Genre Focus & Community:

A Good Bet For Digital Music Retail

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Introduction

The emergence of digital music has sparked considerable debate: concerning the probable demise of record labels, the role of cell phone carriers, the trade-offs between subscription versus a la carte consumption and the likely victor in the race for dominance among super-aggregators like iTunes, MSN, Yahoo Music, Napster and Rhapsody. Seemingly, in the answer to these questions lies the future of digital music. However, none of this matters if there is no economically viable model for aggregating and distributing digital music, which one might conclude given that none of the so-called dominant players in the market for digital music have reached profitability solely through music sales.

….as much as their future may depend upon digital downloads, no one seems to be making much of a profit from them. "We're in it for the long haul," said Mike Conte, the new general manager of MSN Marketplaces, … " Music is not a big moneymaker for MSN. We cover our costs and little more." ¹

With an average price of about 99 cents per digital song, of which the major record labels get roughly two-thirds ², there is apparently little room to make money with direct sales of digital music. As Charles Wolf, a securities analyst with Needham & Co was quoted as saying: “Profit margins are thin in selling music online. After the credit card company,

¹ Shannon, Victoria, “Online music catches on, but profit is hard to find”, *International Herald Tribune*, January 24, 2005
² Raymond, Steve, VP Business Development, Yahoo Music, Interview, May 2005
song publisher, and record labels take their share of the 99 cents per song, only 8 to 10 cents are left for the digital storefront's operator.\(^3\)

What seems to make sense to companies like iTunes and Wal Mart is music as a loss leader:

\[\ldots\text{For companies, like Apple Computer, a break-even digital music store is a way to entice consumers to buy expensive music players, like its iPods; for others, like Coca-Cola in Britain, Tiscali in Italy and Wal-Mart Stores in the United States, it is a brand investment, a consumer-loyalty measure.}\(^4\)

Given all of this, should we conclude that the future of digital music is inexorably tied to the sale of some other service or product? Or does it mean that the models being pursued by these firms are missing something fundamental with regard to digital music? In this paper, I intend to argue that the reason for scarce profits in digital music is that current players in the online music space are simply missing the point of a digital media reality. That point being that with infinite shelf space, low margin popular content is meant to drive sales towards higher margin obscure content in the “Long Tail”.

Furthermore, complicated licensing makes the generic, media category “music” appear to be too broad in terms of creating meaningful depth across a spectrum of content while maintaining any semblance of quality or cost control. Thus, digital music retail calls for


\(^4\) Shannon, Victoria, “Online music catches on, but profit is hard to find”, International Herald Tribune, January 24, 2005
smaller, more manageable units of aggregation that allow for effective sell-through and filtering. I propose that genres or sub-genres are a highly efficient unit of aggregation given the economy of scope found both in terms of content acquisition and delivery. Moreover, unlike any other form of media, music choice is an extension of identity which gives way to whole communities of like-minded personalities. As will be discussed, online communities are proving to be a powerful tool for attracting and more importantly, maintaining large groups of people.

In summary, I posit that the future of digital music is one dominated by genre-focused niche/affinity hubs, rather than category concepts such as iTunes, Napster or Yahoo Music. Underlying my argument are the inherent advantages afforded genre-based, niche music services as a result of: 1) Long Tail economics 2) content licensing 3) the phenomenon of music as culture 4) the power of online communities and finally 5) economies of scope in certain critical filtering technologies.
Digital Music & The Long Tail Theory

From December 2002 to December 2004, the number of Americans 12 years or older that had paid for digital music downloads went from 2% to 11%\(^5\), among 8 – 12 year olds 26% purchase music online\(^6\). Simultaneously, the infrastructure that supports digital music distribution is maturing at a rapid pace, giving rise to whole new entities, devices and software that make digital music delivery possible. Clearly, digital music is here to stay. The only question is what will it be when it grows up.

