: 7%
- No: 36%
- Don't know: 57%

Did you buy CDs in the last 3 months?

<table>
<thead>
<tr>
<th>Total</th>
<th>NO</th>
<th>YES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>57%</td>
<td>49%</td>
</tr>
<tr>
<td>No</td>
<td>36%</td>
<td>43%</td>
</tr>
<tr>
<td>Don't know</td>
<td>7%</td>
<td>8%</td>
</tr>
</tbody>
</table>

2 out of 3 CD buyers are interested in a value-added proposition.

Disinterest grows amongst those who did not buy

QUESTION: Which of the following phrases more closely reflects your opinion?

- If I could, I would like to have my entire collection be original CDs: 63%
- Regardless of price, I am not concerned with having my entire collection be original CDs: 31%
- Don't know: 6%

Did you buy CDs in the last 3 months?

<table>
<thead>
<tr>
<th>Total</th>
<th>NO</th>
<th>YES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Would like to have</td>
<td>63%</td>
<td>51%</td>
</tr>
<tr>
<td>Not interested</td>
<td>31%</td>
<td>42%</td>
</tr>
<tr>
<td>Don't know</td>
<td>6%</td>
<td>8%</td>
</tr>
</tbody>
</table>

3 out of 4 buyers would like to have their entire collection in originals

42% of those who didn't buy is not interested in having their entire collection in originals

Base: Total interviewees

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Pirate CD purchasing habits

QUESTION: How often do you buy pirate CDs?

- Very often: 4%
- Usually: 12%
- Seldom: 26%
- Very Rarely: 21%
- Never: 22% (in 11 to 15 yrs old)

QUESTION: Approximately how many pirate CDs did you buy in the last month?

- None: 8%
- 1 CD: 3%
- 2 CDs: 22%
- 3 - 5 CDs: 9%
- 6 - 10 CDs: 6%
- Over 10 CDs: 6%

Total: 100%

Base: Total interviewees

Pirate CDs bought (last 3 months)
- Average CDs bought (total interviewees): 2.21 CDs
- Average of all buyers (pirate CD consumers): 4.60 CDs

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Original CD vs. Pirate Copies

<table>
<thead>
<tr>
<th>Statement</th>
<th>Agree</th>
<th>Neither</th>
<th>Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>The only advantage to buying a pirate CD is the price.</td>
<td>13%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>The only disadvantage of buying an original CD is the price.</td>
<td>17%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>I like to own originals of my favourite albums</td>
<td>24%</td>
<td>19%</td>
<td></td>
</tr>
<tr>
<td>I don't like pirate shops because they don't have what I like</td>
<td>44%</td>
<td>24%</td>
<td></td>
</tr>
</tbody>
</table>

Base: Total interviewees
QUESTION: In the last two months, how much did you spend in music related items?

54% goes to record stores “very often”

11%

20%

38% never goes to record stores

25% is ABC1

41% never goes to record stores

42% is 11 to 15 yrs old

“Permanents” spend the most in music: (35% spent over $60)

Base: Total interviewees

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Ringtones

DOWNLOADS OF RINGTONES IN THE LAST MONTH

- Has no cell phone
- Has cell but never downloaded
- Very occasionally
- Usually / Very Often

47%
30%
17%

AMOUNT OF RINGTONES DOWNLOADED IN THE LAST MONTH

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>19%</td>
</tr>
<tr>
<td>1-2</td>
<td>39%</td>
</tr>
<tr>
<td>3-4</td>
<td>17%</td>
</tr>
<tr>
<td>5-9</td>
<td>11%</td>
</tr>
<tr>
<td>Over 10</td>
<td>14%</td>
</tr>
</tbody>
</table>

Base: Total interviewees

Ringtone downloading is highest amongst:
- Lower SEL downloaders.
- Younger downloaders.
- Downloaders outside of Bs. As.

