

Selling Music Online

Version

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*As the number of
Napster users
stubbornly grows,
technological and legal
issues have begun to
head toward a
resolution.*

*But what about
marketing, which
matters most of all?*

When Napster made the headlines a year ago, it turned online music distribution into one of the most hotly debated issues in the news. In the months since the publication of our widely cited white paper 'Selling Music Online' in October 2000, the five major record labels - and the resulting media attention - have focused primarily on the legal issues surrounding Napster and MP3.com rather than on the opportunity to develop a workable online music distribution venture.

Then April arrived.

In less than a week, RealNetworks, Microsoft (through MSN Music), the interactive unit of MTV, and the Internet portal Yahoo! all announced online music plans or ventures, partly in partnership with some or all of the major labels. Can it really be true that after months of vehement resistance, the five major record companies have suddenly decided to embrace digital distribution? If so, significant changes in the current structure of partnerships and alliances will gradually take us toward a situation that mirrors the traditional music market, in which a handful of strong players stand in head-to-head competition.

But the market for online music distribution nonetheless remains in its infancy. The player who develops the keenest business model will have the best chances of taking this baby out of intensive care, providing it a nice home, and giving it the future it deserves.

Differentiation is the basis for competitive advantages

All potential players in this market currently have one thing in common: vagueness. Launch dates, products, and revenue models remain very sketchy and unclear. This was the essence of a comment in early April

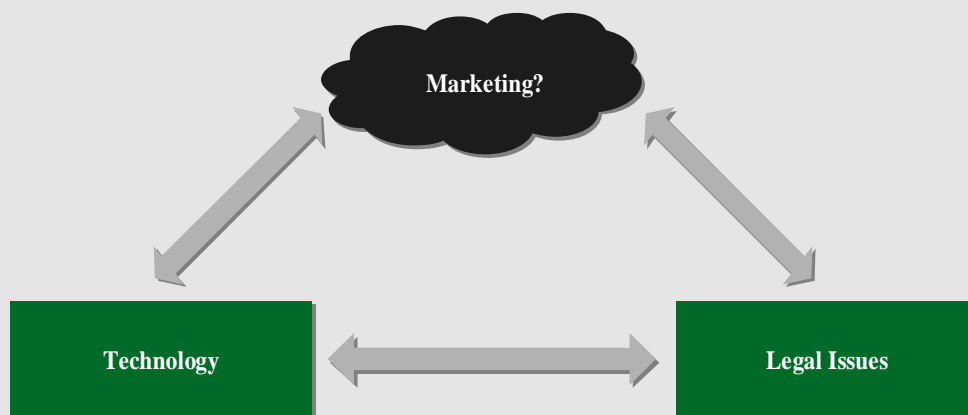
Technology, legal issues, and marketing are the three dimensions which will determine the business models for online music.

But only marketing leaves room for differentiation.

from MSN Music's Jeremy Hinman, who told CNN that anyone who knows how to develop a profitable business model in this area should give him a ring.

Three dimensions will determine the ultimate business models of these ventures: technology, legal issues and marketing. The former two have held the spotlight over the last few months, as the Napsterites latest crusade on Capitol Hill showed. But marketing is the only area in which the players have a real opportunity for sig-

The realization of a successful business model depends on all three factors. Marketing is currently the weakest link.



nificant differentiation and for the creation of competitive advantages.

- **Technology will be standardized:** Differentiation is nearly impossible, as all important technical solutions are currently available to all players. MusicNet - the platform created by RealNetworks, BMG, EMI and Warner Music - can be licensed by any online outlet. The only significant format available for music files is .MP3. The (albeit slow) evolution of broadband will improve the possibilities of all players equally.

The two fundamental questions are:

1) How do I bring value to the market?

2) How do I extract that value back through intelligent pricing?

