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# Windows into the Future

## How Lessons from Hollywood Will Shape the Music Industry

by G. Krishan Bhatia, Richard C. Gay, and W. Ross Honey

**Surprised by MP3 and other technologies, major music labels are finally unveiling their plans for digital music. By adopting the film industry's windowing strategy, the labels could give fans more ways to listen and drive a new wave of growth for the music business.**

For several years, new digital technologies and startup companies have put the music industry in a defensive posture by driving innovation and disrupting established format, pricing, and distribution standards. However, with MP3.com and Napster now defanged, the major labels that dominate the industry are reclaiming the spotlight and taking proactive steps to secure their place in the online music arena.

Eager to capitalize on the undeniable demand for online music, the major labels recently co-opted the very companies that had been aggravating them. Bertelsmann invested nearly $60 million in Napster, while Vivendi Universal acquired MP3.com for $372 million. This spring, the five major labels revealed their broad strategies, which center around new "intermediaries" that will license online music services to third parties. The labels divided into two camps: Bertelsmann, AOL Time Warner, and EMI Group joined with RealNetworks to form MusicNet, while Vivendi Universal and Sony are backing Pressplay, which will now incorporate MP3.com's experience and technology. Details about pricing, selection, and packaging won't be known until the intermediaries launch their programs, perhaps this summer.

As the labels sort out the opportunities and risks of online music, we believe the music industry will start to resemble the film business, which has adapted to several waves of technological disruption over the past half-century: television in the 1950s, then cable TV, home video, and pay-TV in the 1970s and 1980s. In response, the film industry's strategy—to release films through distinct channels in a set sequence called "windowing"—was a huge success. In 1974, the year before HBO popularized pay-TV, the U.S. film industry had $2 billion in revenues, all of it generated by theatrical ticket sales.[1] By 1999, U.S. revenues had increased to $33 billion thanks to the growth of new distribution channels such as pay-TV and home video, which now generates 77 percent of total revenues. While still a key driver of overall revenues,

[1] Based on consumer spending only; excludes revenues generated from sales to ad-supported television networks.

the original theatrical window now accounts for only 23 percent of revenues.

Based on our analysis, the combination of digital technology with sequenced releases will shape the labels' online music strategy. The implications for the music industry are:

- Consumers will soon have new ways to buy and enjoy music, choosing among multiple value propositions differentiated by platform, product features, and price.
- Record labels are here to stay, and will remain the dominant force in the industry; however, they will move away from their current role in physical distribution to focus increasingly on managing a smaller set of artists, multiple distribution channels, and customer information.
- New intermediaries will become the industry's primary contact with online-music consumers, packaging and bundling content, overseeing distribution and payments, and capturing customer data.
- New business models will distribute greater revenues—and risks—among a larger number of industry participants.

**Record labels will remain the dominant force in the industry.**

Our goal here is to sketch the broad strategies and directions resulting from digital distribution, rather than to speculate on the growth rate or potential size of the music business as changes take hold. The lessons apply broadly to other industries, such as book publishing and education, where content digitization also heralds a significant change in accepted business models. For this specific discussion, we're proceeding with two major premises: First, that through a combination of utilizing technology and offering well-priced, legitimate services, the industry will keep the level of piracy in check; and second, that it resolves questions about music publishing rights, which must be revised to accommodate new technologies. So long as those premises hold, the music business should evolve into one of the most dynamic sectors of the entertainment business.

**New Ways to Listen**

Since the earliest recordings of The Phonograph Company, which later became Columbia Records, consumers have had relatively limited ways to enjoy music. The primary choices were: 1) buying packaged product, mostly full-length albums that they would own, and 2) listening to free over-the-air radio broadcasts, which had limited quality, flexibility, and selection. That's not to say that innovators did not try to give consumers more choices; in 1988 a company called Personics created an alternative system that let consumers create their own audiotapes, choosing from several thousand songs that Personics had licensed from the labels. But the system, based in record stores, failed because labels would not license their most popular music, fearing consumers would cherry-pick single hits rather than buy the more expensive CDs that contained those hits.