“Ringtones prove digital and pay are not antonims: everyone laughed at first thinking no one would pay $4 for 30 seconds and now look at what it has become”

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MIT Sloan School of Management
**Cell phones and music: technology**

**QUESTION:** Besides ringtones, can your cell phone handle full track downloads?

- 48%
- 24%
- 11%
- 17%

□ Doesn't Have Cell   □ Doesn't Know   □ No   □ Yes

**QUESTION:** Can you transfer songs from your computer to your phone?

- 21%
- 11%
- 17%

Base: Total interviewees

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Willingness to pay for music in cell phones

1. QUESTION: How would you like to download songs directly to your cell phone?

   INTERESTED IN DOWNLOADING AND PLAYING MUSIC IN CELL
   - Not at all / Little: 45%
   - Somewhat: 22%
   - Very / A Lot: 33%

2. QUESTION: If you could download full songs to your cell, how willing to pay would you be?

   PREDISPOSED TO PAY
   - Not predisposed / Little: 68%
   - Indifferent: 10%
   - Somewhat Predisposed / Well predisposed: 22%

3. QUESTION: How much would you be willing to pay to get a full, original song in your cell phone?

   HOW MUCH THEY’D PAY
   - Nothing: 49%
   - Up to $0.50: 12%
   - From $0.50 to $1: 14%
   - From $1 to $2: 13%
   - Over $2: 12%

   AVERAGE
   - All: $1
   - Well predisposed: $1,90

Base: Total interviewees
PAGES (S) MISSING FROM ORIGINAL

Page 65 missing
WHAT IS PIRACY AS IT RELATES TO THE MUSIC INDUSTRY AND WHY IT IS ILLEGAL

Virtually everyone dealing with music piracy knows that it is illegal, but why it is illegal is not so well understood. The answer lies primarily in the way that copyright laws apply to music.

To ensure there are proper incentives for companies to continue investing in the creation, production, promotion and marketing of sound recordings, international treaties and national laws grant producers of sound recordings various rights in those recordings. These rights include the exclusive right to commercially copy the recordings and to distribute/import/export those copies.

It is these rights that enable law enforcement bodies to take criminal action against those who copy and distribute music without the permission of the record companies that invested in producing it. They also allow record producers to take civil actions to recover compensation for damages suffered as a result of music piracy. While there are often other laws or regulations that are broken by music pirates (e.g. tax laws, trademark laws), the rights of music producers under copyright or related/neighboring rights laws are the fundamental basis for the illegality of music piracy.

A vast majority of analysts and industry insiders agree that it was in 1998/99 that the music industry faced its biggest new challenges in the form of digital piracy as well as the threat of new technologies which allowed blank CD's to be copied by most home PC users with basic knowledge of how to operate their computers and CD duplicating plants to be opened worldwide -oftentimes in hard to scrutinize and control countries like China, Macau and Malaysia-

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The massively available means for copying and distributing music freely and seemingly uncontrollably amongst users posed a big threat for the industry’s revenue stream on a worldwide basis, specially in countries where local authorities had long been failing or unwilling to stop other forms of piracy managed by organized crime (clothing, jewelry, watches, etc.)

In territories where physical piracy was not yet a major threat (like the US and most of western Europe), consumers began to question the cost / profit scheme of the industry, mainly by making the assumption that the perceived cost of a commercial CD should be the same as that of a blank CD.

This was -and continues to be- a gross misconception, as there are numerous, costly steps, that go into a music CD before reaching consumers (recording, mixing, mastering, artwork design, manufacturing, wrapping, shipping, handling, marketing) and other associated costs post-release (further marketing efforts, royalties paid to artists, the labels’ salaries and other overheads and around a 100 % markup courtesy of retailers’ own costs and profit margins). We will discuss this further when we talk about record label’s basic economics.

Two-thirds of Internet users who download music are unconcerned that they are violating copyright laws, while only 29 % say they do care and 6 % have no opinion on the issue according to a Pew Internet and American Life Project survey. Not only that, the number of downloaders who say they don’t care about copyright has increased over the past year, from 61 % to 67 %. A slightly smaller percentage (65%) of respondents who share files online (music or video) say they don’t care whether the files they swap are copyrighted or not.