The web is in many ways an ideal platform for music distribution: there are no limitations on shelf-space, and features such as search and playlist sharing make cross- and up-selling an organic process. The “Long Tail”\(^7\) characteristics of digital media distribution means that the “misses” are as important to total sales as are the “hits.” In fact, online music retailers are reporting that more than half of their listening activity occurs among older, more obscure titles.

Unlike a traditional record store, digital music services’ customers love to explore the weirder corners of their libraries. Rhapsody and Napster, which offer subscription services, say that less than 50% of the songs that customers groove to each month come from major-label catalogs. When a big-name artist like Eminem puts out a record, one of its cuts will quickly become the services' most downloaded song, but that will still account for just a tiny fraction of what

\(^6\) Harris Interactive, “YouthPulse Study”, February 1, 2005
\(^7\) Anderson, Chris, “The Long Tail”, *Wired Magazine*, issue 12.10, October 2004
subscribers are actually listening to. Says Napster COO Laura Goldberg: "Our people are really into sampling new stuff."\textsuperscript{8}

Thus, it appears that there is a special opportunity for online music services that can find a way to offer depth. Particularly when you consider that Long Tail or obscure content carries a higher margin. According to Steve Gordon, a well know entertainment lawyer in the digital media space:

A typical deal for securing content for a web service from content providers for downloading or streaming will entail an advance against royalties of between 25 percent and 60 percent or more of income generated from the service depending on the quality and quantity of content being licensed\textsuperscript{9}.

In order to maximize profits then, an online music retailer should look to diversify its catalog so that low margin popular content is balanced by medium to high margin content from independent and non-current artists. Figure 2, below, depicts a hypothetical portfolio of content for a diversified online music retailer.

\begin{footnotesize}
\textsuperscript{8} Leonard, Devin, “25 Breakout Companies 2005: IODA”, \textit{Fortune.com}, May 16, 2005
\textsuperscript{9} Gordon, Steve, “Clearing Music Recordings and Compositions for Use in Digital Music Services”, March 2002
\end{footnotesize}
However, the current leaders in the digital music retail market—iTunes, Napster, Yahoo and Rhapsody—concentrate on “breadth” of available titles, offering a wide selection of the most current and popular releases but little in terms of older material. This is due in part to the fact that there is no wholesale way to secure rights to older material other than soliciting the rights holders one by one and when there are multiple genres to service, this problem quickly becomes untenable. New content brokers such as IODA (Independent Online Distribution Alliance) and The Orchard have sprung up to help with this, however they still only account for a fraction of all music content.\textsuperscript{10}

\textsuperscript{10} See Table 1
Licensing

The digital delivery of music has required changes in the licensing structures that have typically supported physical music retail. New licensing structures have been created by legislation, copyright owners themselves, and others are still being defined. The net result is that music retailers who do not own sound recording masters must negotiate individual licenses with the owners of the masters. This can be quite a challenge for online music services hoping to capture meaningful depth across multiple genres, given the sheer number of artists and labels involved.

Music brokers IODA, The Orchard and MusicNet make it easier to secure a substantial amount of content by; themselves negotiating one-by-one with labels and artists and offering a brokered package to online music services. However, record labels, online retailers and now cell phone carriers pursuing various digital music retail strategies will be challenged by: 1) lack of comprehensive depth in brokered catalogs 2) lack of uniform terms across license holders, 3) large up-front costs for major label content and 4) lack of flexibility in distribution terms.

By connecting Long Tail content producers to Long Tail content aggregators, these brokers help populate the tail in digital music services. As the Long Tail theory goes, once tail content is seamlessly integrated with popular content, recommendations and other filters like search can drive demand from the low margin head (popular content) to the high margin tail. However, by relying on these brokers to populate their catalogs, the major online music retailers are at a disadvantage. Incentives are somewhat misaligned,
where content brokers are better off going after low hanging fruit and the retailer best to respond to consumer demands and shifting technology.