The introduction of the compact disc had driven a huge surge in back-catalog sales throughout the '80s and '90s. Ultimately, the CD format became a mature platform and sales began to slow. But in the late '90s the public rekindled its passion for music with the arrival of the MP3 format and Napster's peer-to-peer file-sharing system. Together, they wrenched control of music from the labels and created radical new options based on the architecture of the Internet; fans no longer had to drive to record stores to get their music. Online distribution combined the most attractive aspects of radio and albums. Digital music was free, like radio, and downloadable files provided the choice and ownership of albums. Listeners could download the songs they wanted and no longer had to buy an entire CD to get one or two favorite songs.

The rapid growth of digital music (Napster's client software has been downloaded more than 70 million times) inspired entrepreneurs to create services geared to the new platform. For instance, digital locker services gave consumers access to their digitized music collections anytime and anywhere; custom radio stations, such as ClickRadio, allowed consumers to influence playlists; and music-oriented sites, such as ArtistDirect.com and Launch.com, let listeners discover new music more readily by offering extensive sampling and artist information.

MP3.com, Napster, and other services had stoked consumers' appetite for an online channel that was more flexible than radio's rigid program formats, and more convenient than albums bought at a music store. Consumers' increasing access to high-speed broadband services also propelled the success of the online platform. Confronting these disruptive forces, label executives faced a real challenge: **How could they profit from the obvious demand for digital music without damaging their existing business?**

If consumers could buy individual songs for $2, versus buying the entire CD for $14 or more, the labels would suffer. Based on consumer behavior to date, cannibalization is a legitimate concern. After all, most fans turned to Napster for individual songs, not entire albums. Consumers' desire to choose individual songs collides with the music industry's determination to sell full-length

**Subscription Services: Celestial Jukebox Versus Managed Selection**

Enthralled by Napster's thousands of songs, many music fans want digital subscription services to function as a "celestial jukebox"—a central source serving up every song ever recorded, by every artist. Napster, the proponents argue, demonstrated that only unlimited selection will satisfy consumers. While consumers would certainly welcome the broadest possible selection, the music industry is unlikely to consider the celestial jukebox a viable proposition anytime soon. Unlimited access to music would significantly hurt sales of catalog titles, a critical source of labels' profitability.

The film industry has shown that consumers will accept a more limited selection if the product quality and price are right. HBO, for one, has amassed 25 million subscribers by featuring select recent blockbusters and high-quality original programming (e.g., *The Sopranos*, *Sex and the City*) at a reasonable price. In the music industry, the record clubs sell over $1 billion worth of CDs each year based on a relatively small selection of titles.

In both cases, consumers care more about the overall value proposition than the sheer quantity of product: They pay $12.95 to HBO for a selection of great movies and series each month. Similarly, they get 12 free CDs for buying four at full price from Columbia House.

So, digital music subscription services should thrive with a limited selection, rotating recent titles into and out of the service after a certain period of time. The service would offer enough appeal to persuade consumers to subscribe, but would manage the selection in a way that leads consumers to buy a physical or downloaded copy if they want to own a song or album.

albums. However, we believe that the film industry's windowing approach to product availability and pricing across distribution channels (theatrical, video, pay-per-view, pay cable) could break the deadlock. The film studios have used windowing to avoid cannibalization, expand consumer choices, and grow the industry's total revenues.

A windowing strategy means that films are released in distinct channels during different, carefully sequenced time periods. Each window opens as consumer demand in the previous window declines. As a result, the film industry has created distinct value propositions for consumers who prefer to watch movies in theaters, rent videos, buy videos, order a 3 A.M. pay-per-view showing, or wait for cable or network TV airings. Each channel's consumer appeal results from price, content quality, and convenience factors, rather than the sheer number of films available.