More than one in three of all music discs purchased around the world is thought to be an illegal copy. It is estimated that some 37 % of all CDs purchased

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(legally or otherwise) in 2005 were pirate – 1.2 billion pirate CDs in total. Pirate CD sales outnumbered legitimate sales in 2005 in a total of 30 markets. IFPI estimates that the global traffic of pirate product was worth $4.5 billion in 2005 based on pirate prices⁷.

In the wake of peer-to-peer technologies and home CD recording devices, many territories were abandoned altogether by record labels unable to make ends meet, and global revenue suffered.

Interestingly enough, the loop seems to be closing on these territories as digital distribution presents the music industry with an unrepeatable opportunity to seize them back and incorporate them to legality. Where there was no legal physical market (countries like Bolivia, Paraguay, Ecuador, Peru, just to name a few in South America alone) will have record labels going back in the next few years and closing deals with local providers of legal internet downloads and mobile phone carriers.

While it is impossible to know now how significant these will be in terms of revenue, at the same time it is certain that there will be a customer base however small, and it is not far fetched to think that accumulated sales in these territories will help get some region’s numbers back in competitive shape.

⁷ IFPI Piracy Report 2006
HOW A SONG BECOMES A “PURCHASABLE” RECORDING: UNDERSTANDING THE PROCESS AND WHY PIRACY HURTS THE MUSIC INDUSTRY DEEPER THAN IMAGINED

1. Repertoire creation or selection: songs are written by the author(s) and selected by the A&R (artists and repertoire) staff at the record label for inclusion in the new album.

2. Demos: basic, sometimes “mock-up” versions of the songs are recorded for reference before entering the actual recording studio to do final versions. The demo is the backbone of a new song onto which arrangements, instruments and form are added to create the actual, finalized song.

3. Recording: with the participation of studio technicians, producers, artistic directors and musicians, the songs are recorded by laying instrument and voice tracks usually onto a computer’s hard drive.

4. Mixing: once the tracks are recorded, they are mixed by the producers and technicians in a process that can take several months in some cases.

5. Mastering: once the album is mixed and the songs created and finalized, the album is mastered –usually by another team of technicians and producers- to ensure sound quality throughout is constant.

6. The master album is sent to the CD plant for mass manufacturing of CDs, and uploaded for digital distribution.

7. Photo sessions are held and the album artwork is designed by graphic designers.

8. CD inserts (booklets) are printed and sent to the CD plant.

9. CDs are assembled, sometimes manually (depending on the complexity of the insert)

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10. CDs are shipped to retail outlets worldwide.

As can easily be noted, the jobs of hundreds, sometimes thousands of people make it possible for one label to release an album. However, while it is simple to imagine that one day the industry will rely less and less on physical supports (CD, DVD, etc) therefore needing less people, currently there are over 100,000 people worldwide working directly in the music business and several hundred thousand more doing so indirectly.

PRICING

The main problem record labels are facing amidst the forecasted death of the CD format, piracy and peer to peer file sharing is that the economics are not what they used to be. "The economics don't necessarily work today," said Bruce Resnikoff, head of Universal Music Enterprises. "But the economics of the business are constantly changing."

As an industry, it claims to spend more on research and development than almost any other sector as a percent of total revenues, but whether or not this qualifies as R & D is certainly debatable: just what constitutes research and development in this industry when we are not just talking about technological applications?

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PHYSICAL PRICING

Taking the example of the US, the largest music market in the world, twenty years after the CD was first introduced, production costs have come down but consumers are still complaining about the cost of CDs, which now are priced at upwards of $16 at retail. The Recording Industry Association of America (RIAA), responds that prices have come down.

According to an article published on the RIAA's Web site, "Between 1983 and 1996, the average price of a CD fell by more than 40 %. Over this same period of time, consumer prices rose nearly 60 %. If CD prices had risen at the same rate as consumer prices over this period, the average retail price of a CD in 1996 would have been $33.86 instead of $12.75."