Table 1: Independent Content Brokers

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<tr>
<th>Broker</th>
<th>Artists/Labels</th>
<th>Customers</th>
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<td>Independent</td>
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<tr>
<td>CDBaby</td>
<td>95,024 artists</td>
<td>None</td>
</tr>
<tr>
<td>The Orchard</td>
<td>Over 14,000</td>
<td>eMusic, iTunes, MSN, Real/Rhapsody, Sony Connect, Napster, Wal-Mart (Liquid Audio), Music-Net/AOL, Yahoo Music Unlimited, Virgin Digital, FYE, Musicmatch, Starbucks, BuyMusic, AT+T Wireless, Audio Lunchbox, Download Punk, Next Radio, Cdigix, Pure Tracks, MyMPO, Bollyvista, MusicNow, Ruckus</td>
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<tr>
<td></td>
<td>artists</td>
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In some cases, iTunes, Napster or Yahoo will be expected to pay substantial advances in addition to a higher royalty to obtain the catalog of a major label with highly popular

11 www.iodalliance.com/partners.php
12 www.CDBaby.com
13 www.theorchard.com
content. On the other hand, independent artists may permit the licensing of their music for no charge in order to gain valuable exposure. In order for music services to be popular across many genres they have to pay substantial up-front costs. This makes a multi-genre, pop focus the most cost intensive of online music retail strategies.

In addition to securing as much music as possible, online music services must be keen to retain flexibility in the terms of their respective agreements with artists and labels. Given the rapid changes taking place with devices, formats and consumer preferences, smart music services should seek the broadest possible rights to enable it to deliver music in a variety of ways. However, the provider may wish to restrict the terms of use for its own benefit. For example, a label may not want its content offered as permanent downloads because that form of delivery may negatively affect sales in other formats, such as CDs.

**Genre specificity**

One way to minimize exposure to high up-front fees and inflexible licensing terms is to reduce the amount of popular content that a music service needs to make available in order to get consumers through the door and buying the obscure content that actually generates profit. One way to narrow the scope is to focus on a category of music such as a genre or group of related genres. By focusing on a single genre or sub-genre, niche online music services can reach significant catalog depth faster than multi-genre sites by virtue of sheer focus. A genre focus allows the niche music retailer to avoid high up-

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front licensing fees while creating and fine-tuning sales tools geared specifically for the music consumer they are targeting.

A study done by McKinsey found that niche focused retail sites in Asia, Europe and North America, score the highest in customer conversion, transactions per customer and revenue per transaction.\(^\text{15}\)

| Web Site Metrics for Profitable E-Tailers Worldwide, Q1 2001 (monthly average) |
|-------------------------------|-----------------|-----------------|----------------------|-------------------|
| Unique visitors | Per visitor marketing costs | Customer conversion | Per customer maintenance costs | Number of transactions per customer | Revenue per transaction |
| Niche           | 17,200           | $4.80            | 13.2%                | $27.30            | 1.4                | $118.2               |
| Middle          | 218,600          | $1.30            | 5.2%                 | $18.20            | 1.1                | $75.0                |
| Dominant        | 758,900          | $0.20            | 8.4%                 | $25.00            | 1.2                | $79.2                |

Note: n=23

When combined with the Long Tail phenomenon, this would mean genre-niche music sites, endowed with higher sell-through (Tail sales), could be more generous with add dollars and convert more prospects, all the while experiencing higher average purchases.

**Music as culture**

"Nothing separates the generations more than music." – Bill Cosby

It is no secret that music both reflects and inspires culture. From The Beatles, to Michael Jackson, to Eminem, music reaches beyond religion, race, time and national borders to

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\(^{15}\) McKinsey Consulting Group, “Profitable Niche Sites Splurge on Marketing”, eMarketer, August 2002
define a unique sense of identity for the people who count themselves as fans. This sense of identity could have far reaching implications: influencing its listeners’ choice of wardrobe, friends, electronics, and other consumer goods. Mike Conte, general manager of MSN Marketplaces, seems to share this view:

… "We think [music] is important because it's part of a consumer's lifestyle," Conte said. "It's a part of what they do on their PCs, it's a part of what they do with their friends."16

In many ways, the web expands the reach of music by making it easy for people to keep up with the latest developments in any particular genre that they identify with most.