Windowing is a logical strategy as fee-based digital music offerings come into focus. These new offerings will allow labels to protect existing revenue streams and still offer consumers new ways to purchase music. Indeed, total revenues should expand as the industry taps into consumer segments that traditionally bought little or no music. Here's how windowing could work: The distribution sequence would start at the same point it does today, with a CD release and radio/TV promotion. The avid fans eager to own a hot release would pay a premium price, from $13 to $18 at retail for the CD. After the initial burst of sales, the first online window would open, allowing digital music fans to download certain singles or the entire album. The next window would include subscription services, where a monthly fee would buy access to a selection of music, perhaps defined by genre or artist (see "Subscription Services" sidebar). The

**Exhibit 1**

**Actual Movie Industry Windowing**

| | | | | | | |
|---|---|---|---|---|---|---|
| | | 5 mos. | 2 mos. | 5 mos. | 15 mos. | 20 mos. |
| **Window** | Theatrical Exhibition | Home Video | Pay-Per-View | Pay-TV | Network/ Broadcast TV | TV Syndication |
| **Average Consumer Price** | $5.40 | $13.85 (sell through)<br>$2.90 (rental) | $3.15 | $11.35 per month | NA | NA |

**Potential Music Industry Windowing**

| | | | | | |
|---|---|---|---|---|---|
| | | | 2 mos. | 6 mos. | 3 mos. |
| **Window** | Radio/Music TV/ Touring | Physical CD | Digital Download | Digital Subscription | Club Sale |
| **Average Consumer Price** | NA | $13.81 | $1.99–$2.99 per track<br>$13.98 per album | $9.95–$19.95 per month | $5–$19 |

Sources: Booz·Allen & Hamilton Analysis, Adams Media Research, Veronis Suhler, MPAA, Kagan

**Exhibit 2**
Potential Music Value Propositions

| Value Proposition | CD Sale | Download | Subscription | Club Sale |
|---|---|---|---|---|
| Window (from initial release) | • Initial release window | • 2 month window | • 8 month window | • 10-12 month window |
| Venue | • Best Buy | • Lycos | • Napster | • Columbia House |
| Price | • Premium price ($13.98-17.98/album) | • Premium price ($1.99-$2.99/track, $13.98/album) | • Discounted price per unit ($9.95-$19.95/month) | • Heavily discounted price ($5.99-$10.99/album) |
| Target Audience | • Avid fan | • Digital music lover (allows portability, ubiquitous access, CD burning) | • Heavy or experimental/curious music listener | • Price-sensitive consumer |
| Product Features/ Characteristics | • Lifetime ownership<br>• Additional product features (DVD audio, exclusive tracks, liner notes, artist information, priority access to concert tickets) | • Per track and album availability<br>• Lifetime digital copy | • Tracks/albums available in delayed rotation after which copies can be downloaded or purchased as a CD at additional cost<br>• Themed by genre, label, interest | • Limited additional features<br>• Cheaper packaging |

Source: Booz·Allen & Hamilton

last step would include record clubs, extending sales to price-conscious consumers. Exhibit 1 compares this potential windowing strategy to the current sequencing of film windows.

Online music's wild card question is: What will consumers pay? According to recent studies, the answer depends on the details of the value proposition. For example, a Webnoize study found that almost 60 percent of Napster users said they would pay $15 a month for the service—as it existed in spring 2000. A Forrester report found that only 25 percent of consumers who have downloaded music would pay on a per-song basis; 59 percent preferred a monthly service charge averaging $9. We won't really know what consumers are willing to pay until they can respond to intermediaries' initial offerings. Certainly, a windowed release strategy would give labels greater pricing flexibility, since they would no longer be locked into a narrow range of CD price points. In the film business, windowing led to reduced price points once a film left theaters (e.g., $8 for a theater ticket, $4 for a video rental, $5.95 for pay-per-view), generating revenues from consumers who either chose not to see it in theaters or wanted to watch it again.