As the following table shows, the average price of a CD in the US has been steadily climbing since 1997. 2005 figures represent a 13.29 % increase from that of 1997.

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>R&amp;D as % of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace</td>
<td>4.6 %</td>
</tr>
<tr>
<td>Chemicals</td>
<td>4.1 %</td>
</tr>
<tr>
<td>Health</td>
<td>7.2 %</td>
</tr>
<tr>
<td>IT Hardware</td>
<td>9.5 %</td>
</tr>
<tr>
<td>Computer Software</td>
<td>10.3 %</td>
</tr>
<tr>
<td><strong>Recorded Music</strong></td>
<td><strong>15.0 %</strong></td>
</tr>
<tr>
<td>Pharma &amp; Biotech</td>
<td>15.1 %</td>
</tr>
</tbody>
</table>

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Retailer markup varies by country, but it averages in the vicinity of 100% worldwide. While for most non-specialized music retailers—those who market thousands of different products, oftentimes including food and clothing items—music sales account for 3 to 5% of their sales, these types of outlets usually represent over 75% of physical sales for record labels. It is easy to see how difficult sales negotiations and conditions are for the labels when they absolutely need these retailers but their music products could be replaced or gone and it would not be life-changing to the chains.

**DIGITAL PRICING**

Just as the price per download was established somewhat “arbitrarily” by Steve Jobs’ iTunes online store in the United States and other territories...
The current consumer price for a digital download (full track, downloaded to a computer via the internet) in Argentina, for example, is AR$ 3.50 (roughly $1.17), more expensive than that of a full track digital download in the US. Needless to say, at such a price this segment of the digital business in Argentina has not exactly “taken off”. In a much cheaper economic environment for retail in general, the Argentinean market has set its standard price a whopping 17.0 % above that of the US market. Also noteworthy is that concerts for example, boast an average price per ticket 33 % lower than that of the US market\(^8\), which should serve as a good indicator of willingness to pay.

However, consumers have begun to pay for “ring tunes” or “master tones”, 30 second snippets of their favorite songs to be played on cell phones when a call is received.

The relatively small incidence of marginal costs in the digital music industry (no physical product involved) suggests that while price elasticity of demand is high—which will depend on the price set- a reduction in price will result in an increase of revenue and profit.

**SIGNING ARTISTS IN THIS CONTEXT**

Record labels say they lose money on 9 out of 10 projects they work on nowadays. In some cases, it has been my experience managing a record label that all local artists lose money for a subsidiary of a major label mainly due to project-specific recording and marketing costs. Without sales of these projects by other subsidiaries that in turn pay the company that originated the product a

---

\(^8\) Based on ticket prices for the latest Rolling Stones tour in the US and Argentina.

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MIT Sloan School of Management
royalty, artists who are sometimes multi-platinum sellers become non-profitable for the repertoire owner.

Large artist rosters and declining sales are not a good combination. Rather, it is my opinion that labels should focus on less artists and commit more strongly to those projects. Working a new artist is not unlike developing a new product from scratch in a saturated market: your product does not come to solve any problems, it will not make life easier on consumers, it will not fulfill any unfulfilled necessities. But, if you can market it well enough you can create a connection with the consumer and create a loyal customer that will buy anything and everything that artist releases.

Smaller sales mean smaller teams. While I am not in favor of reducing the marketing structures of record labels, sometimes it has to be done. When this is the case, every effort should be made to focus on an ambitious yet realistic set of goals in terms of how many artists -products- are worked by marketing.

The full rights model has to be a condition in every contract signed by new artists. Artists must be made to understand that recorded music is not only a source of revenue but also -and as of late, basically- a marketing tool allowing them to move into bigger, better revenue generating businesses and that labels will reinvest most of any income received in marketing and promoting more artists.

For the same reasons we discussed before about how consumers are now exposed to content, it is also more difficult and costly than ever for labels to market their products, and at the same time easier for artists to record in home studios, distribute themselves and grow into niche markets on their own. While they will never have the power of a record label in marketing muscle, they can

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advance their careers to a point where a lot of the groundwork that labels used to do is done for them. These artists, the ones with a somewhat established name and fan base are the main ones the industry should be targeting for signing.