By creating a single destination point for the music within a given genre, niche music services will effectively offer the consumer richness in terms of depth. This has the potential to establish media brands much like Blue Note is to Jazz or Motown is to Soul. By establishing a brand that represents a given category of music, online music services can also diversify their offerings, ultimately benefiting from:

- Related sales in apparel, video, and live performances.
- High-margin, exclusive content
- Highly - targeted advertising

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16 Shannon, Victoria, “Online music catches on, but profit is hard to find”, *International Herald Tribune*, January 24, 2005
Niche music services should aim to add product, content and functionality such that the user base will rely on the application as its key outlet for staying one step ahead in their chosen music community. As Chris Anderson, of Wired Magazine puts it “if you can match content to interested audiences, you can take advantage of the long tail”\textsuperscript{17}. My thesis is that genre focus combined with community is the ultimate context for maximizing audience demand for music online, albeit one genre at a time.

**Community**

The opportunity for niche retail sites, and indirectly sold consumer brands is in creating and aggregating consumer demand by using community as an incentive. As shown in the figure below, community provides a comprehensive context for media aggregation with advantages that are farther reaching—in terms of diversified revenue streams—than generic media categories. This diversity will be critical going forward as online media services look for ways to grow while defending against direct competition and responding to rapid technological change. In this way, community acts as an efficient and stable enabler of commerce by facilitating media aggregation which is unique to a specific consumer base.

\textsuperscript{17} Anderson, Chris, “The Long Tail”, *Wired Magazine*, Issue 12.10, October 2004
By controlling the community space as an outgrowth of the media, the affinity hub becomes a tastemaker, which has profound implications for advertisers and in-house content production. The end-game then, is completely vertical channels which can produce, promote, and distribute content with extremely high efficiency. Some music community sites are already demonstrating their power to grow and sustain an audience.

Thanks to its addictive appeal, MySpace has become one of the hottest properties on the Web. Only 20 months old, it already has 14 million unique visitors a month, according to market researcher comScore Media Metrix. That makes it far and away the most popular of what are known as social-networking Web sites. Friendster Inc., started three years ago and at one time the clear leader, has a mere 1 million unique monthly visitors. "We're crushing it," says MySpace Chief Executive Chris DeWolfe.

The draw? It started with music… That pulled in fans and their friends, who all found that MySpace offered loads of options that other sites lacked. Now,
MySpace has become something akin to the hottest bar in town, teeming with musicians and models.\textsuperscript{18}

Sites like MySpace are the template of a whole new breed of social-commerce sites that give artists and musicians direct access to an enormous consumer base and offer music consumers far more in terms of music content, recommendations and interaction.

The genre-affinity model provides relevant context and community which allows for the organic expansion of content to dimensions related to, but outside the scope of simply music. In other words, music provides a gateway into people’s identity. The net effect is that users stick around longer, attract more users and end up buying more music.

In comparison to a traditional record label, the affinity hub will have the benefit of a loyal audience, valuable behavioral data, low promotion costs and technology. For a record label to promote a single artist they have to incur significant costs in terms of promotion (e.g. printing, radio, TV, artwork, etc.). The affinity hub could simply tap into an installed base of users. For example, by utilizing a web tracking system to monitor the success of an aspiring artist in the community, the affinity hub could make real time decisions on when to raise the artist(s) to commercial status (i.e. retail catalog).

\textsuperscript{18} Rosenbush, Steve, “Hey, Come To This Site Often?: MySpace's networking portal has a cool factor MSN and Yahoo! can't match – yet”, \textit{BusinessWeek Online}, June 2005
The value proposition for the consumer of a genre focused, affinity music service versus multi-genre online music retailers is as follows:

1. Depth of relevant music
2. A community of like-minded fans
3. Editorial and commentary
4. A personalized interface
5. Genre-specific filtering (e.g. search & recommendations)

Filtering is the final key to selling deeper catalog material. The more accurate the recommendations and search, the more likely it is that consumers will trust the services’ guidance and make incidental purchases.