In our view, digital distribution will lead the music industry to embrace new distribution channels, broaden product features, and adopt more flexible pricing models to create distinct value propositions for specific target audiences. Exhibit 2 summarizes the options for four potential windows.

### Labels Are Here to Stay

Labels will remain the hub of the recorded music industry based on their artist and retailer relationships, marketing and promotional prowess, and music libraries. It is no coincidence that 92 percent of the music played on major radio stations comes from major-label artists (see Exhibit 3).

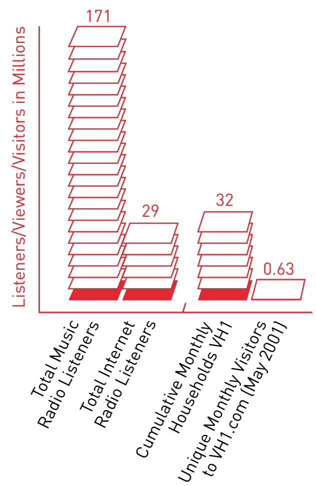
However, a reconfigured label model will emerge from the current disruptions. Going forward, major labels will focus less on physically distributing albums and more on managing a smaller set of artists, multiple distribution channels, and customer information. This will follow the path of the film studios, which shifted their emphasis as new platforms emerged. In the late 1940s, the film studios shed their theater operations for antitrust reasons, then outsourced the physical distribution of film prints to a third party, as television sliced into theatrical admissions in the 1950s. In later decades the studios started home video and cable divisions to control and market movies in those channels. Labels could follow suit, eventually selling off physical distribution operations to concentrate on new digital channels, which will only increase in strategic relevance.

### *New Roles for A&R*

Digital delivery has already shown it can get new music in front of audiences—without label support. Bands that previously sold albums from their car trunks can now go online and potentially reach millions of listeners, then parlay success into record contracts. For example, in 2000, Brooke Allison earned label attention after her song "The Kiss-Off (Goodbye)" topped the charts of MP3.com. 2KSounds, a Virgin label, signed her, and soon Allison's single became the most added song on pop radio stations. At the same time, established artists are using the Web to their benefit. For example, Prince's NPG Music Club (www.npgmusic-club.com) offers music downloads and other benefits through a basic $7.77/month membership, and a premium $100/year membership. Popular folk-rocker Jonatha

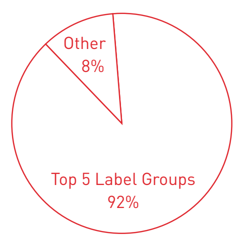
**Exhibit 3**

**THE REACH OF THE TRADITIONAL PROMOTIONAL OUTLETS DOMINATES THAT OF ONLINE VEHICLES...**




**...AND THE MAJOR LABELS CONTROL ACCESS TO THESE TRADITIONAL MEDIA OUTLETS**

Percent of Major FM Stations' Playlists from the Top 5 Label Groups*




*Based on a recent 2-week sample

Sources: Booz·Allen & Hamilton Analysis, Veronis Suhler, Cable TV Ad Bureau, Radio & Records, Nielsen NetRatings

Brooke offers video streaming and sells her albums on CD and DVD-audio directly from her Web site (www.jonathabrooke.com).

As emerging artists in essence "pre-release" their work over the Internet, the labels' talent hunters (the artist and repertoire, or A&R, staff) will spend less time roaming the country looking for promising acts; they can monitor the Internet for new talent, as 2KSounds did with Allison. As a result, the A&R function will shift from "seed stage" to "later stage" investing, to borrow an analogy from the private equity industry. That is, A&R will be more about attracting, nurturing, and retaining a smaller stable of artists, and less about discovering a large number of unproven artists.

***Managing Multiple Distribution Channels***

Labels will need to expand their set of skills to manage multiple distribution channels, including pricing, content selection, and competing interests among a larger set of players.