- **Legal issues will converge to universal licensing:** Only a few ventures, namely MP3.com and MTV, have reached agreements with all five major labels. Duet, Sony's and Universal's service, accounts for only about 37% of the world music market, MusicNet for about 39%. But let's be serious. No venture will be successful if it does not offer consumers access to the full range of music – and the labels and listeners know that. Thomas Middelhoff, CEO of BMG's parent Bertelsmann, recently said that he could well imagine that Duet and MusicNet will license their music catalogs to one another. Key players in this market will need to offer very similar music catalogs to their customers, who often do not know or care about which labels publish their favorite artists.
- **Marketing is still virgin territory:** Ironically, marketing is the only point where differentiation can succeed. With technology and legal issues progressing on a favorable path, at least for now, the record companies - and any other contenders for a piece of this market - must now invest the same level of energy and intensity into segmenting the market, developing the right products, and constructing the right revenue models. Two fundamental questions need to be answered: How do I bring value to the market? And how do I extract that value back through intelligent pricing?

Delivering value to the market

The question "where's the value?" is closely linked to the question "what's the product?". This emerged as a common theme at the recent *ddmiglobal 2001* conference in London. Is the product really music? Is Tina Turner the real "product", or is it her studio recordings? What about the lyrics, the cover art, the song version, the file size, the sound quality etc.? Answering these questions means understanding that any product is really a bundle of features, with in this case the music as one central element. The broad market of music listeners must be segmented in order to ensure that the right product bundles - those which

Smaller segments can be better cultivated and more economically served than currently possible, because the potential for customization permits a finer segmentation.

maximize the perceived value for each segment - are created and offered.

The customers: target segments must be re-defined

Before you can create a sound offer, you need to understand the target segments and customize the benefits of Internet music. The opportunities online rest not only in your ability to serve a large number of customers at low cost, but also in greater access to smaller segments, which can be better cultivated and more economically served than currently possible. The potential for customization opens up possibilities for a finer segmentation based on customers' needs.

A hardcore Lenny Kravitz fan will take advantage of the opportunity to download not only the latest Lenny Kravitz song, but also seek to download all upcoming new versions (unplugged, live) of the same song. Previously unreleased content or newly released versions of songs from the artist's earliest days - which may have too small an audience to warrant pressing a CD in commercial quantities - can be made available to all comers at minimal marginal cost. If you know that artists such as John Mellencamp record up to 25 new songs for an album, but only 10 make it in the end, you can imagine the largely untapped monetary opportunities these unreleased songs have within the Mellencamp fan community.

This desire among fans is nothing new, but it has remained largely outside the record companies' domains. Loyal fan communities of artists as diverse as Bruce Springsteen and the Grateful Dead have been swapping bootleg concert tapes on the black market for nearly three decades, and fans of house music artists for nearly two decades. But these fans would now have the opportunity to gain access to more and better quality versions - all of it legal!

The same applies to niche markets such as blues. While most blues artists remain outside the mainstream, they all have hardcore followings who feel poorly served

Services will make the real difference, bundled with a high quality core product: music.

by mainstream record stores and would be willing to take their money online. Casual fans, in contrast, would appreciate a helping hand that guides them to certain songs and to other bands of the same genre. This segment may also include those who want to find an out-of-print nugget but lack the time to search used record stores, cut-out bins, or flea markets.

The net benefit in all of these cases is nearly identical - someone gets a desired song - but the differences in perceived value are enormous. This leads to nearly endless opportunities for marketeers to design relevant and exciting products.

The product: Services make the real difference

First things first: the online product has to provide high quality downloads to distinguish itself from many of today's peer-to-peer exchanges. Napster & Co. may offer a wide range of files, but the sound quality and the completeness of the songs is highly unpredictable. Users only know the true quality of the desired track after they have downloaded it and tested it. This is entirely unacceptable for a premium commercial offer from a reputable record company.

Furthermore, the network must have enough capacity so that customers will be able to log in at anytime, and be robust enough so that customers can download files without disruptions or lost connections. Broadband connections will alleviate this problem to some degree, but the responsibility is primarily with the online venture.