**Genre-specific filtering**

Current online music retailers, who offer music across multiple genres, rely heavily on purchasing patterns to generate internal recommendations. While these recommendations can be useful and are obviously efficient, they are based on very broad dimensions of artist classification and rarely go beyond simple algorithms.

The affinity hub has an economy of scope, able to incorporate far more specific recommendation taxonomies (i.e. meta-tags) derived from a thorough understanding of a
given genre’s unique nomenclature. This will give the user greater quality and quantity of artist recommendations across multiple yet highly relevant parameters.

The relevance of recommendations is absolutely critical to success in a Long Tail media world, as recommendations are the primary driver of incidental- and impulse-purchasing. For example, Netflix gets 60% of its rentals from recommendations\textsuperscript{19}. A side-by-side comparison helps to illustrate the benefits of a genre-specific music search engine versus a multi-genre approach. If, for example, an iTunes consumer searches for songs by hip-hop artist “50-Cent”, iTunes will provide the following artist recommendations:

- G-Unit
- Big Tymers
- Young Buck
- The Game
- Lloyd Banks\textsuperscript{20}

These recommendations may be based on the following taxonomy:

Top-Sellers > Hip-Hop > Gangsta Rap

\textsuperscript{19} Anderson, Chris, “The Long Tail”, \textit{Wired Magazine}, Issue 12.10, October 2004
\textsuperscript{20} Actual output from iTunes search feature, June 2005
It can be seen that these meta-tags (i.e. dimensions of artist classification) are extremely broad. They may lead to several useful recommendations, but the service fails to suggest purchases based on other less-obvious but equally meaningful dimensions such as producer, record label, vocal style or year of release. This is an important point because the way one artist relates to another within genres varies from genre to genre. For example, in Hip Hop music the producer is a major determinant of popularity, whereas in Jazz, instrumentation is everything. The artists listed above, in fact, are already widely known to be affiliated with 50-Cent, so these recommendations are relatively low value added. A genre focus means that relevant recommendations can be based on many more genre-specific dimensions versus simple purchase patterns and broad, general artist categorizations.

Utilizing the same 50-Cent example, a genre-specific taxonomy might be demonstrated by the following:

Hip-Hop > Gangsta Rap > East Coast > Queens, NY > Interscope Records > Produced by Dr. Dre > Guest appearances by Eminem > G-Unit affiliation

Given the above parameters the genre-specific search output might look like the following:
As demonstrated, a highly detailed level of genre-specific meta-tags would support a search and recommendation engine which offered higher-volume, multi-dimensional recommendation output.

**Conclusion**

Until now, music consumption has been artificially constrained by the limitations of physical distribution. Music’s evolution from Vinyl to CDs was along the dimensions of quality and cost however, nothing fundamental changed in terms of the consumer’s access to music. That is, shelf space still put a limit on what titles were available at any given point in time.

Conversely, Digital media represents an entirely new paradigm for consumption, one in which access is virtually infinite. In order to accommodate digital consumption norms
online music retailers must come to appreciate the economics of the Long Tail, which is the reverse of hit-driven economics. In a hit-driven music market, popular content makes up the bulk of a retailer’s inventory because, given some cost-to-carry, a profit-maximizing music retailer will rationally choose titles that it knows will generate reliable sales. In the Long Tail, retailers should look to minimize popular content because it is now a commodity with virtually zero margins.

The obscure music is the luxury good of the Long Tail. By focusing on narrower categories of music, online music retailers will be better positioned to offer deep catalogs of high-margin obscure content. The idea is to offer just enough of the popular fare to get people through the door. Genres satisfy the “just enough” criteria by being large enough to gather significant numbers of consumers yet small enough to dramatically reduce content overhead and create highly effective filtering. Furthermore, the identity connection music consumers have with some genres like urban, rock & roll and country open the door to community, ancillary product sales and advertising revenue.
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