New distribution channels, each with a unique value proposition, will create far greater pricing and bundling opportunities for the labels. To fully exploit these opportunities, labels will need to build the organization and tools required for identifying price drivers (e.g., initial album sales) and developing appropriate pricing strategies. For example, film studios have managed to successfully bundle B product with hits to generate additional revenues from broadcast and cable TV sales.

**Labels will need to build the organization and tools required for identifying price drivers and developing appropriate pricing strategies.**

Labels will also need to carefully manage the selection of product, monitoring what songs are available in which channel, and under what terms. The selection will have to be adjusted constantly to maximize the value of their catalogs.

Finally, potential conflicts among distribution channels or copyright holders will need to be managed closely. For example, digital distribution will put stress on labels' relations with major record chains, such as Tower Records and Musicland. Retailers may see digital music as a threat of disintermediation. However, labels also have an incentive to maintain the relationship, given the near- to mid-term dominance of physical product sales.

***Managing Customer Data***

Labels will also need better customer-data mining skills to handle the demographic and purchasing information available from online platforms. Today, the labels know relatively little about their customers—who is buying what music, in what format, where, and the results of the most effective marketing vehicles for reaching these customers. Going forward, a finer understanding of their customers will be critical to more efficient marketing and tapping greater consumer spending. More timely purchasing and consumption data will allow labels to instantly adjust their marketing mix and spending according to how consumers are responding to labels' campaigns. Customers' purchasing history and contact information will also allow for more targeted direct-marketing campaigns. Fans who have purchased Offspring records may receive an e-mail promotion related to an upcoming blink-182 album or Green Day concert schedule. Customer data will obviously be a key battleground for all industry participants—record labels will need to aggressively ensure access to customer information when negotiating content licenses and partnering for new services with intermediaries.

**Jockeying for Digital Positions**

While opportunities in digital music are attracting a host of new and old intermediaries—including portals, online music sites, access players, consumer electronics manufacturers, and retailers—it will be those intermediaries that own the consumer relationship who will play the dominant role and create the most value. By developing compelling consumer solutions—packaging and bundling content, providing value-added services and ease of transaction, capturing and exploiting customer data—these players will create sustainable roles allowing them to be successful in the long run.

We believe that, ultimately, a few consumer services will emerge to function as the primary intermediaries between the labels and consumers. Already, we are seeing various platforms and services merge or align: MP3.com was absorbed by Universal Music and its jointly owned Pressplay service; Napster will use RealNetwork's MusicNet platform for its subscription service. Further consolidation and partnering is likely among the remaining contenders, ultimately leaving a small number of service providers that own the critical consumer relationship.

**The intermediaries that own the consumer relationship will play the dominant role and create the most value in digital music.**

The challenge for all remaining players, be they online music sites, portals, access players, consumer electronics manufacturers, or retailers, will be to insinuate themselves into these emerging label-intermediary constellations.

For each of these players, it will be critical to determine which assets to trade with. For instance, smaller online music sites may best position themselves by focusing on the unique technology or features that they have developed, rather than attempting to develop a consumer service themselves. MP3.com's and MyPlay's assets were their technology and experience. Both companies would have had a tough time building sustainable businesses by themselves but traded their currency well and, as a result, were both absorbed by major music companies. MP3.com's technology and talent will now form a critical component of Vivendi Universal's digital music offering, particularly its Pressplay service with Sony. MyPlay's locker and subscription technology will be incorporated with Bertelsmann's other digital music assets, including Napster and CDNow.

And what about music retailers? Are they left to sell CDs and audiotapes in stores while some portion of their customer base migrates online? Retailers may actually be well positioned to obtain a seat at the digital table by trading on their customer access and consumer mind-share for music. After all, it is the Towers, Sam Goodys, and Best Buys of the world that consumers associate with buying music today. Who better to introduce them to digital music services than these retailers, much like consumer electronics retailers have done with Internet access, satellite TV, and wireless telephony services.