IN CONCLUSION

The history of recorded music has always been closely linked to technological advances as well as to innovative, instinctive creators, whether they be inventors or creative staff at record labels in charge of identifying “talent” worthy of being signed and promoted. The industry has always relied heavily on creative folk and for a long time, they were believed to be the cornerstone of the business and hence placed in key positions (CEO, President, executive management).

I believe that while creative men and women belong for sure in the recorded music business and are absolutely key to the further development and survival of the industry, it has been the tendency to have these people, the “intuitive” – who unfortunately, in a vast majority of cases have nothing but their great intuition to fall back on- run the business. Throughout the late 1990’s and the advent of the internet, the lack of formal knowledge of how to deal with a crisis became most apparent. The industry initially dismissed the threat and the opportunity that new technologies posed, was utterly unable to react in a serious manner and suffered a much more severe impact than it should have by ultimately going the way of opposition instead of embracing the countless possibilities that this new era presented. It is just now getting around to doing this, and one cannot help but wonder if it is too late for desperate measures.
Having worked in this industry for the last 12 years and seeing what has happened in the last seven or eight, I would argue that even though the A&R and marketing people of the majors have long thought of themselves as been "intuitive" enough to know what would become trendy, in reality all the industry did was control the media to the extent that consumers were only exposed to the music it wanted to expose them to. Now that "consumer is king" and he or she are over exposed to content and means of accessing it, it is no longer as easy to create hit records as it was before. Whether the labels can solve this new riddle of how to communicate with their costumers remains to be seen.

As willingness to pay varies necessarily by country depending on purchasing power of consumers in each one and it is easy to block arbitrage opportunities by determining the origin of consumer funds, different prices for in different countries for digital products makes a lot of sense. This makes it all the more difficult to understand cases like the quoted one in Argentina.

Downloading music is not the same as purchasing physical pirate formats containing recorded music, and it should not be treated in the same way.

Downloaders see their practice as a creative outlet to a very large extent, so internet piracy must be addressed creatively with alternative means and not just like physical piracy. The focus must be on understanding the phenomenon, embracing technology and not fighting it, and more than anything on realizing that a large amount of the people who download music may be lost as paying customers of recorded music but are very passionate about the artists, the creativity and yes, the music: they can still be sold a number of other products related to their favorite artists.

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Digitally – in the digital world, that is – record labels must not be reluctant to embrace technology and new ideas. Every single format, every single business model that comes along must be tried out, adapted to fit each label’s mindset and given a go. No one knows what the future of the industry is, or what new technologies will come around to change the face of the business once again, and as the internet has proven it is not as costly to attempt and test new things in the new world as it was in the bricks and mortar one.

The music industry is not going to disappear, it will always exist in some form or size, because music is, as our study shows, number one amongst a set of key cultural elements, and although listening to music may not always be the same as “consuming” it, it is a daily or almost daily practice for consumers worldwide.

Exhibit 1 shows what the traditional business model has been for the recorded music industry and where it needs to move to become profitable again. It is the music industry that has always strived to identify the potential talent and spent the marketing money to increase the artists’ popularity. By doing so, it has created a lot of value that others have captured (when an artist goes from being a performer to being an “entertainer”, capable of doing more than just record music: clothes, live performances, acting in movies, writing and performing in soundtracks, merchandising, advertising, etc.) This seems to be crystal clear, yet it is not uncommon in my daily interactions with top executives to find old school thoughts like “we only sell music, let people who know how to do the rest”.

The full rights model we discussed previously is a must but it imposes on record labels the need to quickly learn about new aspects of the music business, like concert promoting. Just “taking” a percentage of artist generated revenues will not be a solution even in the short term: the labels must be involved and ready
to really manage the careers of artists, and this includes producing shows, selling merchandise other than CDs, and being able to diversify into other areas of business. This is the only chance, if not only for survival, for growth in the future.
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