But the real question concerns the "product" itself. Will all songs be available separately, or will some be available only on complete albums? Does this make the whole concept of the traditional pop album - which is really just a few singles and lots of filler - obsolete? In the Internet world, the only meaningful constraints are the capacity of the users' hard drives, the quality of their connections, and their ability to produce their own tapes or CD's. Finally freed from the constraints of vinyl and its successors, record companies can bundle

Online music ventures have a wide range of possibilities to create additional revenue streams through totally new products for their customers

music as they see fit in order to exploit customers' desires. Redefining these bundles attractively will be at the heart of any successful strategy for the online sale of music, because the possibilities - in terms of unit size, artists, genres, etc. - are nearly limitless.

In one sense, the vast file-sharing community has willingly taken on the production and distribution of music for the record companies, whether they like it or not. They hijacked Humpty Dumpty on his way to the record store, dragged him from the wall, and have swapped the fragments of egg shells ever since. They have unbundled and re-bundled them to fit their own needs. Allowed to thrive further, this trend will cement a major shift in power from suppliers to consumers.

Why? Without the bundles, we have the extreme situation in which every song is available as a separate unit. This creates a higher benefit for customers, for it allows them to fully customize their purchases. But it also effectively turns every song into a "single" which needs to survive on its own. What happens if just a tiny fraction of the songs account for the bulk of sales? Will this be the end of the 'fillers' which are, however, very popular with the true fan of an artist? Will the overall output of an artist be dramatically reduced? In this case, the Internet would prove a disaster for many. The record companies and artists have to weigh the outcomes here: higher costs for new releases on one hand, and higher benefits for customers on the other.

Online music ventures also have a wide range of possibilities to create additional revenue streams through totally new products for their customers:

- **Artist subscriptions:** A true Don Henley fan could subscribe to a special product which automatically sends new Don Henley songs or song versions to him via email. That way no time is spent on fruitless searches and the fan never misses anything. Of course the labels and artists would have to guarantee a regular flow of content, but especially for bands that have been around for five years or more, the files are full of material. Similar subscriptions could be offered for certain types of music (i.e. Latin

If you want to subscribe to an artist, what role does the record company play? Do they become an MSP (music service provider)?

American) or based on other value dimensions (i.e. #1 songs in Top 10 markets worldwide are automatically emailed). This also raises an intriguing question: if I want to subscribe to Don Henley, what role does the record company play? Do they become Don Henley's MSP (music service provider)? Or do they offer Mr. Henley's fans an array of value-added services which he cannot provide himself?

- **Taste matching:** Several companies have started to develop and fine-tune technology that helps to identify music tastes based on collaborative filtering, pattern analysis, music evaluation and other techniques, in order to find out what other music could match a consumer's taste. While these technologies are not yet perfect, the idea of incorporating them into an online music distribution website in order to increase the site's cross-selling potential, is very intriguing.
- **Mixing digital and physical:** Although the future will see wireless music-on-demand, current technologies such as the CD still have a role to play. Why not offer the customers a service in which they buy - or perhaps sample - individual tracks, decide how to compile them to an album, and then have the CD produced and sent by the music company? The value-added is clear, in terms of time savings, quality control and convenience.
- **Exclusivity:** A company could, for example, offer a special version of Beethoven's Ninth Symphony played at the Vienna Festival exclusively online to further differentiate between the channels. Companies could also make special bonus tracks available only to online subscribers.

The possibility for other services and product enhancements is nearly unlimited compared to CD's or old vinyl records. These range from cover art files, interviews (recorded and print), featured lyrics, previews of new songs, up-to-date notifications of tour dates, excerpts from tour magazines, the possibility to buy concert tickets and merchandise (posters, t-shirts,

No one seriously doubts that record companies will have to charge money for digital downloads in order to compensate artists and publishers. But how are users supposed to pay for their downloads?

etc.), to interactive opportunities such as artist chats and review posting.

The ability to use other media as the basis of a product offer is an unexplored but potentially profitable territory for the record companies. From a technological standpoint, we are not all that far away from having listeners be able to hear a song on the radio, call their online music sales company on their Internet-compatible mobile phones, and order the song from wherever they are. This can happen spontaneously, or be promoted by through sponsorship or cross-promotion. When third generation mobile phone systems are launched, the carriers will be scrambling for high-traffic content. Working with them to promote online music sales could help both sides build their businesses.