Access players, such as cable companies, telecoms, and ISPs, may have a harder time since they do not enjoy the gatekeeper position in digital music that they currently do in other media and services. However, they should be able to leverage their core capabilities in marketing/promotion, bundling services, and billing to drive adoption of these new digital music services and share in the revenues. For instance, Verizon could offer Napster's digital music subscription service bundled with its DSL, at a discounted price, and charge it to its customers' current monthly bill. The consumer gets convenience and Verizon accesses a new revenue stream.

Clearly, opportunities in digital music exist for new intermediaries. While most of the value is likely to accrue to a small number of dominant players who own the consumer relationship, there are a number of opportunities for other players to insinuate themselves into the market as long as they trade on their unique value-added role and assets.

**Adapting the Business Model**

Today, sales of music in physical formats generate most of the music industry's revenues. In 2000, prerecorded music accounted for $14.3 billion in revenues in the United States, according to the Recording Industry Association of America (RIAA). At the center of the current business model are the major music companies and retailers. On average, these players split the revenues on a 75/25 basis, with the labels claiming the bigger slice because they add most of the value and bear most of the risk. The labels are tasked with finding and handling the artists; financing and producing the album; manufacturing, packaging, and distributing the end product; and paying for retail marketing support through co-op programs. They are even responsible for unsold product returned by retailers.

**Digital delivery will give rise to a new business model that reapportions rewards and risks among industry players.**

Digital delivery—with its new value propositions and intermediaries—will give rise to a new business model that reapportions rewards and risks among industry players. While new channels increase the potential rewards, they will also lead to a rise in production, marketing, and royalty costs. At the same time, the relative value-added and revenue shares will begin to shift from the record labels to the intermediaries. New relationships and revenue flows, compensation models, and approaches to production and marketing will emerge.

***Rewards Get Richer…***

Based on the film industry's experience, new distribution channels are likely to expand the overall music industry. Just as movies generate most of their revenue from nontheatrical channels, hit songs and albums will have more upside potential as they become available in more channels. In addition, previously unprofitable albums and older catalog titles, which have little visibility in most retail stores, could benefit as they are bundled with more popular product in subscription services or discovered by consumers searching for new music online.

***…As Risks Rise***

New channels are unlikely to lower overall music costs. While some costs (e.g., pressing CDs, shipping product to stores) may be reduced or eliminated, other expenses should rise with industry revenues. Artists and rights holders are already claiming a share of the revenues from new platforms. Don Henley's Recording Artists Coalition, which counts Bruce Springsteen, Eric Clapton, and Alanis Morissette among its members, is already fighting for a greater cut of digital royalties, as well as term limitations on recording contracts. Furthermore, while radio broadcasters pay performance royalties only to songwriters and publishers via such organizations as BMI and ASCAP, music Webcasters have to pay an additional royalty to the record labels. Technology investment will also surge as intermediaries build out their services. Finally, marketing costs will rise as labels start supporting new intermediaries in addition to radio stations, music TV, and retailers.

In the film industry, production and marketing costs rose once the studios began to compete for the larger revenue base created by home video and pay-TV. Over the past two decades, the average production and marketing spending for a theatrical film release in the United States grew 600 percent, from $13.7 million in 1980 to $82.1 million in 2000. With box office receipts growing only 137 percent during the same period, this increased investment was justified only by the new revenue streams from home video and pay-TV.

***Sharing Risks and Rewards***

The risk-reward profile will stay the same in the physical distribution channel, with labels doing the most work and reaping the most revenues. In digital channels, however, risks and rewards will shift from the labels to the intermediaries. Record labels will no longer bear the risk of manufacturing and distributing albums that do not sell through to consumers. Instead, they will provide their content to the intermediaries charged with promoting and selling digital music to consumers.

