

From major to minor

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Last year was terrible for the recorded-music majors. The next few years are likely to be even worse

IN 2006 EMI, the world's fourth-biggest recorded-music company, invited some teenagers into its headquarters in London to talk to its top managers about their listening habits. At the end of the session the EMI bosses thanked them for their comments and told them to help themselves to a big pile of CDs sitting on a table. But none of the teens took any of the CDs, even though they were free. "That was the moment we realised the game was completely up," says a person who was there.

In public, of course, music executives continued to talk a good game: recovery was just around the corner, they argued, and digital downloads would rescue the music business. But the results from 2007 confirm what EMI's focus group showed: that the record industry's main product, the CD, which in 2006 accounted for over 80% of total global sales, is rapidly fading away. In America, according to Nielsen SoundScan, the volume of physical albums sold dropped by 19% in 2007 from the year before—faster than anyone had expected. For the first half of 2007, sales of music on CD and other physical formats fell by 6% in Britain, by 9% in Japan, France and Spain, by 12% in Italy, 14% in Australia and 21% in Canada. (Sales were flat in Germany.) Paid digital downloads grew rapidly, but did not begin to make up for the loss of revenue from CDs. More worryingly for the industry, the growth of digital downloads appears to be slowing.

"In 2007 it became clear that the recorded-music industry is contracting and that it will be a very different beast from what it was in the 20th century," says Mark Mulligan, an analyst at JupiterResearch. Last year several big-name artists bypassed the record labels altogether. Madonna left Warner Music to strike a deal with Live Nation, a concert promoter, and the Eagles distributed a bestselling album in America without any help from a record label. Radiohead, a British band, deserted EMI to release an album over the internet. These were isolated, unusual deals, by artists whose careers had already brought years of profits to the big music companies. But they made the labels look irrelevant and will no doubt prompt other artists to think about leaving them too.

The smallest major labels, EMI and Warner Music, are struggling most visibly. Warner Music's share price has fallen to \$4.75, 72% lower than its IPO price in 2005, and it is weighed down by debt. EMI's new private-equity owner, Terra Firma, paid a high price for the business in August 2007. Now, having got rid of most of EMI's senior managers and revealed embarrassing details of their spending habits (£200,000 a year went on sundries euphemistically referred to in the music business as "fruit and flowers"), Terra Firma is due to produce a new strategy later this month. But many observers reckon the private-equity men are out of their depth.

The two biggest majors—Universal, which is owned by Vivendi, a French conglomerate, and Sony BMG, a joint venture between Sony and Bertelsmann, a German media firm—derive some protection from their parent companies. Universal is the strongest and is gaining market share. But people speculate that Bertelsmann may want to sell out to Sony next year.

Three vicious circles have now set in for the recorded-music firms. First, because sales of CDs are tumbling, big retailers such as Wal-Mart are cutting the amount of shelf-space they give to music, which in turn accelerates the decline. Richard Greenfield of Pali Research, an independent research firm, reckons that retail floor-space devoted to CDs in America will be cut by 30% or more in 2008. The pattern is likely to repeat itself elsewhere as sales fall.

Circular arguments

Second, because the majors are cutting costs severely, particularly at EMI and Warner Music, artists are receiving far less marketing and promotional support than before, which could prompt them to seek alternatives. “They've cut out the guts of middle managers and there are fewer people on the ground to promote records,” says Peter Mensch, manager of the Red Hot Chili Peppers and Shania Twain.

Third, record companies face such hostile conditions that their backers, whether private equity or corporations, are loth to spend the sums required to move into the bits of the music industry that are thriving, such as touring and merchandising. The majors are trying to strike “360-degree” deals with artists that grant them a share of these earnings. But even if artists agree to such deals, they will not hand over new rights unless they get better terms on recorded music, so the majors may not see much benefit overall. Tim Renner, a former boss of Universal Music in Germany, says the majors should have acted years ago. “Then they had the money and could have built the competence by buying concert agencies and merchandise companies,” he says. Now it may be too late.

By mid-2007, when the majors realised that digital downloads were not growing as quickly as they had hoped, they landed on a more adventurous digital strategy. They now want to move beyond Apple's iTunes and its paid-for downloads. The direction of most of their recent digital deals, such as with Imeem, a social network that offers advertising-supported streamed music, is to offer music free at the point of delivery to consumers. Perhaps the most important experiment of all is a deal Universal struck in December with Nokia, the biggest mobile-phone maker, to supply its music for new handsets that will go on sale later this year. These “Comes With Music” phones will allow customers to download all the music they want to their phones and PCs and keep it—even if they change handsets when their year's subscription ends. Instead of charging consumers directly, Universal will take a cut of the price of each phone. The other majors are expected to strike similar deals.

“‘Comes with Music' is a recognition that music has to be given away for free, or close to free, on the internet,” says Mr Mulligan. Paid-for download services will continue and ad-supported music will become more widespread, but subsidised services where people do not pay directly for music will become by far the most popular, he says. For the recorded-music industry this is a leap into the unknown. Universal and its fellow majors may never earn anything like as much from partnership with device-makers as they did from physical formats. Some among their number, indeed, may not survive.

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