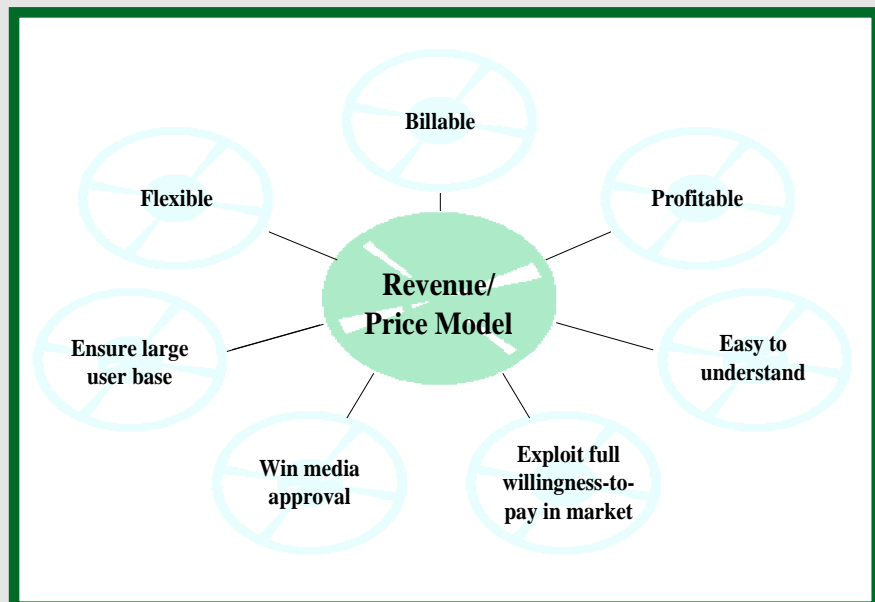
The constraints are gone. The record companies' thinking and actions must begin to reflect that.

The pricing structure: Forget obvious solutions like simple subscriptions

Pricing will play a make-or-break role. If the record industry seizes the initiative and anchors the prices for online music sales at acceptable, sustainable, and profitable levels, it will strike a knock-out blow against the renegade systems and drive them to the margins. After all, studies by the record companies themselves and by independent sources such as *Webnoize* revealed that as many as three out of four Napster-type users would be willing to pay for a download offer in exchange for the assurance that they were not violating any laws. However, the danger is that the future major online distribution players like Napster, AOL Music, Duet etc. will try to fight it out on the price dimension rather than the product and service dimension. Such a price war could ruin the profits of the entire music industry. Pricing is a dangerous lever, and the industry has little room for mistakes.

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In principle the revenue model must fulfill certain general criteria, in order to be successful, as the chart below shows.