**Much like film, hit music will have more upside potential as it becomes available in more channels.**

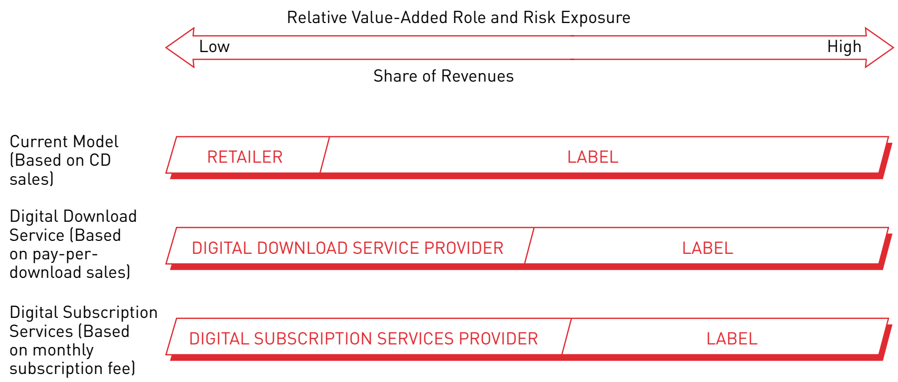
Intermediaries will compensate labels through revenue sharing, licensing fees, and output deals. Each scheme implies a specific division of risks and rewards. Revenue sharing is the most likely approach for pay-per-use services, with the label and the intermediary getting a cut of the revenue every time a consumer downloads a song or album. In the Hollywood precedent, video rental chains and pay-per-view providers share revenues with studios on a per-transaction basis.

Intermediaries that sell digital subscription services may compensate labels through licensing fees or output deals. An intermediary could pay a flat licensing fee for a package of titles, similar to the way pay-TV channels buy a slate of films from major studios. Alternatively, intermediaries could absorb some of the direct production costs of new releases through output deals, in return for licenses and online rights. In the film industry, cable networks and international distributors regularly co-finance films to lock up rights to those films in their respective channels and markets.

As the risks and roles shift, so will the relative share of revenues retained by each player. In the film industry, a studio's role and revenue share vary across distribution channels. On average, studios retain 30 percent of the subscription revenues generated by pay-TV services such as Showtime, while they keep 75 percent of the $19.95 that consumers pay for a video sold at retail. Why the difference? Once studios license movies to a pay-TV channel and set the window date, their involvement ends; the pay-TV service promotes the movies to its viewers and programs them within its schedule. In an output deal, the pay-TV service bears the risk that the movies may lack customer appeal, and diminish the service's brand equity and its ability to attract subscribers and minimize churn. With video sales, however, studios must estimate demand, produce copies, and oversee distribution, while retailers need only stock the videos. In this case, the studios do more work and bear more risk than they do in the pay-TV realm.

Similarly, as labels assume a more limited role in a digital world, intermediaries will add more value to new consumer services. As a result, intermediaries' revenue share from digital sales will exceed the typical 25 percent share retailers retain on an album sale. The split may be closer to fifty-fifty for pay-per-use services, similar to how studios and pay-per-view providers share revenues. Intermediaries may claim an even larger share of subscription-service revenues, since they select, package, promote, and deliver the music, and bear the risk of consumers'

**Exhibit 4**
Shifts in Relative Value-Added Role and Share of Revenues




Source: Booz·Allen & Hamilton

not ordering or renewing subscriptions. Exhibit 4 shows how value-added roles, risk, and revenue shares may shift.

Going forward, the revenue pool will expand, as will the number of players jostling for shares of that pool. The larger shares will go to those players that embrace the risks of creating and marketing untried services to consumers. Labels, intermediaries, and others will need to sort out how the pie is split up.

## Conclusion

Digital distribution is new for the music industry. But as we have seen, the film business has shown it can adapt to new technologies and distribution channels. Yes, digital music has already rocked the industry's existing model, but the labels have regrouped with a reasonable strategy for capturing the value created by digital music.

The new intermediaries are going to give music fans a range of options for listening to and buying digital music. Will fans get the celestial jukebox? No. Will they be offered packages geared to their hunger for new and catalog selections? That's the aspiration. We will all find out soon, when the industry opens the windows into its future. ■

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