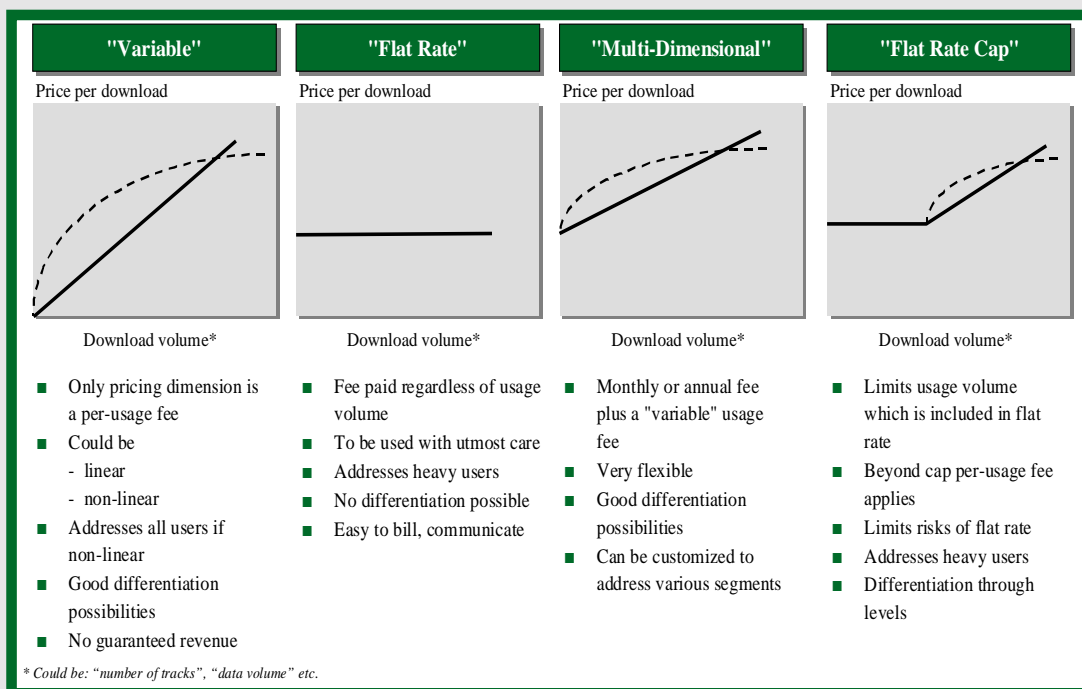
To optimize pricing means to optimize first the price structure and then the price levels. Let us focus first on the price structure, which offers many opportunities for differentiation. Several aspects need to be understood. What pricing elements matter most in the perception of the customer? Where will the customer's eye be drawn when he or she examines the offer? Would they pay more attention to one-off charges, a monthly fee, or a price per download, or some other element?

Those elements which are in the customers' focus warrant attractive prices, while those outside the customers' main focus can be held at higher, less attractive levels. The colorful mix of pricing elements in mobile telephony - which range from one-off installation charges to monthly fees to per minute charges (peak, off-peak, weekend) to billing intervals (full minutes, 10 seconds), etc. - shows how many degrees of freedom such a complex pricing challenge can present. In

What are the customers willing to pay for the new products and services? This has no easy answer and raises many additional questions of perception.

principle there are four alternative price structures, each with certain advantages and disadvantages, as the following chart shows. They can easily be combined for multiple membership tiers or service levels.

The two most discussed pricing elements for the record companies are a straightforward pay-per-download system and a flat subscription fee. A pay-per-download may hinder the companies in their ef-



forts to gain a loyal user community and collect some valid data about it. Buyers who make separate purchases leave only a limited data trail. This makes Dell Computer an apt analogy for the record companies. One of the competitive advantages in Dell's business model is its unrivalled customer database gained through years of direct selling both on- and off-line.

A flat subscription fee might be more suitable, because it guarantees the record companies a stream of customer information. But watch out: Experience with pricing for Internet access shows that flat rates tend to

Pricing approaches can include bundling, multi-step discounts, price customization, stretch discounts, or bulk bundles, among many others.

attract heavy users who make up a small percentage of all customers, but block a large part of the available capacity. In the U.S., some 4% of AT&T's flat-rate users block 50% of the network resources, according to a company source.

Neither per-download nor subscription - the two most obvious pricing structures - is ideal on its own. A more intelligent pricing structure is required. Both components - subscription fee and pay-per-download - could be combined into a multi-dimensional tariff to avoid uneconomical usage while strengthening the relationship with the customer. Other pricing alternatives include:

- **Bundling**, which fosters sales of products that might not seem too attractive when sold separately. Example: You can download Metallica's "S&M" at \$14, or you can download "S&M" *and* another, older album together for \$19.95. Or you buy the latest U2 single and receive future versions - live, unplugged, or maxi - automatically via e-mail free of charge.
- **Multi-step discounts**, which encourage higher usage. Example: you can purchase your first 10 rap singles at \$0.99 apiece, the next 10 singles at \$0.79, and so on.
- **Price customization**, which is a useful tool to approach different segments in different ways. Example: To attract new users, a tariff with a low subscription and high per-download component makes sense; while heavy users are better served by a high subscription fee and low per-download fees. Once their usage surpasses a certain point, they are better off. The fencing between the segments, however, has to be supported by the product structure.
- **Stretch discounts**, which are designed to encourage a user to buy a marginal number of additional units in order to receive a certain bonus or discount. For example, if usage patterns reveal that someone buys 3-4 albums per month on a regular basis,

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able to get?***

they could be enticed to "stretch" to 5 albums, by being offered album 6 for free.

- **Bulk bundles**, which means that the basic monthly subscription fee includes the right to receive a certain number of songs or units automatically. The user then pays only for the songs or albums purchased beyond that basic amount. This model is common in mobile telephony in Europe, where a subscriber receives a fixed block of minutes per month for a regular fee, then pays only for minutes used beyond the fixed block.

The price levels: How to find the magic numbers

No matter *how* the record companies plan to get their money from customers, the big question still remains: *how much* will they be able to get? Good question. The main battleground for determining this answer is not the board room or the gut feeling of an experienced marketing executive, but in the field with the customers themselves. The revenue and profit at stake is not trivial and to miss the optimal price levels by even just a few dimes, means that tens of millions of dollars in profit are lost forever. Consider the revenue model that Napster has recently communicated to the market:

- Basic subscription: \$2.95-\$4.95 for limited access
- Premium subscription: \$5.95-\$9.95 for unlimited access

The difference in revenue between the bottom and the upper level of the respective ranges, conservatively assuming we have 2 million users for each subscription level, is \$144 million per year! This shows that detailed and thorough analysis is a must.

We would like to emphasize a point we made previously: If the music industry fails to act or sets the price anchors too low, prices will degenerate and gut the industry's profitability and stability. Pricing is a dangerous lever, and the industry has little room for mistakes.

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One of the most important current trends working for the music industry is that there is a strong shift in nearly all online sectors away from giving content and products away for free or at heavily subsidized prices. These first attempts at business models have proven unsuccessful and the remaining players are fighting hard to change the consumers' expectations and increase their willingness-to-pay.

The willingness-to-pay is of course closely linked to the benefits generated by the product. Herein lies the challenge for an offer for downloading music. The 'legal' ventures must differentiate themselves on the value-side vs. the Gnutella's of this world which are hard to beat in the courtroom. State-of-the-art research tools like conjoint measurement can measure those benefits and transform them into the underlying willingness-to-pay. It can isolate what various parts of the bundle are worth to the listeners.

The online music ventures should also not lose sight of the total cost from the consumer side. While customers may not always consider the travel, time, and research costs when they drive to the mall and spend \$14.99 on a CD, they may be more sensitive to the additional – and transparent – costs incurred for downloading music. These include Internet access fees, hardware storage costs, on-line time, and so on, and not just the average cost per download. Napster is not free. We estimate out-of-pocket costs for Napster users at well over \$1 billion per year.

There are five key success factors in marketing for online music distribution services.

What the companies need to do now

Online ventures face huge marketing challenges. They must act quickly to optimize both the product and services they will offer, as well as the revenue model. To succeed, they need to:

1. **Segment their markets.** Not all customers can be treated the same. Identifying the most important segments is a must. Valid data will be crucial. Sophisticated research with state-of-the-art multivariate methods will provide indispensable insights that can be turned into a long lasting strategic advantage.
2. **Start with the most promising segments.** Not every customer segment has to be served from the start. In order to get on the fast track to profitability, companies need to focus on those segments that hold a large enough potential to reach the critical mass that justifies large investments.
3. **Focus on premium quality offers.** Value for money. It's as simple as that. Premium products are an absolute must for the new services, because reliable, first class quality is the one thing file-sharing pirates will never be able to deliver consistently.
4. **Develop sexy products.** The sale of music online is nearly constraint-free. It forces the music industry to think beyond its established borders and look for new products and services (bundles, additional services) as well as new partners (ISP's, mobile phone companies).
5. **Optimize the revenue models.** We are talking about a multi-billion dollar market at stake. This calls for a little more sophistication than a mere subscription fee. A huge part of the potential profits will be generated by utilizing advanced pricing tools like stretch discounts. Neglecting those tools means sacrificing those profits. Not doing the necessary research most certainly means missing the optimal prices and giving away millions in profits.

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By Stephan Butscher, André Weber and Frank Luby

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